Schulte Roth & Zabel

27TH ANNUAL

PIF

PRIVATE INVESTMENT FUNDS SEMINAR

JANUARY 16, 2018

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Regulatory Compliance 2018

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Brad L. Caswell

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 multi-billion 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*.

Brad received his J.D., *cum laude*, from Boston College Law School and his B.A., *magna cum laude*, from Georgetown University.

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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 "Handling ERISA Issues When Managing a Plan Asset Look-Through Fund" for a Financial Research Associates Hedge Fund Tax, Accounting and Administration Master Class and 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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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*, *Chambers USA*, and *The Legal 500 US* list Brian as a "leading individual" in investment funds. In addition to hosting SRZ webinars, participating in firm-sponsored seminars and workshops, and authoring *SRZ Client Alerts* and *SRZ White Papers*, he authored "Cross-Border Implementation of MiFID II Research Provisions – SEC No-Action Relief to Investment Advisers and Broker-Dealers and European Commission Guidance," published in *The Hedge Fund Journal*, among others. Brian was also quoted in the articles, "SEC Warns on Common Advertising Violations," published in *Compliance Reporter* and "SEC Waits on Sidelines as New Bitcoin Market Opens," published in *Bloomberg BNA*. His recent speaking engagements addressed topics including MiFID II, Python for compliance personnel and the legal and operational aspects of potential blockchain applications in the derivatives market. Brian also taught 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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Marc E. Elovitz

Marc is the chair of the 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 recently presented on whistleblowing, regulatory and compliance issues for private funds and SEC inspections and examinations of hedge funds and private equity funds. *Chambers USA, The Legal 500 US*, *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. 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.

A recognized thought leader, Marc is regularly interviewed by leading media outlets, including *Bloomberg*, *HFMWeek*, *HFM Compliance*, *Compliance Reporter*, *IA Watch*, *Private Funds Management* and *Law360*, among many others. He is also an accomplished author. Most recently, Marc co-authored "Complying on Pay-to-Play: Tips for CCOs," published in *Compliance Reporter*, "Second Circuit, in Split Decision, Overrules Limitation on Insider Trading Liability Established in *U.S. v. Newman*," and "Cross-Border Implementation of MiFID II Research Provisions – SEC No-Action Relief to Investment Advisers and Broker-Dealers and European Commission Guidance," which were published in *The Hedge Fund Journal* and "Sovereign Immunity Implications for Investment Advisers," published in *Compliance Corner*. He is 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).

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Ian L. Levin

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 *Chambers USA*, *The Legal 500 US* and *New York Super Lawyers*. A highly sought-after thought leader, he was recently quoted in articles published by *Bloomberg* and *The Washington Post*. He also co-authored the *SRZ Client Alert* "House Tax Reform Bill: Potential Dramatic Changes for U.S. Compensation Arrangements" and he discussed "The M&A Transactional Practice" at Practising Law Institute ERISA: The Evolving World Seminar. Ian serves as an adjunct professor at New York Law School, and as a member of the Emory Law Alumni Board and as chair of Emory Law School's Center for Transactional Law and Practice Advisory Board.

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Jacob focuses his practice on counseling commodity pool operators, commodity trading advisors, other commodity professionals and private investment fund managers on operational and 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 also counsels clients concerning issuing and investing in digital assets. 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 SRZ 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 numerous SRZ workshops, seminars and webinars on investing in digital assets and blockchain technology, CFTC registration, NFA examinations, trade compliance and hedge fund and management company structures, among other topics. He is the co-author of *SRZ Client Alerts* "Bitcoin Derivatives and Expanded CFTC Jurisdiction" and "LabCFTC Releases Primer on Virtual Currencies." In addition, Jacob was 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.

Regulatory Compliance 2018

I. Securities Regulatory Update

A. Recent Amendments to Advisers Act Rules

1. Amendments to Form ADV [1]

(a) The amended Form ADV became effective Oct. 1, 2017, but most advisers will first interact with the new Form ADV in Q1 2018.[2]

(b) Separately Managed Account ("SMA") Disclosures (Item 5 of Part 1A of Form ADV)

(i) New SMA-Related Disclosures:

(1) Types of clients and regulatory assets under management ("RAUM") by client type (Item 5.D);

(2) SMA Portfolio Breakdown (Section 5.K.(1) of Schedule D);

(3) SMA Borrowings and Derivatives (Section 5.K.(2) of Schedule D); and

(4) SMA Custodian Information (Section 5.K.(3) of Schedule D).

(ii) Definition of Separately Managed Accounts

(1) In promulgating the new Form ADV, the SEC declined to explicitly define the term "separately managed account." In practice, Form ADV now treats all advisory clients as separately managed accounts, except pooled investment vehicles, investment companies and business development companies.[3]

(2) Whether funds-of-one should be considered separately managed accounts is dependent on the facts and circumstances of the arrangements.

(iii) Item 5.D — Types of Clients and RAUM by Client Type

(1) Old

Disclosures of clients by client type and RAUM by client type in percentage bands.

(2) New

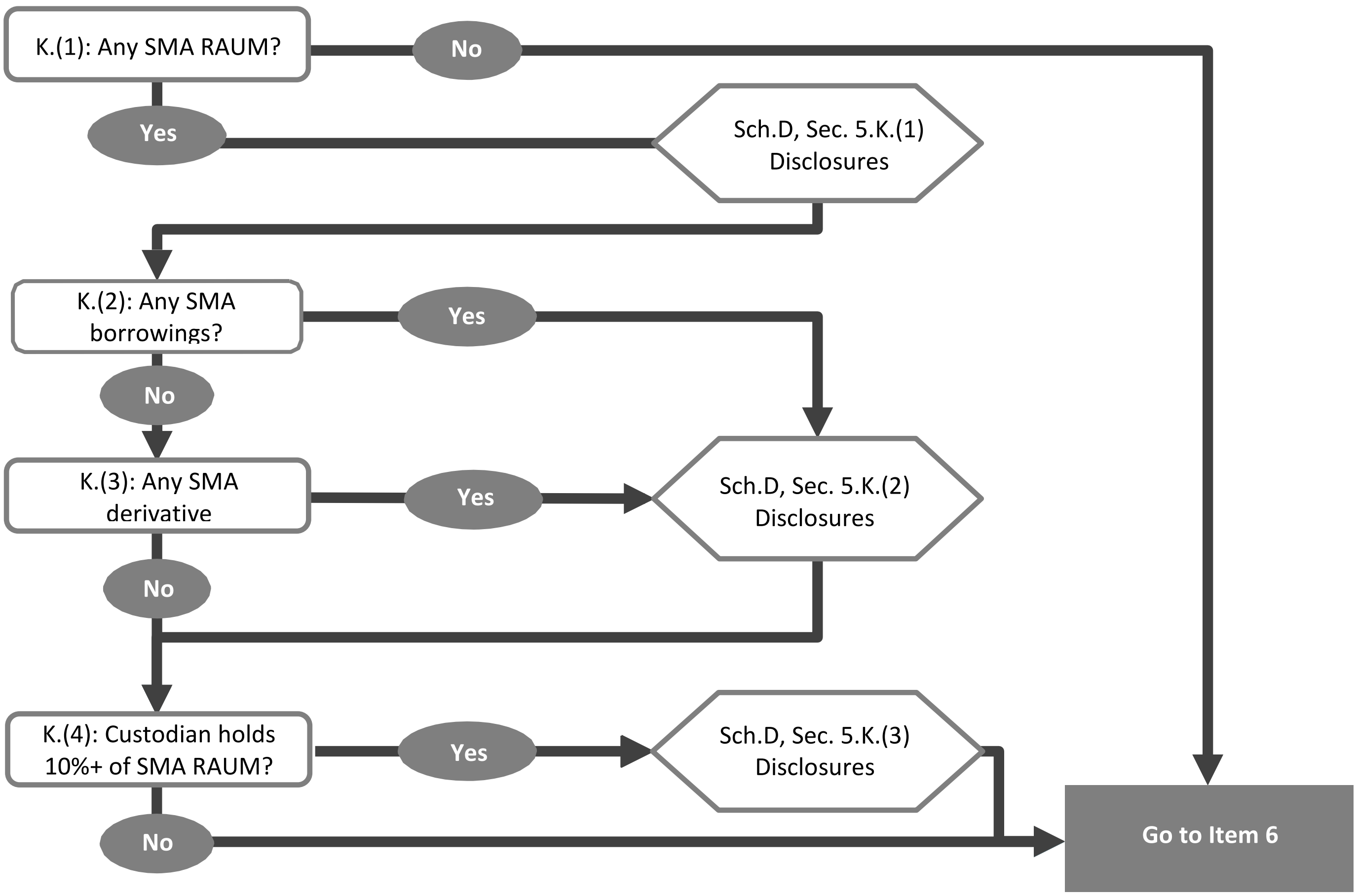
a. Number of clients by type (with a "Fewer Than Five" option).

b. Total regulatory assets under management by client type.

[1] See *Final Rule: Form ADV and Investment Advisers Act Rules*, Release No. IA-4509 (Aug. 25, 2016), [https://www.sec.gov/rules/final/2016/ia-4509.pdf].

[2] For a mark-up of the New Form ADV highlighting these changes, see [https://www.sec.gov/rules/final/2016/ia-4509-form-adv-summary-of-changes.pdf].

[3] See, Form ADV, Part 1A , Item 5.K.(1) [https://www.sec.gov/about/forms/formadv-part1a.pdf].



(iv) Item 5.K — The chart below is a guide to whether an adviser must fill out Item 5.K, and if so, which sections must be completed.

(v) Section 5.K.(1) of Schedule D — SMA Portfolio Breakdown

All RIAs with SMA RAUM (regardless of the amount) need to disclose allocation of SMA RAUM by asset class (aggregate, across all SMAs).

(1) RIAs with at least $10 billion in SMA RAUM provide mid-year and end-of-year percentages.

(2) RIAs with less than $10 billion in SMA RAUM provide end-of-year percentages only.

(vi) Section 5.K.(2) of Schedule D — SMA Borrowings and Derivatives

(1) Advisers with SMA RAUM of $500 million or less.

No Section 5.K.(2) disclosure for advisers with SMA RAUM of $500 million or less.

(2) Advisers with SMA RAUM of at least $500 million, but less than $10 billion.

Must complete Question (b) and provide data for the end-of-year.

(3) Question (b) calls for the completion of the following table reporting RAUM and "borrowings"[4] by "gross notional exposure."[5] This section allows for an optional narrative description for clarifying an RIA's response.

Gross Notional Exposure	1 Regulatory AUM	2 Borrowing
Less than 10%	*[Dollar value]*	*[Dollar value]*
10-149%	*[Dollar value]*	*[Dollar value]*
150% or more	*[Dollar value]*	*[Dollar value]*

(4) Advisers with SMA RAUM of at least $10 billion

a. Must complete Question (a) and provide data as of mid-year and end-of-year.

b. Question (a) calls for the completion of the following table and allows for an optional narrative description for clarifying an RIA's response. Note that derivatives disclosure must be reported using "gross notional value."[6]

Gross Notional Exposure	1 Regulatory AUM	2 Borrowing	3 Derivative Exposures					
			(a) Interest Rate Derivative	(b) Foreign Exchange Derivative	(c) Credit Derivative	(d) Equity Derivative	(e) Commodity Derivative	(f) Other Derivative
Less than 10%	*[Dollar value]*	*[Dollar value]*	*[Gross Notional Value]*	*[Gross Notional Value]*	*[Gross Notional Value]*	*[Gross Notional Value]*	*[Gross Notional Value]*	*[Gross Notional Value]*
10-149%	*[Dollar value]*	*[Dollar value]*	*[Gross Notional Value]*	*[Gross Notional Value]*	*[Gross Notional Value]*	*[Gross Notional Value]*	*[Gross Notional Value]*	*[Gross Notional Value]*
150% or more	*[Dollar value]*	*[Dollar value]*	*[Gross Notional Value]*	*[Gross Notional Value]*	*[Gross Notional Value]*	*[Gross Notional Value]*	*[Gross Notional Value]*	*[Gross Notional Value]*

[4] Form ADV, Glossary of Terms, 27 [https://www.sec.gov/about/forms/formadv-instructions.pdf].

- "Borrowings include secured borrowings and unsecured borrowings, collectively.
- Secured borrowings are obligations for borrowed money in respect of which the borrower has posted collateral or other credit support and should include any reverse repos (i.e., any sale of securities coupled with an agreement to repurchase the same (or similar) securities at a later date at an agreed price).
- Unsecured borrowings are obligations for borrowed money in respect of which the borrower has not posted collateral or other credit support."

[5] Form ADV, Part 1A, Schedule D, Section 5.K.(2).

- "The gross notional exposure of an account is the percentage obtained by dividing (i) the sum of (a) the dollar amount of any borrowings and (b) the gross notional value of all derivatives, by (ii) the regulatory assets under management of the account."

[6] Form ADV, Glossary of Terms, 30 [https://www.sec.gov/about/forms/formadv-instructions.pdf].

- "The gross nominal or notional value of all transactions that have been entered into but not yet settled as of the reporting date.
- For contracts with variable nominal or notional principal amounts, the basis for reporting is the nominal or notional principal amounts as of the reporting date.
- For options, use delta adjusted notional value."

(c) Umbrella Registration (Schedule R)

(i) Umbrella registration allows multiple investment advisers to register on a single Form ADV.

(ii) The amendments to Form ADV codify the SEC staff's previous guidance in no-action letters regarding umbrella registration and requires each adviser that relies on the filing adviser's registration ("relying advisers") to submit a Schedule R.[7]

Schedule R is not required for special purpose vehicles ("SPVs"), defined as entities that were formed to be general partners or managing members of funds, and which do not have their own employees.[8]

(iii) Conditions for Umbrella Registration[9]

(1) The filing adviser and each relying adviser advise only private funds and clients in SMAs that are qualified clients.

(2) The filing adviser has its principal office and place of business in the United States.

(3) Each relying adviser, its employees and the persons acting on its behalf are subject to the filing adviser's supervision and control.

(4) The advisory activities of each relying adviser are subject to the Advisers Act and the rules thereunder, and each relying adviser is subject to examination by the SEC.

(5) The filing adviser and each relying adviser operate under a single code of ethics and a single set of written policies and procedures, both of which are administered by a single chief compliance officer.

(iv) Umbrella Registration in the Non-U.S. Context

(1) Non-U.S. relying advisers

a. Non-U.S. relying advisers are subject to the Advisers Act with respect to all of their advisory activities, including with respect to non-U.S. clients.

b. The SEC's general principle that non-U.S. advisory activities of a non-U.S. RIA are outside of the scope of the Advisers Act does not apply to non-U.S. relying advisers.[10]

c. If a non-U.S. adviser wants to avoid the application of the Advisers Act to its non-U.S. advisory activities, it must separately register with the SEC.

(2) Advisers with a non-U.S. principal place of business

a. Advisers who have their principal place of business outside of the United States are unable to utilize umbrella registration.

b. Advisers who cannot utilize umbrella registration must submit separate Form ADV filings for each investment adviser required to be registered with the SEC.

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[7] See *Final Rule: Form ADV and Investment Advisers Act Rules*, Release No. IA-4509, 61-7 (Aug. 25, 2016), [https://www.sec.gov/rules/final/2016/ia-4509.pdf]; Form ADV, General Instruction 5, [https://www.sec.gov/about/forms/formadv-instructions.pdf].

[8] SEC Division of Investment Management, *Frequently Asked Questions on Form ADV and IARD* (last updated Sept. 29, 2017), [https://www.sec.gov/divisions/investment/iard/iardfaq.shtml#schedr]; ABA Subcommittee on Private Investment Entities, SEC No-Action Letter (Dec. 8, 2005), [http://www.sec.gov/divisions/investment/noaction/aba120805.htm].

[9] *Final Rule: Form ADV and Investment Advisers Act Rules*, Release No. IA-4509, 64 (Aug. 25, 2016), [https://www.sec.gov/rules/final/2016/ia-4509.pdf].

[10] See Form ADV, General Instruction 5, 5 [https://www.sec.gov/about/forms/formadv-instructions.pdf].

(v) Impact on Exempt Reporting Advisers

(1) SEC staff guidance permits exempt reporting advisers (“ERAs”) to include certain SPVs that do not have their own employees (e.g., fund general partner entities) on a single Form ADV with the ERA serving as the filing adviser.[11]

(2) ERAs are not permitted to submit a single Form ADV with respect to non-SPV advisory entities (i.e., affiliates of the ERA that have employees and provide advisory services) and must instead submit separate Form ADV filings. New Form ADV does not alter this prohibition.[12]

(d) Additional Significant Changes

(i) Additional Offices (Item 1.F)

(1) Advisers are now required to list their 25 largest offices (the prior requirement was the largest five offices) and the total number of offices where investment advisory services are provided.

(2) With respect to each office, advisers must disclose: (i) the number of employees providing investment-related services; (ii) whether certain other business activities are conducted; and (iii) whether any additional investment-related activities are conducted.

(ii) Social Media Accounts (Item 1.I)

(1) Advisers are now required to disclose whether they have publicly available social media accounts and list them on Section 1.I of Schedule D.

(2) Advisers do not need to disclose employee accounts or accounts where a third party controls the content.

(iii) Non-Employee CCOs (Item 1.J.(2))

Advisers must disclose the name and IRS Employer Identification Number of any person (other than the adviser, the adviser’s related persons or a registered investment company advised by the adviser) that compensates the adviser’s CCO for CCO services.

(iv) 120-Day Registration (Item 2.A.(9))

Advisers no longer need to be “newly formed” in order to utilize Item 2.A.(9) as a basis for registration if they expect to be eligible for SEC registration within 120 days.

(v) Non-U.S. Client Disclosure (Item 5.F.(3))

Advisers must now disclose the approximate amount of their total RAUM attributable to clients who are non-U.S. persons.

(vi) RAUM vs. “Real” AUM disclosures (Item 5.J.(2))

Advisers must disclose whether they report client assets in Item 4.E of Part 2A of Form ADV using different computational methods than the method used to compute RAUM.

(vii) Qualified Client Disclosure (Section 7.B.(1)(A)(15)(b) of Schedule D)

Advisers must answer whether private funds they advise that rely on Section 3(c)(1) limit the sale of fund interests to qualified clients.

[11] SEC Division of Investment Management, *Frequently Asked Questions on Form ADV and IARD* (last updated Sept. 29, 2017), [https://www.sec.gov/divisions/investment/iard/iardfaq.shtml#exemptreportingadviser].

[12] See, *Final Rule: Form ADV and Investment Advisers Act Rules*, Release No. IA-4509 (Aug. 25, 2016), [https://www.sec.gov/rules/final/2016/ia-4509.pdf].

2. Update to Rule 204-2 (the "Books and Records Rule")[13]

(a) Performance Calculation Records Retention

RIAs are now required to maintain support for all calculations of performance contained in communications to any person (instead of only communications distributed to 10 or more persons).

(b) Communications Relating to Performance Information

RIAs are now required to maintain all communications relating to the performance or rate of return of any or all managed accounts and securities recommendations.

B. Areas of Continued SEC Focus

1. RIA Compliance When Utilizing Third Parties:

(a) 2017 saw an increased number of SEC enforcement actions charging advisers with violations resulting from failures to effectively monitor interactions with third parties for Advisers Act compliance.

(b) *Deerfield Management Company, L.P.*, Advisers Act Release No. 4749, Admin Proc. File No. 3-18120 (Aug. 21, 2017).

(i) The SEC brought an enforcement action against Deerfield alleging a failure to establish, maintain and enforce policies and procedures reasonably designed to prevent the misuse of material nonpublic information ("MNPI"). [14] Deerfield settled the proceeding without admitting or denying the allegations.

(ii) The SEC alleged that from at least May 2012 through November 2013, a political intelligence analyst at a research firm retained by Deerfield conveyed MNPI regarding key regulatory decisions. Despite red flags, Deerfield employees traded on the information and Deerfield continued to retain the political intelligence firm.

(iii) During the relevant period, Deerfield's policies and procedures regarding research firms only required an initial review where research firms were asked to demonstrate that they "observe policies and procedures to prevent the disclosure of MNPI or any information in breach of a duty." Deerfield's compliance manual called for the demonstration to be refreshed "from time to time," but did not provide procedures for these reviews. Deerfield also relied on its own employees to self-report the receipt of MNPI and did not set forth additional testing requirements.

(iv) Lessons: RIAs may consider establishing and enforcing policies and procedures to provide oversight of employee interactions with third party research providers. These procedures should be robust and involve testing or monitoring for compliance with the firm's policies (instead of solely relying on self-reporting by employees).

(c) The *F-Squared* Series of Cases

(i) Over the last several years, the SEC has brought a series of enforcement actions against over 15 RIA firms that used a trading model, known as AlphaSector, developed by F-Squared Investments.[15]

[13] 17 C.F.R. § 275.204-2; *Final Rule: Form ADV and Investment Advisers Act Rules*, Release No. IA-4509 (Aug. 25, 2016), [https://www.sec.gov/rules/final/2016/ia-4509.pdf].

[14] Investment Advisers Act of 1940 § 204A, 15 U.S.C. § 80b-4a, [https://www.sec.gov/about/laws/iaa40.pdf].

[15] *See* e.g., *F-Squared Investments, Inc.*, Investment Company Act Release No. 31393, Advisers Act Release No. 3988, Admin. Proc. File No. 3-16325 (Dec. 22, 2014), [https://www.sec.gov/litigation/admin/2014/ia-3988.pdf]; Complaint, SEC v. Navellier & Associates, Inc. and Louis Navellier, Civil Action No. 17-CV-11633, (D. Mass. Aug. 31, 2017), [https://www.sec.gov/litigation/complaints/2017/comp23925.pdf]; SEC Press Release, *Investment Advisers Paying Penalties for Advertising False Performance Claims* (Aug. 25, 2016), [https://www.sec.gov/news/pressrelease/2016-167.html].

(ii) F-Squared developed AlphaSector, an algorithmic ETF sector rotation strategy, in September 2008. While marketing the AlphaSector algorithm, F-Squared provided performance data from 2001 to 2008. They labeled the performance data as real, actual performance of the AlphaSector rotation strategy during the time period. In fact, the advertised performance data was back-tested and hypothetical. In addition, the back-testing included a performance calculation error that resulted in the returns being materially overstated. In its settlement with the SEC, F-Squared admitted to the facts as stated by the SEC.[16]

(iii) F-Squared entered into subadvisory agreements with a number of other RIAs, who agreed to offer the AlphaSector trading strategy to their clients. Some of these advisers included F-Squared's misleading performance data in their own advertisements.

(iv) The SEC filed claims against a number of RIAs who distributed F-Squared's misleading performance data, alleging violations of Section 206(4) of the Advisers Act and Rule 206(4)-1(a)(5) thereunder. These anti-fraud rules prohibit the distribution of materially misleading advertisements.[17] A violation of Section 206(4) and the rules thereunder does not require scienter, however, instead only negligence is required to establish a violation.[18] The SEC alleged that, with sufficient due diligence, the RIAs should have known that F-Squared's advertisements were misleading, and the RIAs did not conduct sufficient due diligence.

(v) Lessons: Effective due diligence is important when utilizing third-party materials that are incorporated into the adviser's marketing materials. RIAs may consider establishing procedures to substantiate any claims made in third-party materials and to obtain the necessary documentation to verify the accuracy of performance data.

2. Material Nonpublic Information

(a) The handling and treatment of MNPI by investment advisers continues to be a focus of the SEC.

(b) Complaint, *SEC v. David Blaszczak, Christopher M. Worrall, Theodore J. Huber, Jordan B. Fogel*, Civ. Action No. 17-cv-03919, (S.D.N.Y., May 24, 2017).

(i) This case arose from the same set of facts as the *Deerfield* enforcement action (discussed above). The SEC brought insider trading claims against Worrall (an agency employee who allegedly tipped a political intelligence consultant regarding agency actions), Blaszczak (a political intelligence consultant who allegedly received the MNPI and then further distributed the information to his clients), Huber and Fogel (two Deerfield employees who allegedly traded on the MNPI received from Blaszczak).

(ii) In its complaint, the SEC returned to a broader view of the personal benefit requirement in insider trading cases in the wake of the Supreme Court's decision in *Salman v. U.S.*[19] (which rejected the more limited view announced in *U.S. v. Newman*[20]). The SEC has increased its enforcement activity relating to the use of political intelligence, as prosecutors and regulators begin to take full advantage of the authority granted to them under the STOCK Act.[21]

3. Disclosure of Conflicts, Fees and Expenses

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[16] *F-Squared Investments, Inc.*, Investment Company Act Release No. 31393, Advisers Act Release No. 3988, Admin. Proc. File No. 3-16325 (Dec. 22, 2014), [https://www.sec.gov/litigation/admin/2014/ia-3988.pdf].

[17] 17 C.F.R. § 275.206(4)-1; Investment Advisers Act of 1940 § 206(4), 15 U.S.C. § 80b-6(4), [https://www.sec.gov/about/laws/iaa40.pdf].

[18] *SEC v. Steadman*, 967 F.2d 636, 647 (D.C. Cir. 1992).

[19] *Salman v. United States*, 137 S. Ct. 420 (2016).

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

[21] Stop Trading on Congressional Knowledge Act, 126 Stat. 291 (2012).

(a) Complete and accurate disclosure continues to be an issue that is focused on by the SEC. In particular, the SEC pays close attention to disclosure surrounding conflicts, fees and expenses.

(b) *Jeffrey Slocum & Associates, Inc. and Jeffrey C. Slocum*, Advisers Act Release No. 4647, Admin. Proc. File No. 3-17833 (Feb. 8, 2017).

(i) As part of an enforcement action, the SEC alleged that, between 2011 and 2014, Jeffrey Slocum & Associates ("JSA"), an RIA and Jeffrey Slocum disseminated marketing materials that included misstatements regarding the firm's acceptance of gifts and hospitality and the firm's enforcement of its code of ethics.

(ii) The SEC alleged that JSA's policies and procedures allowed for JSA employees to accept gifts that were under $100 in value, and gifts worth over $100 could be accepted with CCO or General Counsel ("GC") approval. In 2012, two JSA employees sought and obtained preapproval for accepting tickets to the Masters Golf Tournament from an investment manager. In 2013, four JSA employees accepted tickets to the Masters without obtaining preapproval, in violation of JSA's Code of Ethics. The CCO and GC of JSA uncovered the violation before the tournament and proposed a response that included requiring the employees to reimburse the cost of the tickets, but at Slocum's direction, the employees were not formally disciplined for the violation of JSA's code of ethics.

(iii) The SEC claimed that the marketing material representations that JSA never accepted gifts from investment managers and enforced its code of ethics were misleading and fraudulent as a result of the conduct described above. JSA and Slocum settled with the SEC without admitting or denying the allegations.

(iv) Lessons. Diligently and regularly review disclosures (including marketing materials) sent to clients, investors and regulators, with a focus on disclosures related to conflicts of interest.

(c) *Platinum Equity Advisors LLC*, Advisers Act Release No. 4772, Admin. Proc. File No. 3-18194 (Sep. 21, 2017).

(i) The SEC brought an enforcement action against Platinum Equity Advisors alleging that Platinum's disclosures regarding expense allocations were misleading.

(ii) From 2004 to 2015, Platinum advised three private equity funds. Pursuant to the funds' limited partnership agreements ("LPAs"), Platinum members, employees and affiliates invested alongside the private equity funds in each consummated portfolio company through separate co-investment vehicles. The LPAs and private placement memoranda for Platinum's funds stated that the funds were responsible for expenses relating to their own operations.

(iii) During this time, Platinum incurred "broken deal expenses." While the co-investors participated in Platinum's successful transactions and benefited from Platinum's sourcing of private equity transactions, Platinum did not allocate any of the broken deal expenses to the co-investors (all such expenses were borne by the funds).

(iv) The SEC alleged that Platinum's disclosures violated Section 206(2) of the Advisers Act, which prohibits registered investment advisers from engaging in "any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."[22] In addition, the SEC charged Platinum with a violation of the Compliance Rule for failing to have policies and procedures in place to properly allocate broken deal expenses.[23] Platinum settled the action without admitting or denying the allegations.

[22] Investment Advisers Act of 1940 § 206(2), 15 U.S.C. § 80b-6(2), [https://www.sec.gov/about/laws/iaa40.pdf].

[23] 17 C.F.R. § 275.206(4)-7.

(v) Lessons. General statements, such as the fund will be responsible for its own expenses, may be inadequate if they do not accurately depict the practice of the advisory business.

4. Back-Tested Performance Advertising

(a) The SEC continues to review marketing materials distributed by RIAs. In particular, allegedly fraudulent advertisements that include back-tested performance data have been the subject of recent enforcement actions.

(b) The *F-Squared* Series of Cases

(i) The *F-Squared* series of cases (discussed above) also highlight the potential issues surrounding advertising that includes back-tested performance data.

(ii) In addition to fraud allegations relating to the misleading advertising, several advisers who republished F-Squared's performance data were also charged with violations of Section 204(a) of the Advisers Act and Rule 204-2(a)(16) thereunder.[24] These rules require investment advisers to maintain true, accurate and current records or documents "that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities recommendations in any . . . communication that the investment adviser circulates or distributes, directly or indirectly, to any person."[25]

(iii) Lessons. The SEC staff expects to be able to reproduce performance calculations from the maintained books and records. Maintaining adequate books and records relating to performance data is therefore essential and such records should be able to substantiate performance data generated by a third party or that references an employee's track record at a previous firm.

(c) *Jeffrey Slocum & Associates, Inc. and Jeffrey C. Slocum*, Advisers Act Release No. 4647, Admin. Proc. File No. 3-17833 (Feb. 8, 2017).

(i) In addition to fraud allegations relating to the disclosure surrounding the firm's gift and hospitality policies (discussed above), the SEC also alleged that JSA disseminated misleading performance advertising, failed to adopt and implement policies and procedures designed to prevent the dissemination of misleading advertising and did not maintain adequate books and records relating to the calculation of the performance data included in the advertisements.

(ii) The SEC claimed that JSA disseminated advertising materials that included a "Value Added Chart" showing returns across asset classes over the previous three, five and 10 years. The returns included in the chart were hypothetical and back-tested, but the chart was often not accompanied with disclosure regarding the methodology used to calculate the rates of return nor disclosure stating that the performance was hypothetical. The SEC alleged that the failure to include adequate disclosure amounted to a fraudulent act under Rule 206(4)-1(a)(5).[26]

(iii) The SEC further claimed that the dissemination of misleading marketing materials was caused in part by JSA's failure to adopt and implement an adequate compliance program, in violation of the Compliance Rule.[27] JSA did not have written policies and procedures regarding the review of marketing materials and instead relied on an informal process where the GC reviewed some materials before dissemination. Additionally, the SEC also charged JSA with a failure to maintain books and records related to the performance advertising. While the "Value Added Chart" was

[24] *See* e.g., *AssetMark Inc. (F/K/A Genworth Financial Wealth Management, Inc.)*, Advisers Act Release No. 4508, Admin. Proc. File No. 3-17504 (Aug. 25, 2016), [https://www.sec.gov/litigation/admin/2016/ia-4508.pdf].

[25] 17 C.F.R. § 275.204-2.

[26] 17 C.F.R. § 275.206(4)-1(a)(5) ("It shall constitute a fraudulent, deceptive, or manipulative act . . . for any investment adviser . . . to publish, circulate or distribute any advertisement . . . which contains any untrue statement of a material fact, or which is otherwise false or misleading.").

[27] 17 C.F.R. § 275.206(4)-7.

being distributed to clients and prospective clients, JSA failed to maintain accurate data relating to the calculations for past time periods and relied on data from a third-party database. JSA did not maintain the data pulled from the database.

(iv) Lessons. The *Slocum* case highlights the importance of having strong policies and procedures surrounding the use of performance data in marketing materials and the maintenance of supporting records. Review marketing materials for compliance with the applicable laws and memorialize the review process in the firm's compliance policies and procedures.

II. ERISA: Who Is a Fiduciary?

A. "Old" Five Factor Test

1. Issued by DOL in 1975

2. A person is a "fiduciary" under ERISA if, for compensation:

(a) They render advice to a plan as to the value or advisability of buying, selling, investing in securities or other property;

(b) The advice is provided on a regular basis;

(c) The advice is provided pursuant to a mutual agreement or understanding;

(d) The advice serves as the primary basis for investment decisions; and

(e) The advice is individualized to the plan.

B. "New" Fiduciary Rule

1. Background

(a) October 2010 — DOL issued a first proposed new fiduciary rule.

(b) September 2011 — DOL withdrew the 2010 proposed rule and announced that it would propose a new rule.

(c) April 2015 — DOL issues new proposed fiduciary rule.

(d) April 2016 — DOL issues final rule which was effective June 7, 2016, but with a delayed applicability date of April 10, 2017.

2. New fiduciary rule replaces Five Factor Test.

3. A person is a "fiduciary" if it provides, for a fee or other compensation, direct or indirect, a "recommendation" as to the advisability of acquiring, holding or disposing of securities

(a) "Recommendation" is defined as "any communication that based on its content, context and presentation, would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action."

(b) Certain advice not treated as a "recommendation" (but not generally relevant to private fund managers).

(i) Investment Platforms. Marketing or making available to a plan fiduciary of a plan, without regard to the individualized needs of the plan, its participants, or beneficiaries a platform from which a plan fiduciary may select or monitor investment alternatives, if the plan fiduciary is independent of the person who markets or makes available the platform or similar mechanism, and the person discloses in writing to the plan fiduciary that the person is not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity.

(ii) General Communications. General communications to a plan or IRA that a reasonable person would not view as an investment recommendation (e.g., general circulation newsletters, commentary in publicly broadcast talk shows, remarks and presentations in widely attended speeches and conferences, research or news reports prepared for general distribution, general marketing materials, general market data).

(iii) Investment Education. Investment-related information and materials, such as plan information, general financial, investment, and retirement information, asset allocation models, interactive investment materials, if the information and materials do not include recommendations with respect to specific investment products or specific plan or IRA alternatives, or recommendations with respect to investment or management of a particular security or securities or other investment property.

(c) Prohibited Transaction Exemptions. In connection with new fiduciary rule, the DOL issued two new prohibited transaction exemptions and amendments to other existing prohibited transaction exemptions.

(d) "Seller's Carve-Out"

(i) Adviser will not be considered an investment advice fiduciary by providing advice to an independent fiduciary of a plan with respect to an arm's length sale, purchase, loan, exchange or other transaction involving the investment of securities or other property.

(ii) For exception to apply:

(1) Adviser cannot receive fees or other compensation from the plan for the investment advice;

(2) Must inform the independent fiduciary of the existence and nature of the adviser's financial interest in the transaction; and

(3) Know or reasonably believe that the independent fiduciary is a bank, registered investment adviser, insurance carrier qualified in more than one state, or manager with at least $50 million in assets under management which is acting independently for the plan and is capable of evaluating the risks of the transaction.

(e) Transactions With Independent Fiduciaries With Financial Expertise — the "Institutional Investor Carve-Out"

Fiduciary status will not apply (even if advice is given) if the following conditions apply.

(i) The IRA or ERISA Investor must be advised/represented by:

(1) a U.S. bank;

(2) a U.S. insurance company;

(3) a registered investment adviser;

(4) a registered U.S. broker-dealer; or

(5) Other independent fiduciary that holds, or has under management or control, total assets of at least $50 million; this does not apply to IRAs.

(ii) The Independent Fiduciary must be independent of the investment manager of the applicable fund.

There cannot be any financial or ownership interest or other relationship between the Independent Fiduciary and the manager that limits the Independent Fiduciary's ability to carry out its fiduciary responsibility beyond the influence of the manager.

(iii) The Independent Fiduciary must be a fiduciary under ERISA or the Internal Revenue Code (or both) responsible for exercising independent judgment in evaluating the investment in the fund but the Independent Fiduciary need not have investment discretion.

(iv) The Independent Fiduciary must be capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies of the fund.

(v) The manager must fairly inform the Independent Fiduciary that:

(1) It is not undertaking to provide impartial investment advice, or giving advice in a fiduciary capacity, in connection with the fund investment; and

(2) The existence and nature of the manager's financial interests in the transaction.

(vi) The manager cannot receive a fee, directly or indirectly, for the provision of investment advice. Condition is not violated by fund paying its manager an AUM fee and/or incentive compensation.

(vii) Reasonable belief requirements may be satisfied by including standardized representations in disclosure that requires the Independent Fiduciary to affirmatively disdain or modify representations.

(viii) Negative consent to written representation can constitute a written representation for purposes of reasonable belief requirements.

(ix) For many ERISA Investors, the plan committee responsible for the plan's investments should constitute the Independent Fiduciary.

(x) $50 million under management and control may be satisfied even if plan AUM is less than $50 million.

For example, if members of plan committee for a university pension plan also have management and control of the university's endowment.

C. 2017 — The Attempt to Put the Brakes on the New Fiduciary Rule

1. Feb. 3, 2017 — Presidential Memorandum directed the DOL to reconsider Fiduciary Duty Rule.

2. March 2, 2017 — DOL published a notice of proposed rulemaking that proposed a 60-day delay of the applicability date of the Fiduciary Rule and related prohibited transaction exemptions.

3. April 7, 2017 — DOL issued final rule delaying Fiduciary Rule until June 9, 2017.

4. May 22, 2017 — DOL issues Field Assistance Bulletin No. 2017-02

   DOL announced that, until Jan. 1, 2018, it would not "pursue claims against fiduciaries who are working diligently and in good faith to comply with the fiduciary duty rule and exemptions, or treat those fiduciaries as being in violation of the fiduciary duty rule and exemptions."

5. May 22, 2017 — DOL Secretary *WSJ* Op-Ed

   The Secretary of Labor authored an *WSJ* op-ed piece which:

   (a) Expressed concern that this new fiduciary regulation did not align with President's Trump's deregulatory goals;

   (b) Concluded that the DOL could not act on its own to postpone the effective date of the regulation;

   (c) DOL continues to study the rule, but any changes will have to be effected in the ordinary course under the Administrative Procedure Act, which requires proposal, notice and a comment period before any changes can be made; and

   (d) On June 7, 2017 the DOL asked for feedback from stakeholders. In reviewing the regulation the DOL will listen to concerns that "were not heard" by the Obama administration.

6. June 9, 2017 — Fiduciary Rule and related prohibited transaction exemptions became applicable, with transition relief through Jan. 1, 2018. During the transition period, only compliance with an "Impartial Conduct Standards" needed to satisfy the exemptions' requirements.

According to the DOL:

"In general, this means that Financial Institutions and Advisers must give prudent advice that is in retirement investors' best interest, charge no more than reasonable compensation, and avoid misleading statements."

7. Nov. 29, 2017 — Prohibited transaction exemptions relating to the Fiduciary Rule (but not the Fiduciary Rule) were delayed until July 1, 2019. Transition period for the prohibited transaction exemptions was extended until July 1, 2019.

   During extended transition period, the "Impartial Conduct Standards" must be met.

D. Impact of New Fiduciary Rule

1. Does not affect plan asset status.

   (a) Has no impact on whether the assets of a private fund such as a hedge fund or a private equity fund are treated as "plan assets" of the investors that are ERISA-covered plans and IRAs.

   (b) Even if a manager were deemed an ERISA fiduciary, a non-plan asset fund will continue to be a non-plan asset fund.

2. Because "recommendation" is defined broadly, typical investor communications could trigger "fiduciary" status.

   (a) Offering Memorandum

   General view is that an offering memorandum should not be viewed as a recommendation.

   (b) Periodic Letters and Other Communications

   Depending on its content, a periodic letter may be viewed as recommending that the investor continue to hold his or her investment in the fund.

   (c) Discussions

   Discussions about the fund between an investor and investor relations or other fund personnel may be viewed as a recommendation depending on content.

E. Action Items for Private Fund Managers

1. Identify all fee-paying IRA and ERISA Plan investors.

2. Send a notice to the fee-paying IRA and ERISA Plan investors that sets forth the required manager disclosures and the manager's understanding of the availability of a carve-out from fiduciary status.[28]

3. For new subscriptions and additional investments, consider using an attachment to the subscription documents containing the manager disclosures and representations from IRA and ERISA Plan investors. Because the DOL could change the applicable requirements, it may be advisable to use an attachment at this point instead of revising the subscription documents themselves.

III. Cryptocurrencies and Digital Assets

A. Types of Digital Assets

1. Cryptocurrencies

   Cryptocurrencies are traditional digital assets that strive to be a fiat currency replacement or alternative. The most popular digital assets are cryptocurrencies, including Bitcoin and Ethereum. Other variants of cryptocurrencies include Bitcoin Cash, Ripple, Litecoin and Dash.

[28] Benefit Plan Investor Notice, June 2017, https://www.srz.com/images/content/1/5/150651/Fiduciary-Rule-Client-Notice.pdf.

2. App Tokens

App tokens are tokens intended for use on specific platforms offering specific services, for access to certain investments or to permit profit sharing. A typical example is where the token issuer is looking to create a network where certain users provide a service that can only be paid for with the network token.

B. Digital Asset Derivatives

Investors can gain indirect exposure to digital assets via derivative instruments referencing the digital asset, for instance a Bitcoin future or swap. The market for digital asset derivatives is growing, and several exchanges now offer Bitcoin derivatives.[29]

C. U.S. Regulation of Digital Assets

1. Securities and Exchange Commission

(a) The SEC will regulate the offering of, and activity relating to advising others with respect to, a digital asset if the digital asset is considered a security.

(b) The SEC has not yet taken a definitive stance on the general status of cryptocurrencies and other digital assets, but it has taken actions with respect to specific digital asset issuers.

(i) *The DAO* (July 2017)[30]

(1) The SEC released an investigative report declaring that DAO tokens were considered securities, but did not pursue an enforcement action.

(2) The DAO was a virtual organization that intended to use the proceeds from an initial coin offering ("ICO") to fund "projects," which could be investments in other digital assets. DAO token holders could monetize their investment by reselling the token, which presumably would appreciate or depreciate in value based on the performance of the projects.

(3) The SEC noted in its report that DAO tokens fulfilled the *Howey* test: [31]

a. DAO token holders invested assets to purchase the tokens;

b. DAO token holders expected to profit from the increase in value of the tokens;

c. The DAO was a common enterprise in which the token holders invested; and

d. The organizers of The DAO played a major role in selecting the projects to be funded through the DAO, and DAO token holders expected profits derived from these efforts of the DAO organizers.

(ii) *Protostarr* (September 2017)[32]

Protostarr intended to offer tokens in an ICO that would permit investors to share in the income streams of YouTubers and Twitch casters. The SEC called Protostarr's organizers, and the organizers decided to cease operations and return funds they had already raised.[33]

[29] The CBOE began trading Bitcoin futures on Dec. 10, 2017 and the CME launched Bitcoin futures on Dec. 18, 2017. CBOE Bitcoin Futures Open for Trading, CBOE (Dec. 10, 2017), [http://ir.cboe.com/press-releases/2017/12-10-2017]*;* CME Group Self-Certifies Bitcoin Futures to Launch Dec. 18, CME Group (Dec. 1, 2017), [http://www.cmegroup.com/media-room/press-releases/2017/12/01/cme_group_self-certifiesbitcoinfuturestolaunchdec18.html].

[30] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81207 (July 25, 2017), [https://www.sec.gov/litigation/investreport/34-81207.pdf].

[31] *SEC v. Howey Co.*, 328 U.S. 293, 298-9 (1946) ("An investment contract, for purposes of the Securities Act, means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.").

[32] *See* Laura Shin, *After Contact by SEC, Protostarr Token Shuts Down Post-ICO, Will Refund Investors*, *Forbes* (Sept. 1, 2017), [https://www.forbes.com/sites/laurashin/2017/09/01/after-contact-by-sec-protostarr-token-shuts-down-post-ico-will-refund-investors/#2dfb44c6192e].

[33] *Id.*

(iii) *REcoin* and *DRC World* (September 2017)[34]

REcoin and DRC World each purported to offer "tokens" or "coins" backed by investments in real estate and diamonds, respectively. The SEC alleged that, in connection with the ICO of the tokens, REcoin and DRC World engaged in fraud and the tokens being offered did not actually exist.

(iv) *PlexCorps* (December 2017)[35]

The SEC obtained an emergency asset freeze to halt an alleged ICO fraud. This case represents the first charges filed by the Cyber Unit of the SEC Division of Enforcement, which was formed in September 2017 to focus on misconduct involving distributed ledger technology and initial coin offerings.

(v) *Munchee Inc.* (December 2017)[36]

Munchee is a California business that created a smart phone application used to review restaurants. Munchee sought to raise capital by creating a token ("MUN") on the Ethereum blockchain. The MUN tokens would be integrated into the Munchee App by paying users in MUN tokens to write food reviews and selling advertisements to restaurants and in-app purchases to users in exchange for MUN tokens.

The SEC has alleged that the MUN ICO was an illegal offering of unregistered securities, and Munchee agreed to cease and desist selling MUN tokens and return all funds already raised.

(c) Special Concerns for RIAs

The Custody Rule

(i) Rule 206(4)-2 under the Advisers Act ("Custody Rule") requires, among other things, that investment advisers maintain client funds and securities with a "qualified custodian."[37]

(ii) "Qualified Custodian" means:

(1) "A bank . . . or a savings association . . . that has deposits insured by the Federal Deposit Insurance Corporation . . . ;

(2) A broker dealer . . . holding the client assets in customer accounts;

(3) A futures commission merchant . . . holding the client assets in customer accounts, but only with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon; and

(4) A foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the clients' assets in customer accounts segregated from its proprietary assets."[38]

(iii) At this point in time, digital assets generally are not maintained by a "qualified custodian," instead they are stored in a user's "digital wallet."

[34] Complaint, *SEC v. REcoin Grp. Found., LLC*, 17 Civ. ( ) (E.D.N.Y. Sept. 29, 2017), [https://www.sec.gov/litigation/complaints/2017/comp-pr2017-185.pdf].

[35] SEC Press Release, *SEC Emergency Action Halts ICO Scam* (Dec. 4, 2017), [https://www.sec.gov/news/press-release/2017-219]; Complaint, SEC v. Plexcorps, CV 17-7007 (E.D.N.Y. Dec. 1, 2017), [https://www.sec.gov/litigation/complaints/2017/comp-pr2017-219.pdf].

[36] *Munchee Inc.*, Securities Act Release No. 10445, Admin. Proc. File No. 3-18304 (December 11, 2017), [https://www.sec.gov/litigation/admin/2017/33-10445.pdf].

[37] 17 C.F.R. 275.206(4)-2.

[38] 17 C.F.R. 275.206(4)-2(d)(6).

(iv) The SEC has not provided guidance regarding how RIAs may comply with the Qualified Custodian requirement of the Custody Rule with respect to digital assets.

2. Commodity Futures Trading Commission

(a) Whether a digital asset is itself a commodity interest requires a case-by-case analysis, but digital asset derivatives are regulated by the CFTC.[39]

(b) In 2015, the CFTC stated in an enforcement order that Bitcoin is a commodity.[40] The CFTC has asserted jurisdiction over derivatives referencing digital assets and has indirect jurisdiction over the digital asset spot market for anti-manipulation purposes.

(c) The CFTC has utilized its anti-manipulation authority with respect to the Bitcoin spot market. In September 2017, the CFTC filed a complaint against an alleged Bitcoin-based Ponzi scheme (even though the defendants were not engaged in trading Bitcoin-based derivative contracts on U.S. exchanges).[41]

(d) Regulatory consequences of investing in commodity interests.

(i) Digital assets themselves may be commodity interests, and digital asset derivatives are commodity interests.

(ii) Firms that invest in commodity interests or operate a fund trading commodity interests may be required to register with the CFTC as a commodity trading advisor ("CTA") or commodity pool operator ("CPO"). Exemptions to registration exist, but as with SEC registration, CFTC registration comes with numerous requirements. Exchanges that offer commodity interests may be required to register with the CFTC as a designated contract market ("DCM") or swap execution facility ("SEF").

(iii) Where an interest is considered a swap, it can only be offered to high-net -worth investors and may be subject to other CFTC requirements such as reporting and minimum margin requirements. Market makers in swaps may be required to register with the CFTC as swap dealers.

IV. Commodity Futures and Derivatives Regulation

A. MiFID II Position Limits

1. The Markets in Financial Instruments Directive (MiFID II) went into effect across the EU on Jan. 3, 2018.

2. One (of many) topics covered by MiFID II is the imposition of commodity derivative position limits.[42]

(a) Commodity derivative position limits are defined as the highest number of derivative contracts an investor is allowed to hold on one underlying asset.

(b) Commodity derivative position limits are designed to limit an investor's ability to corner the market and manipulate the price of a commodity or instrument.

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[39] 7 U.S.C. § 2; An exception would be when the underlying digital asset is considered a security. Derivatives referencing securities are generally considered securities and are regulated by the SEC.

[40] *Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan*, CFTC Docket No, 15-29 (Sep. 17, 2015), [http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliprorder09172015.pdf].

[41] Complaint, *CFTC v. Gelfman Blueprint, Inc.*, Civil Action No. 17-cv-07181 (S.D.N.Y. Sept. 21, 2017), [http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfgelfmancomplaint09212017.pdf].

[42] *See e.g.*, Financial Conduct Authority, *Position limits for commodity derivative contracts*, FCA (Oct. 18, 2017), [https://www.fca.org.uk/markets/mifid-ii/commodity-derivatives/position-limits]; European Securities and Market Authority, *Questions and Answers on MiFID II and MiFIR commodity derivative topics*, ESMA (Nov. 14, 2017), [https://www.esma.europa.eu/sites/default/files/library/esma70-872942901-28_cdtf_qas.pdf].

3. Investment managers who are active in European derivative markets may consider analyzing the applicability of the new MiFID II position limits to their businesses.

B. Enforcement and Examinations

1. *In the Matter of Tillage Commodities, LLC*, CFTC Docket No. 17 – 27, Sept. 28, 2017.

   (a) The CFTC alleged that Tillage Commodities violated Commission Regulation 166.3, which requires CFTC registrants to "diligently supervise the handling by its . . . agents . . . of all commodity interest accounts . . . advised . . . by the registrant."[43]

   (b) The CFTC claims that Tillage, which was registered as a CPO, failed to supervise its fund administrator's operation of the pool's bank account containing client assets. The CFTC alleged that this failure to provide specific oversight delayed the detection of an ongoing fraud that resulted in the pool losing 64 percent of its capital.

   (c) Similarly to the SEC's focus on diligence of third party service providers, CFTC registrants may consider establishing policies and procedures to provide oversight and supervision of third parties to which the registrant delegates responsibilities.

2. *In the Matter of Rosenthal Collins Capital Markets LLC*, now known as DV Trading LLC, CFTC Docket No. 17-17 (June 29, 2017).

   (a) The CFTC settled charges against DV Trading LLC for engaging in illegal wash sales in order to generate rebates of exchange fees based upon increased trading volumes.

   (b) Wash sales occur when a single beneficial holder enters into matching purchase and sale transactions of the same asset, which creates the illusion of trading activity without actually incurring any additional exposure to the market. Wash sales violate Section 4c(a) of the Commodity Exchange Act ("CEA"), which explicitly outlaws wash sales and Commission Regulation 1.38(a), which requires transactions in commodity interests to be executed "openly and competitively."[44]

   (c) The CFTC alleged that DV Trading traders engaged in three different wash trading strategies to generate rebates through the Eurodollar Pack and Bundle Market Maker Program offered by the CME. Although a separate CFTC order found a responsible trader liable,[45] DV Trading was held directly liable for the actions of its employees pursuant to Section 2(a)(1)(B) of the CEA.[46]

   (d) The CFTC and the exchanges continue to be vigilant regarding illicit trading activities. CFTC registrants should have compliance policies and procedures in place to detect trading anomalies.

V. Conducting an Annual Compliance Review

A. Legal Guidance

1. Under the Compliance Rule, an RIA is required to conduct an annual compliance review. There is limited formal guidance available from the SEC on how to conduct such a review.

2. The Compliance Rule[47]

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[43] 17 C.F.R. § 166.3

[44] 7 U.S.C. § 6c(a); 17 C.F.R. § 1.38.

[45] *Brandon Elsasser*, CFTC Docket No. 17-18 (June 29, 2017), [http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfelsasserorder062917.pdf].

[46] 7 U.S.C. § 2(a)(1)(B).

[47] 17 C.F.R. § 275.206(4)-7.

Rule 206(4)-7 ("Compliance Rule") requires advisers to "[r]eview, no less frequently than annually, the adequacy of the policies and procedures established pursuant to this section and the effectiveness of their implementation."

3. Adopting Release for Rule 206(4)-7[48]

   (a) The adopting release for the Compliance Rule provides that an annual compliance review should consider:

      (i) Any compliance matters that arose during the year;

      (ii) Any changes in the business activities of the adviser or its affiliates; and

      (iii) Any changes in the Advisers Act or applicable regulations that might suggest a need to revise the policies or procedures.

   (b) Advisers should also consider the need for interim reviews in response to significant compliance events, changes in business arrangements and regulatory developments.

B. Planning and Conducting an Annual Compliance Review

1. Importance of the Annual Compliance Review

   (a) The annual compliance review provides valuable preparation for an SEC examination.

      (i) The SEC examination staff expects investment advisers to conduct a rigorous annual compliance review.[49] A rigorous and intense annual compliance review generally reflects positively on an adviser's culture of compliance.

      (ii) A rigorous annual compliance review can detect issues before an SEC examination. Learning about a compliance issue for the first time in the midst of an SEC examination can lead to a difficult and costly situation to navigate.

   (b) The annual compliance review also provides an opportunity for an investment adviser to protect the firm by improving its compliance practices.

2. Planning an Annual Compliance Review

   Timing of the Annual Compliance Review

   (a) Many firms default to conducting the annual compliance review at the end of the year. But competition for internal resources can pose significant challenges for end-of-year annual compliance reviews. The firm's internal finance teams may be focused on conducting the annual audit and other year-end pressures could impose limitations on the CCO's ability to conduct an effective annual compliance review.

   (b) Firms may consider conducting the annual compliance review during the middle of the year. Frequently, a mid-year review will provide more available internal resources. Senior management and compliance personnel will have more time to take a step back and look at the big picture during the review.

3. Conducting an Annual Compliance Review

   (a) Assessing Areas of Risk

[48] *Final Rule: Compliance Programs of Investment Companies and Investment Advisers*, IA-2204 (Dec. 17, 2003) [https://www.sec.gov/rules/final/ia-2204.htm].

[49] *See* SEC Office of Compliance Inspections and Examinations, *Risk Alert: Examinations of Advisers and Funds that Outsource Their Chief Compliance Officers* (Nov. 9, 2015), [https://www.sec.gov/ocie/announcement/ocie-2015-risk-alert-cco-outsourcing.pdf].

(i) The compliance team should discuss both within the compliance department and with senior management the major risks facing the firm. Risks will often differ significantly based on the firm's structure, investment strategy and types of clients.[50]

(ii) While assessing the risks to the firm, consider the audience of the annual compliance review.

(1) One audience for the annual compliance review is the SEC staff. In an examination, the SEC staff is likely to notice key risk areas that have gone unaddressed in the annual compliance review.

(2) The annual compliance review also benefits senior management of the firm, and is an opportunity for the compliance team to describe the firm's compliance program to the rest of the firm.

(b) Addressing Risk Areas

(i) Review the firm's compliance procedures and test them to ensure that they are functioning properly.

(ii) Reassessing prior positions on issues can be very helpful. Positions that may have been appropriate in the past may no longer be the best fit for the firm going forward.

(iii) Address the compliance practices in place with respect to third parties, such as investment research consultants, third-party marketers and third-party valuation agents.

(c) Reporting the Annual Compliance Review

(i) Although the Compliance Rule contains no specific requirements regarding documentation of the annual compliance review, RIAs are required to maintain "[a]ny records documenting the investment adviser's annual review of those policies and procedures conducted pursuant to [the Compliance Rule]."[51]

(ii) The SEC examination staff expects RIAs to create an annual compliance review report, and that report is one of the first documents the SEC will request during an examination.[52]

(iii) The report should not be a form document. It should contain substantive analysis of the firm, it's policies and procedures, it's business strategy and an assessment of the effectiveness of the firm's compliance program.[53]

(d) After concluding the annual compliance review, the compliance team should address issues uncovered in the review[54] and appropriately document the resolution of any issues. The annual compliance review also provides a blueprint for other obligations, such as updating the Form ADV, conducting training and updating the compliance manual.

VI. Building an Effective Compliance Program

A. Chief Compliance Officer Effectiveness

1. Recent "SEC" examinations have resulted in deficiency letters stating that the investment adviser had an "ineffective" "CCO".

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[50] *Id.*

[51] 17 C.F.R. § 275.204-2(a)(17)(ii).

[52] *See* SEC Office of Compliance Inspections and Examinations, *Risk Alert: Examinations of Advisers and Funds that Outsource Their Chief Compliance Officers* (Nov. 9, 2015), [https://www.sec.gov/ocie/announcement/ocie-2015-risk-alert-cco-outsourcing.pdf].

[53] *See* SEC Office of Compliance Inspections and Examinations, *Risk Alert: The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers* (Feb. 7, 2017), [https://www.sec.gov/ocie/Article/risk-alert-5-most-frequent-ia-compliance-topics.pdf].

[54] *Id.*

2. The Compliance Rule

   (a) Rule 206(4)-7 (“Compliance Rule”) under the Investment Advisers Act of 1940 (“Advisers Act”) requires registered investment advisers (“RIAs”) to “[d]esignate an individual (who is a supervised person) responsible for administering [the firm’s] policies and procedures.”[55]

   (b) The adopting release for the Compliance Rule states that “[a]n adviser’s chief compliance officer should be competent and knowledgeable regarding the Advisers Act and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm.”[56]

3. SEC examiners expect an investment adviser’s CCO to be knowledgeable about not only the Advisers Act, but also other federal securities laws as they apply to the adviser’s business (e.g., Rule 105 of Regulation M and Form 13F filing obligations). National Futures Association (“NFA”) examiners expect CCOs to be knowledgeable about the relevant “CFTC,” NFA and exchange regulations, as well as about the impact of these laws and regulations on the adviser’s business. In addition, CCOs are expected to:

   (a) Understand the firm’s business operations in order to effectively monitor for compliance-related issues;

   (b) Thoroughly understand the firm’s policies and procedures;

   (c) Stay up-to-date with the latest regulatory changes and enforcement actions; and

   (d) Proactively address potential issues as they are identified.

B. Training

1. Although there is not a specific provision requiring training, the SEC views compliance training as “critical to obtaining good compliance and avoiding inadvertent violations” and as “among best practices for advisers.”[57]

2. Training should be an ongoing process and it should be tailored to the adviser’s business.[58]

   (a) Certain topics may warrant separate trainings. For example:

      (i) Use of electronic communications platforms;[59] and

      (ii) Cybersecurity.[60]

   (b) Advisers may consider tailoring training to their investment strategy. For example:

      (i) Quantitative trading firms could provide training to all employees (and not just the financial and technology teams) to ensure sufficient understanding of the firm’s trading process. This may require the firm’s CCO to delegate the teaching aspect of the training to the firm’s IT team and participate in the training as a student; and

[55] 17 C.F.R. § 275.206(4)-7.

[56] *Final Rule: Compliance Programs of Investment Companies and Investment Advisers*, IA-2204 (Dec. 17, 2003), [https://www.sec.gov/rules/final/ia-2204.htm].

[57] *Final Rule: Investment Adviser Codes of Ethics*, IA-2256 (July 2, 2004), [https://www.sec.gov/rules/final/ia-2256.htm].

[58] *See generally* SEC Office of Compliance Inspections and Examinations, *Risk Alert: The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers*, 2 (Feb. 7, 2017), [https://www.sec.gov/ocie/Article/risk-alert-5-most-frequent-ia-compliance-topics.pdf] (identifying failures to tailor compliance programs to advisers’ business practices as a common weakness in compliance with the Compliance Rule).

[59] *See*, SEC Office of Compliance Inspections and Examinations, *Risk Alert: Investment Adviser Use of Social Media ,* 4 (Jan. 4, 2012), [https://www.sec.gov/about/offices/ocie/riskalert-socialmedia.pdf].

[60] *See*, SEC Office of Compliance Inspections and Examinations, *Risk Alert: OCIE’s 2015 Cybersecurity Examination Initiative* (Sept. 15, 2015), [https://www.sec.gov/ocie/announcement/ocie-2015-cybersecurity-examination-initiative.pdf].

(ii) Activist managers may seek to ensure that their employees understand the Section 13 filing obligations and the definition of "group" under Rule 13d-5.[61]

(c) Advisers also frequently provide specific training to individual business units. For example:

(i) Separately training employees engaged in marketing on the relevant marketing regulations[62]; and

(ii) Separately training traders on the regulations surrounding trading.[63]

C. Testing

1. Testing the firm's policies and procedures is an important component of effective implementation of a firm's compliance program.[64] Recent examinations have focused on testing.

2. Examples of testing relating to issues that have recently arisen on SEC examinations:

(a) Testing fee calculations to confirm they are accurate and conform with the agreed-upon fee rate;

(b) Testing expense allocations to confirm they are accurate and conform with disclosures sent to investors;

(c) Conducting email reviews to detect potential issues regarding "MNPI" and other confidential information;

(d) Monitoring app usage on employee's devices to ensure employees are not communicating through improper channels; and

(e) Monitoring the firm's trading activity to ensure traders are not engaging in wash trades, cross trades or other unlawful trading activity.

[61] 17 C.F.R. § 240.13d-5.

[62] *See generally*, SEC Office of Compliance Inspections and Examinations, *Risk Alert: The Most Frequent Advertising Rule Compliance Issues Identified in OCIE Examinations of Investment Advisers* (Sept. 14, 2017), [https://www.sec.gov/ocie/Article/risk-alert-advertising.pdf].

[63] *See generally* SEC Office of Compliance Inspections and Examinations, *Risk Alert: Rule 105 of Regulation M: Short Selling in Connection with a Public Offering,* (Sept. 17, 2013), [https://www.sec.gov/about/offices/ocie/risk-alert-091713-rule105-regm.pdf] ("In order to advance compliance with Rule 105, it is important to provide training to their employees regarding the application of the Rule").

[64] *Final Rule: Compliance Programs of Investment Companies and Investment Advisers*, IA-2204, fn. 15 (Dec. 17, 2003), [https://www.sec.gov/rules/final/ia-2204.htm] ("Where appropriate, advisers' policies and procedures should employ, among other methods of detection, compliance tests that analyze information over time in order to identify unusual patterns").

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August 7, 2017

Via Email

Office of Exemption Determinations
Employee Benefits Security Administration
Attn: D-11933 (RIN 1210-AB82)
U.S. Department of Labor
200 Constitution Avenue, NW
Washington, DC 20210

Dear Sir or Madam:

Re: Schulte Roth & Zabel LLP Comments on Request for Information Regarding the Fiduciary Rule and Prohibited Transaction Exemptions (RIN 1210-AB82)

Schulte Roth & Zabel LLP is a multidisciplinary law firm with offices in New York, Washington, D.C. and London, England. Founded in 1969, the Firm has, since its beginning, represented numerous private funds, including hedge funds, private equity funds and real estate funds; currently in the hundreds. This experience has enabled us to develop a deep understanding both with respect to how private funds operate and with respect to the needs and desires of the investors who invest in private funds. As discussed below, that understanding has made clear the adverse effect that the Fiduciary Duty Rule (the "Rule") and its related Best Interest Contract Exemption (the "BIC Exemption") has already had on the ability of sophisticated individual investors who desire to invest in private funds through their individual retirement accounts ("IRAs") and individual accounts in self-directed defined contribution plans ("Individual Accounts"), typically alongside their personal investment in such funds, to make such investments. For many such investors, access to such investments closed on June 9. For the reasons discussed below and in furtherance of both President Trump's February 3 Presidential Memorandum on the Fiduciary Duty Rule (the "President's Memorandum") and the Secretary of Labor's Op-Ed piece regarding the Rule, we believe that the Rule should be revised with respect to such sophisticated IRA and Individual Account Investors and, while such a process is occurring, the effective date of the BIC Exemption should be postponed and the non-enforcement period should be extended.

1. <u>The Rule is adversely effecting sophisticated individual investors who desire to invest in private funds through IRAs and Individual Accounts.</u> The Rule, as currently drafted, denies sophisticated individual investors the freedom of choice given them by Congress to invest in

private funds without the need to seek and pay for outside advice. Congress has specifically and repeatedly chosen to treat an IRA and its IRA holder, and an Individual Account and its Individual Account holder, as one for investment sophistication purposes (both in the definition of "accredited investor" and the definition of "qualified purchaser"). Congress thus enabled the typically smaller IRAs and Individual Accounts to make investments that are only available to sophisticated investors and accordingly enabled such sophisticated investors to take a holistic approach to investing their personal, IRA and Individual Account portfolio. Yet, in commentary issued by the Department in connection with the Rule, the Department has specifically rejected this treatment of IRAs and Individual Accounts as one and the same. Accordingly, sophisticated individual investors are now face the unappealing and unnecessary choice of giving up the ability to make investments in a manner that is most advantageous to them, while they adopt a holistic view of their investment portfolio, or paying an outside person a fee to tell them how to invest their IRA and/or Individual Account, a decision they are fully capable of making on their own. As mentioned above, forcing such sophisticated individual investors into a framework best designed for retail investors is antithetical both to the directives set forth in the President's Memorandum and Secretary Acosta's Op-Ed piece, both of which emphasize expanding investment freedom of choice where it has been unnecessarily limited.

2. The BIC Exemption provides no relief to private funds nor their IRA and Individual Account Investors

The fundamental approach of the BIC Exemption is to require the advice fiduciary to view its client and their investment portfolio on a holistic basis. While this may make sense in the retail setting, private funds are not designed in this manner and private fund investors do not look to the manager of the private fund to provide such advice. Moreover, such investors and potential investors do not even want to receive such advice from the private fund manager because that would entail giving the private fund manager access to the potential investor's entire portfolio. Private fund managers typically offer a very limited menu of investments (often just one fund) and may have expertise only in the particular investment strategy they pursue. Typically, they do not have staff to analyze the overall investment portfolio of existing and, often times the existing and potential investors do not and will not give the private fund manager access to such information. Of course, some individual investors hire do outside investment advisory consultants. That is their choice. Many other sophisticated investors make their own investment choices without advice or input from outside advisers, much less from the private fund manager, although they may have a discussion with the private fund manager solely with respect to the fund's investment strategy and philosophy. The sophisticated IRA and Individual Account Investor is looking to the private fund manager for one thing only, execution of the investment strategy laid out in the fund's private placement memorandum. Thus, as drafted, the BIC Exemption provides no relief because it requires an analysis of the IRA Investor's or Individual Account Investor's portfolio in a way that those investors are not seeking.

Further, because neither the BIC Exemption nor the so-called seller's exemption provide relief from fiduciary status in connection with the marketing of private funds, we have found that large numbers of private funds have been forced by necessity to simply close their private funds to investments from unrepresented IRAs and Individual Accounts. This is the antithesis of the directives set forth in the President's Memorandum and Secretary Acosta's statement in the Op-

Ed piece which emphasize expanding freedom of investment choice, rather than narrowing it, as has been accomplished by the Rule.

We also note that there have been instances since June 9 where private fund managers, including private fund managers that manage plan asset look-through funds, have been denied access to private funds managed by others because they saw no need to hire outside consultants to advise them how to invest their IRAs. In addition, some private funds have already begun to compulsorily redeem existing IRA and Individual Account Investors. During this non-enforcement period and in light of the President's Memorandum and Secretary Acosta's Op-Ed piece, other funds have taken a more wait and see approach in the hope that the Department will revise the Rule and/or the BIC Exemption so that they are not in contravention of the directives set forth in the President's Memorandum and Secretary Acosta's Op-Ed piece.

3. <u>The marketing of private funds does not constitute investment advice.</u> The marketing of private funds is not intended to be and is not in the nature of investment recommendations to potential investors. Rather, such marketing activities are in the nature of an explanation of how the private fund works, its investment aims and strategies, and the risk surrounding such investments. This is true both with respect to a fund's offering memorandum and subsequent investor letters. They speak to a particular product, but not the role of that product in an investor's overall investment portfolio. Yet the lack of clarity in the Rule with respect to investment education could cause these materials to render the private fund manager a fiduciary to the unrepresented IRA and Individual Account Investor, adding to the reason that many private funds are denying access to sophisticated IRA and Individual Account Investors. This, in turn, results in a situation that limits the ability of sophisticated investors to invest their combined assets in an optimal manner. This too is inconsistent with the directives set forth in the Presidential Memorandum and Secretary Acosta's emphasis in his Op-Ed piece with respect to investment freedom of choice.

4. <u>The lack of a Realistic Hire Me Exception inhibits investment of unrepresented IRAs and Individual Accounts in Private Funds.</u> In formulating ERISA's Plan Asset regulation and Section 3(42) of ERISA, both the Department and Congress viewed the investment in a private investment vehicle as tantamount to the hiring of the investment manager. Even though both regulation and the law provide an exception for a fund in which benefit plan investors hold less than under 25% of the equity interests in such vehicle, the fundamental underpinning of the Plan Asset regulation is quite clear. The Rule allegedly provides a hire me exception from fiduciary status in marketing the services of an investment manager, but the Rule has defined that exception so narrowly as to itself bring about the potential for a violation of section 404 of ERISA by the hiring plan fiduciary. Although the Rule is particularly unclear in this area, if a manager seeking to comply with the hire me exception is unable to discuss his or her investment strategy and philosophy with potential clients, then the plan fiduciary is arguably in violation of his or her fiduciary duty under ERISA to understand how the manager it selects will manage the money entrusted to the manager. Given the Department's over 30-year view that the investment in an over 25%-plan asset fund is tantamount to an investing plan hiring the pooled vehicle manager as a direct fiduciary of that plan, investing in a pooled investment vehicle should be subject to a realistically revised hire me exception. Such a revision both as to the scope of the hire me exception and its application to private funds would be consistent with the fundamental underpinnings of the Plan Asset regulation that an investment in a private pooled vehicle is akin

to hiring the pool's investment manager as a direct investment manager of each investing plan and would also be consistent with the directives in the President's Memorandum and Secretary Acosta's Op-Ed piece regarding the restoration of the freedom of investment choices unnecessarily removed by the Rule as applied to sophisticated IRA and Individual Account Investors.

5. The lack of recognition of co-investing. The Rule ignores the reality that many sophisticated investors invest both their personal assets and their IRA or Individual Account together in the same private funds. When private funds communicate with investors they rarely, if ever, differentiate those communications between different types of investors other than to explain the tax ramifications of investing taxable and tax exempt monies. Yet the Rule as written would require the unrepresented sophisticated IRA and Individual Account Investor to ignore his or her personal investments and pay an outside consultant in order to be able to invest in the very same private fund. Here too, this limitation contravenes the directives on expanding freedom of investment choice set forth in the President's memorandum and Secretary Acosta's Op-Ed piece.

Each of the points raised in this letter are capable of appropriate resolution by modifying the Rule and the BIC Exemption to provide an exemption for investment by sophisticated unrepresented IRAs and Individual Accounts to avoid this class of investors from being shut out from investing in private funds where a sophisticated investor has determined that such an investment is appropriate. We encourage the Department to follow the clear guidance from Congress in treating such sophisticated investors as different from retail investors and recognize that the protections necessary for such investors have been clearly set by Congress and the SEC, rather than subjecting them to rules that will close off private funds as an investment option, no matter how appropriate. We also encourage the Department to clarify the rules surrounding the marketing of private funds and recognize the investment education rather than investment recommendation nature of those marketing materials. In addition we encourage the Department to adopt a realistic hire me exception that will apply to the marketing of private funds, both Plan Asset and non-Plan Asset. Finally, we encourage the Department to carve out from coverage under the Rule the situation where a sophisticated investor has invested both his or her personal assets and his or her IRA or Individual Account in the same fund.

Schulte Roth & Zabel LLP would like to reiterate its thanks to the Department for the opportunity to provide comments in response to the Request for Information and we would welcome the opportunity to discuss our views in greater detail. Please do not hesitate to contact David M. Cohen at (212) 756-2141 with any questions that the Department or its staff have regarding this letter.

____
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Practices

Tax

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David concentrates his practice on tax issues related to the formation and operation of onshore and offshore investment funds and their investment managers, as well as tax issues that 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 US* 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 regularly presents on the topic of "Hedge Funds" at PLI's Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances conferences. 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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John represents private equity firms, hedge funds 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. 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, D.C. 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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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. He 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. Omoz 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. His 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 US* and he regularly speaks at industry events covering current developments impacting private investment funds. Omoz also contributed to the *Fund Formation and Incentives Report* (Private Equity International in association with SRZ) and authored the article "Investor Remedies: The Importance of Key-Person Provisions," published in *Law360*. Most recently, he was featured in the article "Ringing the Changes," published in leading private equity magazine *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.

Permanent Capital Investment Vehicles

I. Overview

A. Characteristics of Permanent Capital Vehicles

1. Longer-term or perpetual life investment vehicles.
2. Limited redemption rights, if any.
3. Includes products regulated under the Investment Company Act of 1940 ("1940 Act"), such as business development companies and registered closed-end funds, as well as non-1940 Act vehicles, such as real estate investment trusts, special purpose acquisition companies and offshore traded funds.

B. Benefits of Permanent Capital

1. Eliminates redemption risks and provides a perpetual supply of capital.
2. Eliminates limited fund life concerns.
3. Allows for managers to pursue longer-term strategies and target longer return profiles on investments.
4. Provides access to follow-on public debt and equity offerings.
5. Provides similar management fee and carried interest/incentive compensation structures to more traditional private investment funds (i.e., hedge funds and private equity funds), while providing greater consistency in management fees due to less AUM fluctuation.
6. 1940 Act products provide access to retail investors.

C. Types of Permanent Capital Vehicles

1. 1940 Act Regulated Funds

(a) Business development companies ("BDCs")

(i) Description. 1940 Act regulated fund subject to less restrictive regulation that invests primarily in U.S.-based private companies.

(ii) Pros

(1) Shares may be publicly traded.

(2) Able to charge incentive fees on realized and unrealized capital gains.

(3) Can use greater leverage than a registered closed-end fund.[1]

(iii) Cons

(1) Required to file Form 10-Ks and 10-Qs like operating companies.

(2) Must invest at least 70 percent of assets in "eligible portfolio companies" – typically U.S.-based non-public issuers.[2]

(iv) Tax treatment: Eligible to elect "regulated investment company" ("RIC") tax status for federal income tax purposes.

(1) RICs issue 1099s to investors and not K-1s.

(2) Unrelated business taxable income ("UBTI") is blocked for tax-exempt investors.

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[1] *See* Section II.C.2 *infra.*

[2] *See* Section II.A.3 *infra*.

(3) Effectively connected income ("ECI") is generally blocked for non-U.S. investors, with interest related dividends generally not subject to U.S. withholding taxes.

(v) Corporate governance. Under 1940 Act requirements, must maintain a majority independent board.

(b) Registered closed-end funds

(i) Description. Investment fund that is registered under the 1940 Act; issues shares that are not redeemable at the option of the investor.

(ii) Pros

(1) Can be publicly traded.

(2) If publicly traded, no restriction on investors that can acquire shares.

(3) Permits both domestic and offshore investments.

(iii) Cons

(1) Publicly traded CEFs cannot charge incentive fees on realized and unrealized capital gains.

(2) Ability to use leverage is greatly reduced relative to a BDC.

(iv) Tax treatment. Eligible to elect RIC status for federal income tax purposes.

(v) Corporate governance. Under 1940 Act requirements, must maintain a majority independent board.

(c) Non-traded regulated funds

(i) Description. Non-exchange listed version of a BDC or closed-end fund.

(ii) Pros

(1) Free from market price fluctuation.

(2) Offerings can be conducted publicly or as private placements.

(iii) Cons

(1) Retail versions require large distribution networks.

(2) Publicly offered versions can be subject to state "blue sky" laws.

(3) Liquidity requirements mandate periodic repurchase offers.

(iv) Tax treatment. May be RICs or partnerships for federal income tax purposes, depending on the circumstances.

(v) Corporate governance. Under 1940 Act requirements, must maintain a majority independent board.

2. Structured Holdco Acquisition Companies ("SHACs")

(a) Description. Holding company structure that acquires controlling interests in one or more operating companies.

(b) Pros

(i) Typically publicly traded.

(ii) No restriction on investors that can acquire shares.

(iii) Not subject to 1940 Act obligations.

(c) Cons

(i) Required to file Form 10-Ks and 10-Qs like operating companies.

(ii) Limited in its ability to acquire non-controlling investments.

(d) Tax treatment. By satisfying an income test, may qualify as a partnership for federal tax purposes even if publicly traded.

(i) Depending on the nature of the assets, subsidiary corporations may be needed for the SHAC to generate the income needed to meet the qualifying income test.

(ii) As a partnership, a SHAC must provide investors with annual K-1s.

(e) Corporate governance. Under exchange listing requirements, must typically maintain a majority independent board.

3. Special Purpose Acquisition Companies ("SPACs")

(a) Description. Shell company that raises capital through an initial public offering to acquire an operating company.

(b) Pros

(i) Typically publicly traded.

(ii) No restriction on investors that can acquire shares.

(iii) Large pool of capital can help minimize the need for debt financing for acquisitions.

(iv) Sponsors typically hold a significant equity position post-acquisition.

(c) Cons

(i) SPACs are fixed life span vehicles, which must return their capital if no acquisition is consummated by the applicable deadline.[3]

(ii) Required to file Form 10-Ks and 10-Qs like operating companies, even when assets consist solely of cash.

(iii) SPACs are treated as "shell companies" for SEC regulatory purposes, which further restricts the resale of their securities.

(d) Tax treatment. Taxed as "C Corporations" for federal income tax purposes.

(e) Corporate governance. Under exchange listing requirements, must typically maintain a majority independent board.

4. Offshore Traded Funds ("OTFs")

(a) Description. Offshore investment fund listed on non-U.S. exchanges, typically in London or Amsterdam, that mirrors a U.S.-regulated fund in its operations.

(b) Pros

(i) Publicly traded.

(ii) If structured properly, OTFs are not subject to 1940 Act reporting and compliance requirements, including restrictions on leverage, liquidity or investment strategy.

(iii) OTFs can raise public capital from non-U.S. investors, as well as private capital from U.S.-based qualified purchasers.

[3] *See* Section VICK *infra*.

(iv) Able to charge an incentive fee or carried interest.

(c) Cons

(i) Shares are subject to transfer restrictions with respect to ownership by U.S. persons and U.S. retail investors are unable to participate.[4]

(ii) OTFs must navigate offshore regulatory and listing requirements.

(iii) Liquidity and investor participation may fall below that of typical U.S.-listed regulated funds.

(d) Tax treatment

(i) Non-U.S. taxation driven by country of incorporation and operation.

(ii) U.S. taxation

(1) If a partnership, the entity will need to meet the qualifying income test.

(2) If a corporation, the entity will likely be a "passive foreign investment company" ("PFIC").

(e) Corporate governance. Board independence requirements driven by country of incorporation and foreign exchange requirements.

5. Real Estate Investment Trusts ("REITs")

(a) Description. Investment funds that invest primarily in physical real estate and real estate-related securities.

(b) Pros

If structured properly, REITs are not subject to 1940 Act reporting and compliance requirements.

(c) Cons

(i) REITs can only invest a small percentage of their assets in non-real estate-related securities.[5]

(ii) Required to file Form 10-Ks and 10-Qs.

(d) Tax treatment. Must meet various requirements, including type of income and assets, to be treated as a "REIT" for federal tax purposes.

(e) Corporate governance. Under exchange listing requirements, must typically maintain a majority independent board.

D. Permanent Capital Investment Strategies

1. Key focus is typically on income-producing portfolios that can generate attractive dividend yields for investors.

2. Strategies typically include:

(a) Credit strategies, particularly in the high-yield space;

(b) Cash flow-focused strategies that target control investments with attractive cash flow potential;

(c) For REITs, real estate strategies that focus on commercial or residential mortgages or rental income properties;

(d) Capital gains-focused strategies that target short-term (i.e., less than one year) realized capital gains; and

[4] *See* Section VIII.B.3 *infra*.

[5] *See* Section IX.A.2 *infra*.

(e) Other strategies that target high ROI levels with significant income component.

II. Business Development Companies

A. What Are BDCs?

1. Special type of closed-end fund that elects to be regulated, rather than registered under the 1940 Act.

   (a) Shares can be offered publicly and may be listed on an exchange.

   (b) Can also be offered in a private placement.

2. Hybrid between a public finance company and a registered investment company from a regulatory perspective.

3. In exchange for greater regulatory flexibility, a BDC must invest 70 percent of its assets in "good" BDC assets.[6]

   (a) Typically U.S.-based non-public operating companies.

   (b) Extends to listed companies with market capitalizations of less than $250 million.

   (c) Excludes "investment companies," including most private funds.

4. A BDC must have at least a 200 percent asset coverage ratio (total assets/total debt) at the time of any new borrowings (less stringent requirement than for 1940 Act registered funds).

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

6. If not publicly traded, BDC public offerings are subject to "blue sky" registration in each state where an offering will be made.

B. Benefits of the BDC Model

1. Not required to limit the number of its investors or sell its shares only to qualified purchasers.

   A BDC making a public offering can advertise and sell its shares to investors who are not accredited investors.

2. Provides access to public capital markets.

3. Securities can be listed on national securities exchanges.

4. Availability of tax treatment as an RIC, which generally avoids entity-level taxation.

5. External model permits management fee and incentive fee structures similar to traditional private fund structures.

   Can charge a performance fee without limiting investors to qualified clients.

6. Increased transparency from publicly available quarterly financial information.

7. Certain offshore and tax-exempt investors can invest directly, rather than through offshore blockers.

C. Other Considerations

1. Federal Tax Compliance. BDCs need to comply with applicable diversification and source of income requirements as RICs. Income must generally be distributed as earned.

2. Leverage Restrictions. BDCs have limits on their use of leverage, and must maintain a 200 percent asset coverage ratio.[7] Those restrictions limit the ability to invest in lower-yielding investments where significant leverage would be required.

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[6] *See* Section 55(a) of the 1940 Act.

3. Restrictions on Transactions With Affiliates. BDCs have specific restrictions on acquiring or selling assets to affiliates and on participating in co-investment transactions with affiliates.[8] Asset manager may need to obtain SEC exemptive relief to permit even pro rata investment allocations involving a BDC.
4. Public Reporting Requirements. Subject to periodic reporting requirements with the SEC that mirror those applicable to publicly traded operating companies (i.e., on Forms 10-Q and 10-K). BDCs must comply with additional compliance requirements under the 1940 Act, including with respect to:
   (i) Custody of assets;
   (ii) Maintenance of records;
   (iii) Appointment of a chief compliance officer; and
   (iv) Restrictions on holding securities of asset managers, broker-dealers and other investment companies.
5. Managerial assistance
   (a) BDCs must "make available" to their investee companies "managerial assistance" (e.g., offer to serve on the company's board or to provide strategic consulting).
   (b) A BDC may be compensated for providing these services.

III. Registered Closed-End Funds ("CEFs")

A. What Are Registered Closed-End Funds?

1. Closed-end fund that registers under the 1940 Act.
2. Can be publicly offered, publicly traded or privately offered.
3. Unlike BDCs, CEFs generally have fewer 1940 Act limitations on nature and type of investments.
   (a) Can be used to deliver various types of alternative investment programs.
   (b) Fund structures include single manager/strategy funds (e.g., long/short, market-neutral, hedged equity), multi-manager alternative funds, private equity funds, funds of hedge funds and funds of private equity funds and real asset/commodities funds.
4. As a result of greater investment flexibility, CEFs are often used by asset managers in lieu of a BDC structure to allow offshore or other investments that would be considered "bad" BDC assets.
5. Unlike a registered fund organized as an open-end fund (i.e., a mutual fund), registered closed-end funds do not offer redeemable securities.
   (a) Enables greater control over the timing of cash flows to/from a fund.
      (i) Can be appropriate structure for funds that invest in illiquid securities.
      (ii) Also appropriate for alternative investment strategies where dealing with daily cash flows might adversely affect investment performance.
   (b) If listed on an exchange, can provide daily liquidity to investors without impacting cash flows.
   (c) Can also provide liquidity similar to the liquidity of an investment in a hedge fund by means of repurchase offers made by the fund, or can provide liquidity similar to the liquidity of an investment in a private equity fund by providing liquidity (by making distributions to investors) only as the fund's investments are sold or become liquid.

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[7] *See* Section 61(a) of the 1940 Act.

[8] *See* Section 57 of the 1940 Act.

6. A CEF must have at least a 300 percent asset coverage ratio (total assets/total debt) at the time of any new borrowings.[9]
7. A CEF must have at least a 200 percent asset coverage ratio (total assets/(preferred stock + total debt)) at the time of issuing any new preferred stock.
8. Incentive fees on realized capital gains are generally prohibited.
9. Public reporting requirements include an annual and semiannual report, along with a publicly filed schedule of investments on off quarters.
10. Public offerings by non-traded CEFs are subject only to notice filings under state "blue sky" laws.

B. BDCs vs. CEFs

1. Business Development Companies

(a) Allow greater leverage than typical registered closed-end funds.

Limit of "one-to-one" debt to equity vs. "one-to-two" debt to equity.

(b) Permit use of capital gains incentive fees for asset managers.

(c) Provide slightly greater flexibility for transactions with remote affiliates.

(d) Greater leverage permits investment in more liquid credit instruments, which lower unleveraged returns.

2. Registered Closed-End Funds

(a) Allow hedge funds or funds of funds to have broader investor bases, without relying on 3(c)(1) or 3(c)(7).

(b) Permit an asset manager to target novel or unique asset classes that would be ineligible in a BDC structure.

(c) Frequently target investments in existing leveraged products or where significant leverage at the fund level is unnecessary.

(d) Reduced state "blue sky" compliance for non-traded vehicle structures compared to BDCs.

(e) Require a reduced public reporting burden compared to a BDC structure.

IV. Non-Traded Regulated Funds

A. What Are Non-traded Regulated Funds?

1. Structured as a BDC or registered closed-end fund and regulated by the 1940 Act.
2. Shares are not listed on an exchange.

(a) Offerings can be conducted publicly or as private placements.

(b) Shares sold through continuous offerings, with periodic closings, up to preset maximum amount.

3. Limited liquidity offered to investors through periodic repurchase offers.
4. Typically have fixed five- to seven-year period before exchange listing or traditional IPO.
5. Can be treated as an RIC or a partnership (with liquidity limitations) for tax purposes.

B. Non-Traded Regulated Fund Structures

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[9] *See* Section 18(a) of the 1940 Act.

Non-traded regulated funds are generally structured as a combination of an investment adviser or sub-adviser and a distributor, often using a joint venture format for the investment manager to the fund.

1. KKR Asset Management is the investment sub-adviser for Corporate Capital Trust, while CNL Fund Advisers serves as the dealer manager.
2. Apollo Global Management serves as investment sub-adviser for CION Investment Corp., while ICON Securities serves as the dealer manager.
3. SIC Advisers (investment personnel of Medley) is the investment adviser to Sierra Income Corporation, while SC Distributors is the dealer manager.

C. Non-Traded Regulated Fund Examples

1. Business Development Corporation of America
2. Business Development Corporation of America II (affiliated with AR Capital)
3. CION Investment Corporation (affiliated with ICON Capital Corp. and Apollo Global Management)
4. Corporate Capital Trust (affiliated with CNL Fund Advisors Company and KKR Asset Management)
5. FS Energy and Power Fund (affiliated with GSO/Blackstone)
6. FS Energy and Power Fund II (affiliated with GSO/Blackstone)
7. FS Investment Corporation II (affiliated with GSO/Blackstone)
8. FS Investment Corporation III (affiliated with GSO/Blackstone)
9. HMS Income Fund (affiliated with Hines Securities and Main Street Capital Corporation)
10. MacKenzie Realty Capital (affiliated with MacKenzie Capital Management)
11. NexPoint Capital (affiliated with NexPoint Advisors and Highland Capital Funds Distributor)
12. Sierra Income Corporation (affiliated with Medley Capital and SC Distributors)
13. VII Peaks Co-Optivist Income BDC II (affiliated with VII Peaks Capital)

V. Private BDCs

A. What Are "Private" BDCs?

1. Often sponsored by credit platforms with an existing institutional or high-net-worth investor base.
2. Operates similar to a traditional BDC from a public reporting and compliance perspective, but draws down capital via a capital call model, similar to a private fund structure.
   (a) Investors provide capital commitments, rather than complete funding up front.
   (b) Capital call structure helps mitigate the drag caused by excess uninvested cash.
3. Shares are offered through a private placement offering to the sponsor's existing investor base.
   (a) Marketing efforts are similar to raising a traditional fixed-life credit fund.
   (b) Onshore and offshore investors can invest in the same vehicle directly.
4. Rather than having a fixed investment period, a private BDC will generally target an initial public offering, exchange listing or merger transaction with an existing public vehicle as a liquidity event for its investors.
   (a) Sponsor can maintain optionality to wind down in lieu of a liquidity event.
   (b) With appropriate structuring, a private BDC can be merged with an existing publicly traded BDC managed by an affiliated adviser, with only board approval required at the publicly traded BDC level.

B. Advantages of the Private BDC Model

1. BDC/RIC structure helps mitigate the need for offshore feeder fund structures for foreign/tax-exempt investors.

    (a) Onshore and offshore investors can invest directly in the same vehicle.

    (b) Marketing and offering efforts are simplified, with only one PPM and subscription agreement.

    (c) Provides investors with greater transparency and the 1940 Act protections that they lack with a traditional private fund.

2. If structured properly, Rule 17a-8 can permit the roll-up of the private BDC with a publicly traded affiliate BDC, helping to grow a single pool of permanent capital.[10]

    (a) Provides an alternative to traditional public offerings to grow AUM for an existing publicly traded BDC.

    (b) With appropriate co-investment relief in place, a private BDC can co-invest alongside an existing publicly traded BDC managed by an affiliated adviser from inception.

3. Private placement structure eliminates the need for the "blue sky" registration process faced by non-traded BDCs.

    Arguably provides a more efficient offering structure than non-traded BDC public offerings.

C. Private BDC Sponsors

Numerous private BDCs have been formed in recent years, including:

1. Carlyle GMS Finance
2. TCW Direct Lending
3. Owl Rock Capital Corp.
4. Crescent Capital BDC Inc.
5. Bain Capital Specialty Finance

VI. Structured Holdco Acquisition Companies

A. What Is a Structured Holdco Acquisition Company?

1. Externally managed publicly traded holding company structure that holds controlling interests in its underlying operating company subsidiaries.
2. Hybrid between a publicly traded holding company and a private equity fund from a regulatory perspective.
3. Typically structured as a publicly traded limited liability company.
4. Top tier holding company holds controlling interests in one or more operating companies.
5. LLC holding company structure provides access to partnership tax treatment.
6. LLC is required to deliver K-1s to its public equity holders, similar to master limited partnership vehicles.
7. The LLC holding company is not subject to registration as an investment company under the 1940 Act.
8. SHACs have been listed on both the NYSE and Nasdaq.
9. SHACs have also conducted successful follow-on equity offerings to fund additional acquisitions.

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[10] *See* Rule 17a-8 under the 1940 Act.

B. Benefits of the SHAC Model

1. Access to public capital markets.
2. Securities can be listed on national securities exchanges.
3. Flow-through tax treatment as a partnership.
4. External model permits management fee and incentive fee/waterfall structures similar to traditional private fund structures.
5. Increased transparency from publicly available quarterly financial information.
6. Unlike regulated funds, SHACs are not subject to the limitations on leverage, co-investment or sales of securities below net asset value imposed under the 1940 Act.

C. Other Considerations

1. Federal tax compliance
   (a) Must comply with applicable source of income requirements to ensure tax treatment as a partnership.
   (b) Income is taxable regardless of distributions being made.
   (c) Unlike regulated funds that are RICs, SHACs that are treated as partnerships must deliver K-1s to investors, rather than 1099s.
2. Avoiding 1940 Act regulation
   (a) SHACs must generally hold controlling interests in each of their portfolio companies.
   (b) Portfolio investments should be based on a "buy and hold" strategy, generally seeking to invest in portfolio companies for cash flow, rather than short-term capital gain, purposes.
3. Public reporting requirements

   Subject to periodic reporting requirements with the SEC in the same manner as publicly traded operating companies.

D. SHAC Examples

1. Macquarie Infrastructure Corporation (formerly Macquarie Infrastructure Company LLC) (NYSE: MIC)
2. Compass Diversified Holdings LLC (NYSE: CODI)
3. Fortress Transportation & Infrastructure LLC (NYSE: FTAI)

VII. Special Purpose Acquisition Companies

A. What Is a Special Purpose Acquisition Company?

1. Publicly traded corporation organized to acquire one or more operating companies through a business combination.
2. SPACs issue units consisting of shares of common stock and warrants to raise public funds in an IPO.
3. Subsequent business combination must occur within a set time frame and meet set criteria identified at the time of a SPAC's IPO:
   (a) Percentage of net assets/available capital;
   (b) Dollar amount; and
   (c) Specific industry designations.

4. SPAC sponsors typically agree to purchase warrants either at the IPO or through subsequent open market purchases post-IPO.

5. Large percentage of IPO proceeds are held in escrow until stockholders approve a "qualifying" business combination.

6. Proceeds from SPAC sponsors typically fund operating expenses.

7. If successful, SPAC sponsors typically hold a significant percentage (10 to 20 percent) of the post-business combination public company.

B. Benefits of the SPAC Model

1. Access to public capital markets.

2. Securities (units, shares and warrants) can generally be listed on national securities exchanges.

3. SPAC sponsors can obtain significant equity in a publicly traded operating company with relatively low direct outlays of capital.

4. Increased transparency from publicly available quarterly financial information.

5. Unlike regulated funds, SPACs are not subject to the regulatory limitations imposed under the 1940 Act.

C. Other Considerations

1. Difficulty completing a successful business combination

(a) Approval is typically subject to a "conversion threshold," where a set percentage of stockholders (as low as 19.99 percent) who vote against a transaction and request their capital be returned will cause a transaction not to be approved.

(b) Hedge funds will often seek to benefit from the difference between market price and cash liquidation value, irrespective of the proposed target company.

(c) Sponsors often must "give up" a portion of their economics to gain shareholder approval.

2. Limited cash flow pre-business combination

(a) Until consummation of a business combination, SPACs must generally limit their investments to money market funds and U.S. government securities.

(b) As a result, SPAC sponsors typically must fund operations prior to completion of a successful business combination.

3. Public reporting requirements

(a) Subject to periodic reporting requirements with the SEC in the same manner as publicly traded operating companies, even prior to consummation of a business combination.

(b) SEC staff will closely scrutinize disclosure regarding any proposed business combination.

VIII. Offshore Traded Funds

A. What Are Offshore Traded Funds?

1. Offshore traded funds are generally structured in a manner similar to a closed-end fund, with no investor redemption rights, but seek to avoid the need for registration as an investment company under the 1940 Act by limiting the scope of their investor base.

2. In order to avoid registration under the 1940 Act, offshore traded funds must be formed outside the United States, often in a jurisdiction such as Guernsey, and generally must conduct their initial public offerings in reliance on Regulation S.

3. U.S. investors that qualify as "qualified purchasers" under the 1940 Act, though, can also acquire securities directly from an offshore traded fund in a concurrent Regulation D private placement.
   (a) Permits institutional and high-net-worth individuals to participate in a new offshore fund launch.
   (b) Once the applicable Regulation S holding period has been satisfied, those shares effectively become freely tradable.
4. Investors gain access to liquidity through an exchange listing, often on Euronext or another foreign securities exchange.
5. Pursuant to SEC staff guidance, U.S. persons who acquire shares of an offshore traded fund in the secondary market need not be "qualified purchasers," as long as no nonqualified U.S. purchaser acquires shares directly from the offshore traded fund.
   (a) Generally, offshore traded funds need only focus on the nature of investors in their primary offerings, rather than tracking subsequent open-market purchasers.
   (b) After the Regulation S holding period has expired, an offshore traded fund could develop a relatively broad U.S. shareholder base through normal secondary market trades without requiring registration under the 1940 Act.
6. Often an offshore traded fund will be managed by a U.S. asset manager, alongside similar public and private domestic funds.
7. Offshore traded funds that are treated as PFICs for U.S. federal tax purposes typically agree to provide statements to relevant U.S. investors that would allow such investors to make "qualified electing fund" elections.

   May in certain cases be eligible for mark-to-market tax treatment under the PFIC rules.
8. Offshore traded funds that are treated as partnerships for U.S. federal tax purposes need to meet the qualifying income test or else will likely revert to PFIC tax status.

B. Benefits of the Offshore Traded Fund Model
1. Access to public offshore capital markets.
2. Avoids the need for compliance with the requirements of the 1940 Act applicable to registered closed-end funds.
   (a) No regulatory leverage restrictions.
   (b) No investment restrictions.
   (c) No co-investment restrictions with affiliated private funds.
3. Increased transparency from publicly available financial information, depending on where listed.
4. Public reporting requirements are often less burdensome than for U.S.-listed public funds.

C. Other Considerations
1. Less liquid public market
   (a) Offshore exchanges generally have lower liquidity than U.S. public trading markets, such as NYSE and Nasdaq.
   (b) Limited secondary market liquidity can potentially hurt market price and potentially limit follow-on equity offerings.
2. Limited ability to directly market to U.S. persons

(a) Offshore traded funds must generally ensure that no public selling efforts occur within the United States.

(b) U.S. direct investors are typically limited solely to "qualified purchasers," making the offshore traded fund more of an institutional vehicle within the United States.

3. Subject to offshore regulatory requirements

(a) Offshore traded funds are subject to periodic reporting requirements depending upon the foreign regulatory and exchange-listing requirements to which the offshore fund is subject.

(b) Depending on jurisdiction, an offshore traded fund may also be subject to registration and ongoing oversight in a manner similar to a U.S. 1940 Act regulated fund.

IX. Real Estate Investment Trusts

A. What Are REITs?

1. Structured in a manner similar to a closed-end fund, but relies on the exception from registration under the 1940 Act under Section 3(c)(5).[11]

2. To comply with Section 3(c)(5), an REIT must generally invest at least 55 percent of its assets in "mortgages and other liens on and interests in real estate."

(a) Remainder of assets must generally consist of investments in "real estate type interests."

(b) Only 20 percent of an REIT's assets may consist of miscellaneous investments.

3. REITs may also comply with the 1940 Act by holding physical real estate in lieu of securities or other interests in real estate.

4. Because REITs fall outside the 1940 Act, they generally have no limit on the use of leverage.

5. Similar to BDCs, REITs file annual, quarterly and current reports under the 1934 Act on the same basis and in the same manner as traditional operating companies.

6. If not publicly traded, REIT public offerings are subject to "blue sky" registration in each state where an offering will be made in the same manner as BDCs.

B. Benefits of the REIT Model

1. Access to public capital markets.

2. Securities can be listed on national securities exchanges.

3. Eligible to elect flow-through tax treatment as a "real estate investment trust" for federal income tax purposes.

4. External model permits management fee and incentive fee structures similar to traditional private fund structures.

5. Increased transparency from publicly available quarterly financial information.

6. No limit on the use of leverage or different classes of equity as with 1940 Act-regulated funds.

C. Other Considerations

1. Federal tax compliance

(a) REITs must meet specific organizational requirements to elect REIT status.

(b) REITs need to comply with applicable asset and source of income requirements.

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[11] *See* Section 3(c)(5) of the 1940 Act.

(c) Income is generally distributed as earned.

(d) Special rules for non-U.S. investors, depending in part on whether the REIT is publicly traded (ownership of 10 percent or less does not generate FIRPTA gain) or private (FIRPTA applies, other than certain mortgage REITs).

2. Investment restrictions

(a) To avoid registration under the 1940 Act, REITs must generally invest principally in physical real estate, or in mortgages and similar interests in real estate.

(b) Those requirements restrict the use of potentially more attractive unsecured credit instruments in transaction structures.

3. Public reporting requirements

Subject to periodic reporting requirements with the SEC that mirror those applicable to publicly traded operating companies.

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Bill focuses on complex commercial litigation, including securities fraud actions, fraudulent transfer actions, M&A litigation, private post-acquisition disputes and derivative actions. He advises leading hedge funds, private equity firms, major corporations, investment banks, prime brokers, lenders and individuals. Bill has substantial trial experience, having tried cases in federal and state courts throughout the United States and in a variety of alternative dispute resolution venues, including AAA, FINRA and JAMS arbitrations. Bill frequently litigates in bankruptcy court, often representing creditors in enterprise valuation and asset ownership disputes. He has broad experience representing both buyers and sellers in deal-related disputes, including in shareholder class actions. He has also assisted clients in connection with SEC investigations.

Bill's jury trial experience includes the successful defense of a leading prime broker in a $141.4-million fraudulent transfer action brought by the trustee of a defunct hedge fund. In that two-week federal trial, he helped to secure a unanimous verdict in favor of the prime broker. In addition, Bill successfully defended a former officer and director of Merck & Co. in a widely publicized securities class action and related cases concerning the painkiller Vioxx. That high-profile matter included the defense of federal and state securities law claims, breach of duty claims, product liability claims and other matters. Bill is ranked as a leading lawyer in *The Legal 500 US*. A recognized thought leader, Bill co-authored the "Market Manipulation" chapter in the leading treatise *Federal Securities Exchange Act of 1934*, published by Matthew Bender and the article "Extending *CalPERS v. ANZ* Securities To Exchange Act Cases," published in *Law360*.

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David leads the firm's Distressed Debt & Claims Trading Group, which provides advice in connection with U.S., European and emerging market debt and claims trading matters. His practice focuses on special situations and distressed investments, and distressed mergers and acquisitions. David represents investment funds, private equity funds and broker-dealers in connection with the financing and trading of distressed, non-performing and esoteric assets across a wide range of issuers in jurisdictions around the globe. He is often called upon to develop secondary market risk transfer structures for illiquid assets and claims including oil and gas royalties, liquidating trusts, litigation claims and many other financial products.

Recognized as a leading lawyer by *New York Super Lawyers*, and by the founder of *Reorg Research* as "undoubtedly one of the best in the field at what he does best: making sure funds and their investments are protected when transacting and executing trades in distressed debt and claims," David is an active member of the American Bankruptcy Institute, Loan Market Association, Emerging Markets Trade Association, National Association of Royalty Owners and the Loan Syndications and Trading Association. He is a frequent author and speaker on distressed investing and oil and gas topics and recently wrote articles, including "Investing in Oil and Gas Royalties: Distressed Counterparty Risk Considerations," "Structuring Winning Bids: European NPL Portfolio Transactions" and "Bank Debt Trading on the Modern Day Back of the Napkin."

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Kurt focuses his practice on the tax aspects of mergers and acquisitions, leveraged buyouts and other private equity transactions; international transactions; the formation of private equity funds; executive compensation; and bankruptcy and workout transactions. With more than 30 years of experience in structuring acquisitions and sales of public and private companies and advising on all the tax aspects of the transaction, Kurt has handled acquisitions in a wide variety of industries, including government contracting, manufacturing, restaurants, media companies, supermarkets and other retail businesses and finance and leasing companies. He has represented both strategic and financial buyers and has handled exits and partial exits via sales, public offerings, leveraged recapitalizations and other methods. Kurt has also acted as tax counsel in connection with structuring private equity funds and representing both fund sponsors and investors in the fund formation and investment process. In addition, he has dealt extensively with corporations that possess valuable tax attributes, such as net operating losses. Both the NOL corporations themselves and investors in those corporations are subject to special tax rules. Kurt is recognized as a leading tax attorney in *The Best Lawyers in America*, *The Legal 500 US* and *New York Super Lawyers*.

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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 and the establishment of capital call credit lines.

Phyllis is recognized as a leading practitioner in her field by numerous independent publications, including *The Legal 500 US*, *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. Interviewed by *Private Funds Management* in the article "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. In addition, she 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" in *Mutual Funds and Exchange Traded Funds Regulation, Volume 2* (Practising Law Institute).

Phyllis received her J.D. from Columbia University Law School and her A.B. from Smith College.

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Practices

Structured Finance & Derivatives

Boris Ziser

Boris is co-head of the Structured Finance & Derivatives Group. With over 20 years of experience across diverse asset classes, Boris focuses on asset-backed securitizations, warehouse facilities, secured financings and commercial paper conduits. His practice encompasses a variety of asset classes, including life settlements, equipment leases, structured settlements, lottery receivables, timeshare loans, litigation financing and cell towers, in addition to other esoteric asset classes such as intellectual property and other cash flow producing assets. He also represents investors, lenders, hedge funds, private equity funds and finance companies in purchases and dispositions of portfolios of assets and financings secured by those portfolios.

Recognized as a leading lawyer in the industry, Boris is ranked in *Chambers USA* and *The Legal 500 US* for his work in structured finance. He serves as outside general counsel to the Institutional Longevity Markets Association (ILMA) and he is a member of the Structured Finance Committee of the New York City Bar Association, the New York State Bar Association, and the Esoteric Assets Committee and Risk Retention Task Force of the Structured Finance Industry Group. A frequent speaker at securitization industry conferences, Boris has conducted various securitization and life settlement seminars in the United States and abroad. Most recently, he was interviewed for the article “Life Settlements and Longevity Swaps: Opportunities for Investors, Individuals, Insurers and Pension Funds,” published in *The Hedge Fund Journal.*

Boris earned his J.D. from the New York University School of Law and his B.A., *with honors*, from Oberlin College.

Investing in Litigation Finance

I. Introduction

A. What is litigation funding?

1. The term litigation funding is sometimes used to describe several forms of funding transactions, some of which do not involve the actual funding of a litigation.

2. The opportunity is to invest in an uncorrelated asset that, while complex, is not generally exposed to market volatility.

B. We represent clients that provide litigation funding. These clients generally are structured as private investment vehicles, but we also represent banking and similar institutions that are active in certain categories of litigation finance.

C. Litigation funding raises numerous issues under applicable laws and regulations, including regulations governing attorney conduct.

D. Tax issues vary depending on the party being financed (usually the plaintiff or the law firm), whether the financing will be treated as debt or equity for tax purposes and the presence of any investors who have special concerns, such as offshore investors and tax-exempts.

E. We coordinate with one another in creating vehicles that will provide litigation funding, negotiating transactions in which the funding is to be provided and identifying legal and regulatory issues affecting these transactions.

II. Types of Litigation Financings

A. Pre-Settlements

1. Advancing funds to personal injury litigation plaintiffs, who use the funds to pay medical expenses or for other purposes.

2. Each individual advance is fairly small, so pre-settlement companies originate a large number of fundings (hundreds or thousands).

3. Each advance will earn an accrual based on amount of time outstanding.

4. The risk is binary. The plaintiff is obligated to repay an advance only if there are proceeds from a judgment or settlement.

5. Funder does not have the right to control the litigation. The plaintiff's lawyer is obligated to do what is best for his or her client, which is the plaintiff.

B. Post-Settlements

1. As the name implies, these fundings are made after a settlement has been finalized and the funded party is awaiting distribution of proceeds.

2. The advances can be made to a plaintiff or to a law firm that's entitled to a contingency fee to be paid from the settlement proceeds.

3. One example of a type of post-settlement funding business is in the class action sector, such as the NFL concussion settlement. The settlement is final and is currently in the implementation stage.

4. Another example is the Deepwater Horizon BP settlement. The two settlements are good examples of how they can vary.

   (a) The BP settlement requires a more complicated assessment of recovery entitlement.

(b) The NFL settlement is based on a grid.

C. Medical Liens (also known as Letter of Protection Fundings)

1. The advances are made to medical professionals.
2. Such medical professionals provided medical care to the plaintiffs and are entitled to be paid from recoveries under the related litigation.
3. "Letter of Protection" refers to the letter signed by the plaintiff's attorney acknowledging the entitlement to payment.

D. Loans to Law Firms

1. Can be secured by fees from one case or multiple cases.
2. Can be full recourse, non-recourse or limited recourse.
3. Can be a pre-settlement or a post-settlement.
4. Has often been done in the class action or other personal injury context, but can also be in commercial tort or other types of cases.

E. Investment in Cases

1. One might say this is the purest form of litigation funding.
2. Advancing money to a plaintiff to prosecute the litigation.
3. One well-publicized recent example was Hulk Hogan's case against Gawker.
4. This type of arrangement can be used in different types of cases (e.g., pharmaceutical, medical devices, patent infringement, matrimonial and others).
5. There is a waterfall for distributing proceeds among the plaintiff, the attorneys and the funder.
6. Some legal issues are usury and champerty.

F. Bankruptcy Litigation Funding

1. Advancing money to debtors-in-possession, creditors' committees, liquidation/litigation trusts, Chapter 7/11 trustees or liquidation trusts.
2. Types of litigation matters to be funded may include fraud/fraudulent transfer/preference actions, other avoidance or clawback actions and/or monetization of pre-bankruptcy or post-bankruptcy judgments.
3. Funding may be required during pendency of bankruptcy case (e.g., commencement of an adversary proceeding or continued prosecution of pre-bankruptcy litigation), post-confirmation or after consummation of a Chapter 11 plan.
4. Bankruptcy Code requires court approval for debtor or trustee to obtain credit outside ordinary course of business and approval of litigation financing is not a "slam dunk."

III. Why do Litigants Seek Funding?

Maximize value of litigation claims for benefit of:

A. War chest;

B. Reduce pressure to settle;

C. Working capital;

D. De-risking; and

E. Refinancing.

IV. Litigation Finance Investment Vehicles

A. Managers

1. The founders of litigation finance investment firms are often litigators or other professionals with trial experience, who may not have previously managed a fund. Some of our clients have directly funded litigation, other than through investment vehicles.

2. The litigation experience of the managers is likely to drive the particular litigation finance strategy.

B. General Structure of Investment Vehicles

1. Litigation finance vehicles are structured with most features used by private equity funds, including management fee and carried interest structures.

2. At least one well-recognized investment vehicle is a publicly registered entity.

3. Privately held litigation finance vehicles are allowed to finance new cases during an "investment period," and have a stated term (both of which are likely to be shorter than a typical five and five year investment/harvest period).

4. Litigation finance vehicles may leverage their investments.

5. Privately held litigation finance vehicles generally do not offer withdrawal rights, as they rely on the settlement or conclusion of the underlying litigation in order to be able to make distributions to investors. When a case settles and the fund receives its proceeds from the case, distributions are made to the investors in the fund, subject to a waterfall.

   The waterfall in the litigation financing vehicle should not be confused with the waterfall in the transaction documents between the funder and a plaintiff. In the transaction documents, proceeds from the case are also divided pursuant to a waterfall.

C. Joint Ventures

1. Litigation funding is a relatively new investment strategy. As a result, managers may not be able to arrange for capital sources on a committed basis, and will form "pledge" or "club" funds that pursue litigation funding.

2. If a club fund is set up to pursue litigation financing transactions, investors have the right to decide whether an underlying case will be financed and are likely to carry out their own diligence of that case.

D. Expenses of Investment Vehicles

In addition to typical fund-related expenses, a litigation funding vehicle will often retain outside experts to assess the strength of a case (even where the managers are also litigators).

E. Drawdowns of Capital From Investors

1. A litigation finance vehicle will draw down capital as needed to cover litigation expenses borne by the plaintiff pursuant to the agreement between the plaintiff and the investment vehicle.

2. If an investment is made at a point when the plaintiff has funded a substantial amount of expenses, the investment vehicle may make a payment to the plaintiff, and hence, a single capital call from investors.

3. As the manager assesses the progress of a case, the manager of the investment vehicle may determine to cease funding that case; in the event that the investment vehicle is set up as a joint venture, investors in the joint venture may have a say in whether the investment vehicle continues to fund the case.

F. Information-Sharing

1. In order to assess the case, the manager will rely on information provided by the plaintiff and its attorneys or that is publicly available. To protect attorney client privilege, such information is likely to be limited.

2. Information provided to investors in a litigation investment vehicle will accordingly be limited.

G. Tax Issues

1. The tax analysis depends on the facts, which can vary dramatically from transaction to transaction. The three principal variables are the identity of the party being funded, the treatment of the investment as debt or equity for tax purposes and the treatment of investors subject to special rules, such as tax-exempt and offshore investors.

2. Transactions structured as loans will generally produce returns characterized as interest or original issue discount, which are treated as ordinary income and taxed at marginal federal rates up to 40.8 percent plus any applicable state or local tax. In some cases, such as equity financings of plaintiffs, it is possible that some of the return could be treated as long-term capital gain, currently taxed at a maximum federal rate of 23.8 percent and state and local rates that vary by jurisdiction.

3. Offshore investors will generally be treated as engaged in a U.S. trade or business and thus will be required to file U.S. federal, and possibly state and local, net income tax returns. To avoid that result, such investors typically invest through "blocker" corporations so that the blocker, rather than the investor himself, files the U.S. tax returns. The good news is that the cost of investing through a blocker has been reduced by 40 percent as the U.S. corporate tax rate was recently reduced from 35 percent to 21 percent.

4. Tax-exempt investors may be subject to the tax on "unrelated business taxable income," depending on the structure of the investment and certain other factors.

5. The tax treatment of the party being financed can also be critical. In general, those parties desire to defer the inclusion of any item of income or gain until the receipt of settlement proceeds that they are entitled to retain.

H. Regulatory Issues

1. Managers may be required to register as investment advisers, depending in part on whether the investments are deemed to be securities

2. Litigation funding vehicles structured using a private equity fund format are unlikely to permit participation by ERISA investors to be 25 percent or more, as these vehicles could not meet the "VCOC" standards.

V. How to Become a Litigation Funder

A. Litigants or their counsel often will market the investment opportunity.

1. Established players in this field.

2. Investment firms interested in alternative investments/opportunities.

3. Attorney referrals.

4. Brokers/investment bankers.

B. In addition to diligence of the litigation, funders should assess additional factors such as:

1. Litigation expenditures (including volume of discovery);

2. Availability of insurance to defendant;

3. Jury vs. bench trials;
4. Likely duration;
5. Probability of one or more appeals;
6. Collection risk;
7. Ability to satisfy judgment;
8. Foreign enforcement risks;
9. Priority encumbrances; and
10. Potential bankruptcy filing.

C. In order to structure, negotiate and document the financing, the following factors should be considered:

1. Percentage recovery of litigation proceeds or multiple of amount invested;
2. Interest rate (if investment is structured as a loan or after some specified period of time);
3. Repayment terms, timing and process;
4. Maturity date, if any;
5. Budget (pre-approval by, or consultation with, funder); and
6. Notifications/updates.

VI. Certain Legal Issues

A. Legality of Transaction

1. Champerty

(a) Champerty is a common law doctrine, which has been codified in some states, aimed at precluding frivolous litigation by preventing the "commercialization of or trading in litigation." *Bluebird Partners v. First Fidelity Bank, N.A.*, 731 N.E.2d, 581, 582 (N.Y. 2000).

(b) New York is one of the states that has codified its prohibition against champerty. *See* New York Judiciary Law § 489(1): "… no corporation … shall solicit, buy or take an assignment of … a bond, promissory note, bill of exchange, book debt, or other thing in action, or any claim or demand, with the intent and for the purpose of bringing an action or proceeding thereon."

(i) New York's champerty statute has a safe harbor exception: New York Judiciary Law § 489(2): 489(1) "shall not apply … if such assignment, purchase or transfer … [has] an aggregate purchase price of at least five hundred thousand dollars … ."

(ii) However, this safe harbor would likely not cover the purchase of all legal claims, but would only exempt claims from Section 489 if they are debt-based claims that meet the threshold value and are "issued by or enforceable against the same obligor." N.Y. Jud. Law § 489(2).

(c) In most jurisdictions, litigation funding agreements are generally not considered champertous if there are limits on the funder's ability to:

(i) Influence/control the litigation and strategy;

(ii) Hire/terminate counsel; and

(iii) Make settlement decisions.

2. Usury

In addition to champerty concerns, litigation funders should be aware of state laws which may set limits on interest rates.

(a) It is not necessarily the case that litigation finance would be subject to usury laws. Some courts have adopted the view that litigation finance arrangements are not loans, since the repayment of the funds is contingent upon the outcome of the underlying lawsuit. *See Hamilton Capital VII LLC, I v. Khorrami, LLP*, 48 Misc.3d 1223(A), at *6 fn. 14 (Sup. Ct. N.Y. Cnty. 2015).

(b) Many states have safe harbors for their usury laws, which protect loans above a certain amount. In New York, loans made over $2.5 million are exempt from usury laws. N.Y. Gen. Oblig. Law § 5-501 (6) (b).

B. Ethical and Privilege Issues

1. Ethical Concerns

(a) Ethical canons in most jurisdictions prohibit attorneys from sharing, or splitting fees, with non-lawyers. Transactions, therefore, should generally be structured so that the plaintiff shares proceeds with the funder, rather than the plaintiff's attorney.

(b) In addition, funders must be mindful to not exert influence over the attorney's professional judgment and impede the party's attorney's ethical duties to his or her client. N.Y.C.B.A. Comm. on Prof'l Ethics, Formal Op. 2011-2 (2011) (discussing third-party litigation financing).

2. Privilege/Work Product/Confidentiality Issues

(a) There is a risk that sharing information with a third-party litigation funder waives attorney client privilege and work product protections.

(b) In addition, privilege concerns may result in a limit on the diligence that the funder can conduct. However, the funder can receive documents that are not privileged, will likely be disclosed to the adversary, and/or have already been disclosed to the adverse party. Funders may receive updates that are publicly available or that have already been disclosed to the adverse party.

C. Increased Regulation

1. As litigation finance becomes more popular, state and federal governments have begun to consider whether the process should be more regulated.

2. Agreement with the N.Y.A.G.

In 2005, the New York Attorney General and nine litigation finance companies entered into an agreement which imposed nine consumer-friendly requirements for future funding agreements, including providing translation into consumers' native languages and providing a disclosure statement. Bureau of Consumer Frauds and Protection, Attorney Gen. of the State of N.Y., Assurance of Discontinuance Pursuant to Executive Law § 63(15) 4-7 (2005). The agreement shows tacit approval of litigation finance arrangements.

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Christopher Hilditch

Chris is the co-head of the firm'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 named as a leading funds lawyer in *Chambers UK*, *Chambers Europe*, *Chambers Global*, *The Legal 500 UK*, *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*. He was recognized at The Hedge Fund Journal Awards 2017 for his "Outstanding Contribution" to the industry. In addition, Chris was invited to participate in the U.K. 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 on a wide range of hedge fund and regulatory topics. Chris recently co-authored "MiFID II: Final FCA Rules Published" and "Brexit: What Alternative Asset Managers Can Expect," both published in *The Hedge Fund Journal*. He also 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.

Chris attended law school at the College of Law, Guildford and graduated with an M.A., *with honors*, from Oxford University.

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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 SRZ, 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. She is admitted to practice in England and Wales and New York.

A “Recommended” lawyer recognized in *The Legal 500 UK*, Anna was named among the world’s “50 Leading Women in Hedge Funds” by *The Hedge Fund Journal*. Anna frequently speaks on a wide range of topics, including MiFID II, market abuse and insider dealing, as well as systematic and quantitative strategies for funds. A sought-after thought leader, Anna recently worked with AIMA to produce “MiFID2 – A Guide for Investment Managers” and authored the “Insider Trading Law in the United Kingdom” chapter in *Insider Trading Law and Compliance Answer Book* (Practising Law Institute). She also co-authored “Brexit: What Alternative Asset Managers Can Expect,” and “Cross-Border Implementation of MiFID II Research Provisions — SEC No-Action Relief to Investment Advisers and Broker-Dealers and European Commission Guidance,” both published in *The Hedge Fund Journal*.

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Julian is co-chair of the 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 response 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 US* as a leading financial services regulatory lawyer, Julian recently co-authored “Cross-Border Implementation of MiFID II Research Provisions – SEC No-Action Relief to Investment Advisers and Broker-Dealers and European Commission Guidance” and was featured in “Execution Enforcement Actions Escalate,” both published in *The Hedge Fund Journal*.

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Holly focuses her practice on the representation of employers, primarily in financial services, in all aspects of employment law and employee relations. She also serves as co-head of the firm's Cybersecurity Group. Holly litigates disputes involving restrictive covenants, ERISA claims, executive compensation, employment agreements, statutory employment discrimination claims, and common law tort and contract claims in federal and state courts, before administrative and government agencies and in arbitral forums. She advises employers on employment law compliance, best practices, human resources matters, hiring and termination, and litigation avoidance; drafts and negotiates employment agreements, separation agreements, data security and privacy policies and other employment-related agreements; and provides training and conducts investigations.

Holly is ranked 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*. She also serves as a member of the Labor and Employment Law Section of the New York State Bar Association. A recognized thought leader, Holly has authored or co-authored numerous articles of interest to employers, recent examples of which include "SCOTUS to Tackle Interaction of FAA, NLRA on Arbitration Agreement Issue" and "'Scrollwrap' Agreement to Arbitrate Held Enforceable While 'Clickwrap' Is Not," both appearing as part of the regular column she co-authors for the *New York Law Journal.* She co-authored *Hedge Funds: Formation, Operation and Regulation*, published by ALM Law Journal Press and wrote a Practice Note for *Practical Law* on "Hedge Fund Employee Compensation." A highly sought-after speaker, Holly recently discussed "Labor Law – Overview Regarding Intro 1253 from an Attorney's Perspective" at the McLagan Alternative Asset Management Fall Conference, covered "Employment-Related Developments Impacting Hiring: Ban on Inquiries Relating to Compensation History, Ban the Box, and Credit History" at Goldman Sachs 12th Annual Hedge Fund Human Capital Management Seminar and discussed "Avoiding Litigation in Workforce Cases" at Benchmark Women in Litigation East conference.

Holly earned a J.D. from the University of Virginia School of Law and a B.A. from Emory University.

Running a Global Investment Firm

I. Establishing a London Office

A. Conducting Regulated Activities

1. The U.K. regulatory regime imposes a general prohibition on any person carrying on a "regulated activity" from an establishment in the United Kingdom unless it is authorized to carry on that activity by the appropriate regulator (e.g., the Financial Conduct Authority ("FCA")), or an exemption or exclusion is available.
2. Examples of regulated activities include investment activities such as making investment management decisions, placing trades with brokers for execution or executing OTC transactions on behalf of a client, arranging transactions in unlisted investments, as well as certain types of marketing activities. Investment activities are regulated when carried on in relation to "specified investments," a term which includes equities, fixed income and derivatives.
3. A "U.K. establishment" for these purposes will include any place of business of the firm, including, for example, the private residence of an employee of the firm if the firm's business is conducted from such a private residence.

B. Formation of a Subsidiary

1. U.S. managers that wish to establish U.K. operations and hire local staff typically choose to establish a subsidiary (rather than a branch office of the U.S. firm). Such subsidiary usually takes the form of a private limited company or a limited liability partnership ("LLP"). The key distinction between a limited company and an LLP is that an LLP is a "pass-through" structure for U.K. taxation purposes.
2. Where the LLP structure is chosen, the more senior members of the U.K. subsidiary (e.g., investment professionals) typically become members (i.e., partners) of the LLP, with some of the junior members of staff becoming employees of the LLP.

II. Differences Between U.S. and U.K. Employment Laws

A. Governing Law

1. In the United States, various laws at the federal, state and municipal levels govern employment matters. In the United Kingdom, there is one set of laws that govern employment matters (with some minor differences in Scotland and Northern Ireland).
2. In the United States, many employers have different classifications of workers (i.e., exempt, non-exempt, independent contractors, partners, etc.). In the United Kingdom, all employees are classified the same for purposes of access to the same basic statutory employment rights. Note that if the U.K.-based staff become members of an LLP, they would not be categorized as employees for the purposes of these employment rights.

B. Hiring Process

1. In the United States, there is no legal requirement for a written employment contract evidencing the employment relationship. Most U.S. states follow the employment-at-will doctrine. Employers typically issue only an offer letter to new employees, accompanied by an employee handbook setting forth the employer's policies. In the United Kingdom, employment is not at-will. While an employment contract need not be in writing, employees in the United Kingdom who have been employed for at least one month must be provided a written statement setting forth certain statutorily required, fundamental details of their employment relationship. These details include remuneration and pension benefits, hours of work, leave entitlement, length of notice required to terminate employment, disciplinary and

grievance procedures, holidays and sick pay. While not required, it is customary in the United Kingdom for employers to provide a more detailed document at the beginning of the employment relationship.

2. In the United States, recent developments in the state and local laws governing background checks have caused employers to change their interviewing and hiring policies and procedures. These limitations are driven by legislators' concerns that more expansive background checks could limit equal employment opportunities. New York City, for example, now prohibits credit checks for most employees and criminal checks before extending an offer to a potential employee. In addition, employers in New York City are not allowed to ask job applicants about their past or current compensation.

3. In the United Kingdom, firms regulated by the FCA are required to assess whether their employees and partners are "fit and proper" persons prior to lodging an application with the FCA for such individuals to be approved in a "controlled function" (e.g., director, partner or customer function). Such an assessment is generally expected to include background checks (including criminal and credit checks) as well as obtaining "regulatory references" from previous firms in the financial sector. The rules related to regulatory references require FCA-regulated firms to provide accurate and complete information in response to a request from other FCA-regulated firms. These obligations apply notwithstanding any compromise agreements entered into between the firm and the individual.

C. Pension and Health Benefits

1. In the United States, employers are not required to offer their employees access to a pension or 401(k) plan. In the United Kingdom, in 2018, all employers will be required to automatically enroll their eligible employees in a qualifying pension scheme (a pension plan) and contribute towards that scheme. Because these employers can require eligible employees to contribute to the pension scheme as well, employees can elect to opt out of participating in the pension scheme (similar to U.S. automatic enrollment 401(k) plans). In 2018, employers will be required to contribute 3 percent of salary to pension schemes.

2. In the United States, under the Patient Protection and Affordable Care Act, large employers (generally employers with at least 50 full-time employees) must offer their full-time employees employer-sponsored health coverage that meets certain requirements or potentially face a penalty. In the United Kingdom, aside from statutory rights to sick pay, family leave and vacation days, employers can choose whether to offer their employees' health benefits, and will not face a penalty if they choose not to do so.

D. Termination of Employment

1. In the United States, employers and employees can terminate the employment relationship at any time without notice, unless they agree otherwise in a contract. In addition, discrimination claims in the United States are heard before a civil jury with the possibility of an uncapped award for a victorious plaintiff, unless the parties agree to another forum, such as arbitration. In the United Kingdom, employees are statutorily entitled to a minimum of one week's notice of termination after the first month of employment, which increases to a maximum of 12 weeks' notice after 12 years of service. If an employee in the United Kingdom does not receive a written document evidencing his or her employment relationship, the employee is entitled to the longer of the statutory minimum notice or "reasonable" notice. Whether notice is "reasonable" is determined based on a facts and circumstances test, including a comparison to the notice period for comparable employees in the same business and the industry in which they are employed. In addition, in the United Kingdom, employees with two years of service have the right not to be "unfairly" terminated. For a termination to be "fair," the employer must establish that a fair reason for termination, under the applicable statute, exists and that the employer carried out the termination process in a fair and equitable manner. Awards for unfair termination are capped at £78,962, or 52 weeks' gross pay, whichever is lower. Discrimination awards, like in the United States, are uncapped.

2. In the United States, non-compete clauses may not be enforceable, depending on the state in which the employer and employee are located and whether the clause is reasonable in scope and duration. In the United Kingdom, for senior and/or key employees, it is common to impose restrictions on competition

after the employment relationship has ended. Generally, in the United Kingdom, a restriction on post-termination employment will be unenforceable unless a court determines that it goes no further than necessary to protect a legitimate business interest. In addition, if an employer in the United Kingdom terminates an employment contract without the necessary notice, the employee will have a claim for wrongful termination, which will likely invalidate any restriction on post-termination competition.

3. If the leaver is approved by the FCA in a controlled function, the employer is required to disclose the reasons for termination to the FCA on Form C. This obligation covers information on any disciplinary investigations by the firm or any factors that may affect the FCA's assessment of the approved person's fitness and propriety. As noted above, this information must also be disclosed to other FCA-regulated firms in response to requests for regulatory references.

E. Dispute Resolution

In the United States, employment disputes will be heard in a court of appropriate jurisdiction unless the employer and employee agree, in writing (for example, in the employee's employment agreement), to mandatory alternative dispute resolution (i.e., mandatory and binding arbitration). In the United Kingdom, an employee has the right to be heard before the Employment Tribunal. If an employer and employee in the United Kingdom agree, in writing, to an alternative form of dispute resolution, such agreement is unlikely to preclude the employee from being heard before the Employment Tribunal. Instead, such agreement merely provides an additional method of dispute resolution, but not the only method of dispute resolution.

F. Remuneration

1. In the United States, investment professionals' compensation is regulated by the Internal Revenue Code Section 409A, solely with respect to the timing of certain deferred compensation payments. The amount and ratio of such payments, however, is unregulated.

2. In the United Kingdom, certain firms are required to meet standards and policies contained in the applicable Remuneration Code when setting pay and bonuses for staff. The Remuneration Codes were established as a response to the financial crisis of 2008, when the United Kingdom determined that inappropriate remuneration policies were widely identified as a contributing factor to the global recession. The Remuneration Codes were established to (i) ensure greater alignment between risk and individual reward; (ii) discourage excessive risk taking and short-termism; (iii) encourage more effective risk management; and (iv) support positive behaviors and a strong and appropriate conduct culture within firms.

3. Under the Remuneration Codes, all in-scope firms (including hedge funds) must make sure their remuneration policies and practices are consistent with, and promote, sound and effective risk management. This includes:

   (a) Ensuring that guarantees are given only in exceptional circumstances to new hires for their first year of employment; and

   (b) Ensuring that senior management adopts, and periodically reviews, the general principles of the employer's remuneration policy, and ensures its implementation. Details of the policy must also be disclosed at least annually.

4. In addition, the following "pay-out process" rules apply to the extent the investment manager concludes, following an assessment, that it would be appropriate to its size, internal organization and the nature, scope and complexity of its activities to apply these rules.

   (a) Requiring that at least 40 percent of a bonus be deferred over a period of at least three years. At least 60 percent must be deferred for the most senior management or when an individual's bonus is a particularly high amount.

   (b) Requiring that at least 50 percent of a bonus be made in shares, share-linked instruments or other equivalent non-cash instruments, subject to an appropriate retention period.

(c) Ensuring that any variable remuneration, including deferred remuneration, is paid or vests only if it is sustainable according to the financial situation of the employer as a whole, and is justified based on both the employer's and employee's performances.

G. U.K. Senior Managers and Certification Regime ("SMCR")

1. On July 26, 2017, the FCA published its consultation paper on the extension of SMCR to all FCA-regulated firms, including hedge fund managers. The final rules are expected to be published in the summer of 2018 with them coming into operation thereafter. The extended SMCR will replace the current approved persons regime.

2. The key aspects of the SMCR are as follows.

(a) Senior Management Functions. Firms will need to allocate six "Senior Management Functions" ("SMFs"): Chief Executive, Executive Director, Partner, Chair, Compliance Oversight and Money Laundering Reporting Officer ("MLRO"). Anyone holding an SMF will be subject to pre-approval and supervision by the FCA ("grandfathering" is expected to apply to individuals currently holding these roles).

(b) Statement of Responsibilities. Certain prescribed responsibilities will need to be allocated amongst the senior managers and their individual responsibilities will need to be set out in a "Statement of Responsibilities" which must be submitted to the regulator with the senior manager's approval application.

(c) Duty of Responsibility. Senior managers will have a statutory "Duty of Responsibility" and will potentially be accountable if they fail to take reasonable steps to prevent a breach by a firm in their area of responsibility as set out in their statement of responsibilities.

(d) Certification Functions. Firms are required to identify "Certified Persons" who fulfil one or more "Certification Functions." Firms must ensure that senior managers, non-executive directors (who are not senior managers) and certified persons are at all times fit and proper, and must certify them as such at least annually.

(e) Conduct Rules. Firms must also ensure that employees comply with certain "Conduct Rules," in respect of which firms will have notification, training and recordkeeping obligations.

H. Data Protection and Privacy

1. In the United States, data protection and privacy is governed by state and local law. New York State, for example, does not require employers to turn over personal files to employees. In addition, New York State is a "one-party" consent state, so employers do not need to disclose the fact that they are monitoring their employees or recording and/or storing communications made over systems owned by the employer.

2. The General Data Protection Regulation ("GDPR") will take direct effect in all EU member states on May 25, 2018. In the United Kingdom, the GDPR will replace the Data Protection Act of 1998, the law that is currently in effect to protect employees' personal information.

3. Currently, under the Data Protection Act, employers must generally comply with basic standards to ensure they are collecting only the minimum amount of information necessary on job applicants and employees, that such information is maintained securely and that individuals have access to their information upon request (similar to HIPAA in the United States). Employees must be aware of the nature and source of any information that is stored about them, how it will be used and to whom it will be disclosed.

4. Some of the key components of the GDPR include: (i) requiring the express consent of individuals for data processing or other lawful grounds for processing data; (ii) requiring firms to establish detailed policies and controls for collecting, storing and processing personal data to enable them to demonstrate

compliance with GDPR to their supervisory authorities; (iii) requirements applicable to collection and storage of data, such as data minimization (i.e., limiting data storage to what is necessary for the purposes of processing) and storage limitation (keeping personal data in identifiable form only for as long as necessary for the relevant purpose); (iv) data breach notifications regime; and (v) requiring certain companies to appoint a data protection officer to oversee GDPR compliance (also very similar to HIPAA in the United States). A non-EU company that offers its goods or services to EU ''data subjects'' (i.e., individuals) or monitors behavior of such EU data subjects is subject to the GDPR.

5. The GDPR also drastically increases fines for breaches. Under the current Data Protection Act, an employer can be fined up to £500,000 for a breach (although the majority of fines imposed have been significantly lower). Under the GDPR, an employer can be fined an amount which is the higher of €20 million or 4 percent of total worldwide turnover for a breach.

I. MiFID II — Telephone Recording

From Jan. 3, 2018, FCA-authorized investment managers are required to record all telephone calls and electronic communications relating to execution of investment transactions (subject to limited exemptions applicable to certain private equity business). In addition, such firms are required to monitor the telephone and electronic communications for, among other things: (i) compliance with the internal policies on recording; and (ii) any evidence of market abuse. Firms subject to these obligations may wish to review their HR policies or compliance manuals to ensure that their staff members have notice of such recording and monitoring and have no expectation of privacy when using the equipment that the firm has permitted to be used for such communications.

III. Trading Compliance — Short Sale Marking Requirements

A. Regulation SHO

1. Rule 200(a) of Regulation SHO defines a "short sale" as any sale of a security which the seller does not own or which is consummated by the delivery of a security borrowed by, or for the account of, the seller.

2. Rule 200(c) further provides that a person shall be deemed to own a security only to the extent that the person has a net long position in such a security.

3. Marking Done at Asset-Owner Level. The term "seller" generally refers to the titled owner of the asset and not the manager making investment decisions.

    (a) An investment adviser to more than one fund should mark sales as "long" or "short" based on the relevant fund's position in the security on a fund-wide basis, without considering the position of other entities also managed by the adviser.

    (b) In marking sales as "long" or "short," a seller must aggregate, and thus calculate on a net basis, its various long and short positions across all strategies in the fund and across multiple prime brokers (unless intending to make delivery of borrowed securities) in order to determine whether the seller has a net long or short position in the subject security.

4. Short Against the Box. A sale in connection with the establishment of a boxed position or the sale of the long portion of a boxed position would each constitute a short sale for purposes of Regulation SHO.

5. Borrowed Securities Determine Marking. Even where a seller is net long the securities sold, it will be required to be marked short where the seller intends to make delivery with borrowed securities.

6. Broker-dealers are required to mark all sell orders as "long" or "short" under Rule 200(g). While the order marking requirements of Rule 200(g) apply to broker-dealers and not their customers, SEC Rule 10b-21 states that it shall be a "manipulative or deceptive device or contrivance" for any person to submit an order to sell an equity security if such person deceives a broker-dealer, a participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security on or

before the settlement date, and such person fails to deliver the security on or before the settlement date.

B. EU Short Selling Regulation

1. The EU Short Selling Regulation ("SSR") implemented a harmonized regime to regulate the short selling of shares of companies with shares admitted to trading on an EU trading venue (other than certain dual-listed shares primarily traded on a non-EU venue), EU sovereign debt instruments and sovereign credit default swaps.

2. The disclosure/transparency regime under the SSR applies to any person anywhere in the world holding a short position in EU shares or sovereign debt and covers net short positions held through derivatives and indices references to shares and sovereign debt.

3. Net short positions of 0.2 percent (and each 0.1 percent above that) of the share capital of the issuer must be notified to the local EU regulator for the market. Net positions of 0.5 percent (and each 0.1 percent above that) must be disclosed publicly.

4. Net short positions in sovereign debt of EU issuers must be disclosed to the relevant EU regulator if the following thresholds are crossed: (i) 0.1 percent if the total amount of outstanding debt is less than €500 billion; and (ii) 0.5 percent if the outstanding debt is more than €500 billion. Thresholds for each issuer are published on ESMA's website on a quarterly basis.

C. MiFID II Transaction Reporting

1. MiFID II expands the scope of instruments that are subject to the transaction reporting obligation, as well as the information to be reported. The transaction reporting obligations will apply to all EU firms authorized under MiFID.

2. The number of data fields in transaction reports has increased from 23 to 65. This includes a designation of whether a transaction is a short sale under the SSR. Note, however, that the Short Selling Indicator is not applicable where the traded instrument is an index or a derivative, such as a CFD, an options/futures contract, a CDS, etc.

IV. Payments for Research

A. General

1. MiFID II will eliminate the ability of certain EU asset managers to pay for research services together with executions through a bundled commission payment and, instead, requires them to pay for research separately from execution services, either through direct payments from asset managers' own funds, separate research payment accounts ("RPA") funded by clients assets, or a combination of the two.

2. On Oct. 26, 2017, the SEC, after consulting with European regulators and the European Commission, published three temporary no-action letters providing U.S. broker-dealers and investment advisers relief in the conduct of their business activities with entities subject to MiFID II, which went into effect on Jan. 3, 2018.

B. Implications for Investment Advisers

1. The no-action relief allows investment advisers to continue to rely on the "soft dollar" safe harbor provided by Section 28(e) of the Exchange Act when the adviser makes payments for research to an executing broker out of client assets — alongside payments to the executing broker for execution — with the research payments credited to an RPA, administered either by the executing broker or a third-party administrator.

2. This no-action relief will only apply if the following four conditions are satisfied:

   (a) The asset manager makes payments to the executing broker-dealer out of client assets for research alongside payments through an RPA to that executing broker-dealer for execution;

(b) The research payments are for research services that are eligible for the safe harbor under Exchange Act Section 28(e);

(c) The executing broker-dealer effects the securities transaction for purposes of Exchange Act Section 28(e); and

(d) The executing broker-dealer is legally obligated by a contract with the asset manager to pay for research through use of an RPA.

3. In coordination with the SEC no-action relief, the European Commission provided the following additional clarifications:

(a) EU managers and Third-Country Delegates may continue making combined payments for research and execution as a single commission to third-country broker-dealers, as long as the payment attributable to research can be identified separately; and

(b) In the absence of a separate research invoice from a third-country broker-dealer, the EU manager or Third-Country Delegate should consult with the broker-dealer or other third parties with a view to determining the charge attributable to the research. In this case, the manager must also ensure that the supply of and charges for those benefits or services should not be influenced or conditioned by the levels of payment for execution services.

V. U.S. Customer Protection Rules

A. Regulatory Framework

1. The Customer Protection Rule. SEC Rule 15c3-3 requires a broker-dealer to maintain possession or control of the customer's fully paid and excess margin securities with a value greater than 140 percent of the customer's debit balance and segregate those securities from the broker-dealer's proprietary securities. In addition, U.S. broker-dealers are required to deposit the excess of free credit balances over margin loans receivable in a special customer reserve account.

2. Rehypothecation. 15c3-3 limits the extent to which a broker can rehypothecate a client's assets. Brokers can rehypothecate assets to the value of 140 percent of a client's liability to a prime broker, but all of the funds borrowed that are secured by a customer's securities is a credit in the reserve formula, increasing the amount on deposit in the reserve account.

B. Securities Investor Protection Act and Bankruptcy Protection

1. The Securities Investor Protection Act ("SIPA") created the Securities Investor Protection Corporation ("SIPC"), which is responsible for restoring funds and securities to investors from financially troubled broker-dealers. The value of the insurance isn't the critical function of SIPA, rather it's that SIPA provides that customer claims have a priority over segregated securities and the reserve account deposits.

2. Under a SIPA liquidation, the broker's customer assets are divided on a pro rata basis, with assets distributed in proportion to the size of claims. If there are insufficient assets in the customer estate to satisfy claims, SIPC's reserve funds are used to supplement the distribution, up to a maximum of $500,000 per customer.

3. SIPA proceedings favor the return of securities to customers, whereas liquidation under Chapter 7 requires the trustee to sell the securities and distribute cash to customers. In either case, customer property is pooled, and if the total pool is not sufficient to pay the customers' aggregate net equity claims, customers share pro rata in the proceeds based on their respective net equity claims.

VI. U.K. Customer Protection Rules

A. Regulatory Framework

1. Protection of Client Assets. When assets are held by the broker-dealer but the client retains title, firms cannot comingle customer assets with firm assets. However, if title is transferred under a title transfer

collateral arrangement ("TTCA"), the broker-dealer may use the assets subject to any contractual limitations.

2. No Rehypothecation Limits. There are no statutory limits on the value of assets that the prime broker can rehypothecate or how much money it can raise from using those assets, although the Client Asset Sourcebook ("CASS") rules require explicit contractual rights to use assets that remain client assets.

B. Prime Broker Default

1. Assuming a TTCA is in place, customers only have to have unsecured contractual claims for their assets to be returned.

2. Unsecured liabilities are either canceled or converted to equity under a Prudential Regulation Authority bail-in.

C. Client Money Rules

1. Asset managers, brokers, custodians and other types of investment firms must comply with the FCA's custody rules to the extent they hold non-cash assets for clients.

2. Investment firms conducting regulated activities that could have them holding cash for clients (e.g., subscription or redemption proceeds) must comply with the FCA's client money rules.

D. Critically, local insolvency regimes control EU bank insolvency claims processes, so a German or French bank operating from a London branch will still be subject to a German or French insolvency regime.

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Harry focuses his practice on complex commercial litigation and regulatory matters for financial services industry clients, including hedge funds, funds of funds and private equity funds, prime and clearing brokers, introducing brokers and interdealer brokers and auditors and administrators. He has substantial experience in both securities regulatory matters and private litigation, including investigations by the SEC, U.S. Attorneys' offices, DOJ, CFTC, FTC, state attorneys general, state securities regulators and self-regulatory organizations. Harry has litigated numerous cases in federal and state courts throughout the United States, including his recent victory for an inter-dealer broker in an arbitration brought by one of its competitors for alleged misappropriation of trade secrets as well as in a four-and-a-half month jury trial in a raiding case, and his successful representation of a prime broker in a hotly contested and 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 US* 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 co-authored an article titled "Second Circuit, in Split Decision, Overrules Limitation on Insider Trading Liability Established in *U.S. v. Newman*," published in *The Hedge Fund Journal*. 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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Doug represents clients in high-profile civil and criminal proceedings, as well as investigative matters. He 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* and *The Legal 500 US*. A highly sought-after thought leader, he has spoken and written widely on key industry topics, including current trends in financial regulation and enforcement and securities laws violations. Most recently, he was quoted in the article “Execution Enforcement Actions Escalate,” published in *The Hedge Fund Journal*.

Doug received his J.D. from Columbia Law School, where he was managing editor of *Columbia Human Rights Law Review*, and his B.A. from Earlham College.

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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 has spoken at industry events covering insider trading and other regulatory compliance and enforcement issues for private investment funds. Most recently, he co-authored “Second Circuit, in Split Decision, Overrules Limitation on Insider Trading Liability Established in *U.S. v. Newman*,” published in *The Hedge Fund Journal* and the “Market Manipulation” chapter in the leading treatise *Federal Securities Exchange Act of 1934* (Matthew Bender). In addition, he authored the “Big Boy Letters” chapter in the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute) and “Managing and Resolving Hedge Fund and Private Equity Fund Disputes,” in *Corporate Disputes*.

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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 counseled a range of companies, including hedge funds, private equity funds, banks, broker-dealers and money services businesses on AML and OFAC compliance, and other regulatory issues. As a federal prosecutor for nearly a decade, Seetha spearheaded and oversaw the 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.

The Legal 500 US has recognized Seetha as a leading lawyer. 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 was recently interviewed by *Financier Worldwide* on tackling fraud and money laundering within financial institutions and for that magazine, she co-authored "Should Lawyers be Required to Investigate Their Own Clients?" In addition, Seetha co-authored "Sanctions Update: Russia, Iran, North Korea and Venezuela" and "Sanctions and AML Update: North Korea and Venezuela," both published in *The Hedge Fund Journal*.

Seetha earned her J.D. from Columbia Law School and her B.A., *magna cum laude*, from Brown University.

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Craig is co-chair of the 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 advises clients on securities trading matters and, when necessary, represents them in regulatory investigations and enforcement actions by the SEC, DOJ, FINRA and other self-regulatory organizations and state regulators. Craig leads training sessions for clients on complying with insider trading and market manipulation laws and assists hedge funds and private equity funds in connection with SEC examinations. Craig also has experience representing entities and individuals under investigation for, or charged with, securities fraud, mail/wire fraud, accounting fraud, money laundering, Foreign Corrupt Practices Act (FCPA) violations and tax offenses. In his previous roles in the U.S. Attorney's Office for the Eastern District of New York and the SEC, Craig prosecuted numerous complex and high-profile securities fraud, accounting fraud and insider trading cases.

Craig is recognized as a leading litigation lawyer in *Benchmark Litigation: The Definitive Guide to America's Leading Litigation Firms and Attorneys*, *The Legal 500 US* and *New York Super Lawyers*. He is a former law clerk to the Honorable Lawrence M. McKenna of the U.S. District Court for the Southern District of New York. Craig has written about enforcement actions against hedge funds and other industry-related topics, and has spoken on attorney-client privilege. Most recently, he was interviewed for the article "Execution Enforcement Actions Escalate," published in *The Hedge Fund Journal*.

Craig received his J.D., *cum laude*, from Benjamin N. Cardozo School of Law and his B.A. from the University of Michigan.

Enforcement

I. Key Personnel Changes

A. New SEC Chairman: Jay Clayton

Mr. Clayton is a former partner at Sullivan & Cromwell, where he specialized in merger and acquisition transactions and capital market offerings.

B. New CFTC Chairman: J. Christopher Giancarlo

Mr. Giancarlo served as acting chair from January 2017 until his confirmation in August 2017. He is the former executive vice president of GFI Group, a financial services firm, and a former partner at Brown Raysman Millstein Felder & Steiner.

C. New SEC Division of Enforcement Directors: Stephanie Avakian and Steven Peikin

1. Ms. Avakian was named co-director of the SEC's Division of Enforcement in June 2017 after serving as acting director since December 2016, and deputy director since 2014. She is a former partner at Wilmer Cutler Pickering Hale and Dorr.

2. Mr. Peikin worked from 1996 to 2004 as an assistant U.S. attorney for the Southern District of New York. He is also the former managing partner of Sullivan & Cromwell's Criminal Defense and Investigations Group.

D. New CFTC Division of Enforcement Director: James McDonald

Mr. McDonald assumed his new role in April 2017 after serving as an assistant U.S. attorney for the Southern District of New York.

E. New SEC New York Regional Office Director: Marc Berger

Mr. Berger is the former global co-head of Ropes & Gray's Securities and Futures Enforcement Practice. Prior to his work at Ropes & Gray, Mr. Berger spent 12 years as an assistant U.S. attorney for the Southern District of New York.

II. Enforcement Priorities

A. Enforcement and Investigation Statistics

1. SEC Enforcement Division Statistics

(a) In 2017, the SEC Enforcement Division initiated a total of 754 actions, compared with 868 in 2016.[1]

(i) This drop-off is not as precipitous as it initially looks. As the SEC report notes, an operation targeted at municipal bond offerings was concluded in FY 2016. Excluding these initiatives, there were 784 total actions initiated in 2016.

(ii) Actions against private funds have decreased, but only slightly. While there were 98 such actions in 2016, there were 91 in 2017.

(b) Actions involving investment advisory issues, securities offerings and issuer reporting/accounting and auditing accounted for roughly 60 percent of the total in 2017. Market manipulation and insider trading were about 20 percent of all actions.

(c) Broker-dealer actions actually increased from 2016 to 2017, accounting for roughly 10 percent of SEC Enforcement actions in 2017.[2]

[1] *See* SEC, Division of Enforcement, Annual Report 2017, *available at* https://www.sec.gov/files/enforcement-annual-report-2017.pdf.

2. CFTC Enforcement Statistics

In FY 2017 the CFTC brought 49 actions,[3] as compared with FY 2016's 68.[4] Forty percent of FY 2017's actions focused on retail fraud.[5]

3. FINRA Statistics

No complete report has been issued yet comparing 2017 statistics with 2016 statistics. However, based on reports of disciplinary and other FINRA actions, rates decreased slightly, on average, in 2017.[6]

B. Budgetary Constraints

1. The SEC budget allocation for FY 2017 was identical to that of FY 2016. This was the first time the budget was not increased since 2013, when a sequester was in place.
2. For FY 2018, the SEC budget is likely to decrease. This will be the first decrease since 2007, when the total budget was half of its current size.[7]
3. The CFTC's budget remained the same from FY 2016 to FY 2017.[8]

C. Pullback from "Broken Windows" Strategy

In October of 2017, co-director of the SEC Enforcement Division Peikin indicated the SEC would drop the "broken windows" strategy of pursuing many cases over even the smallest legal violations.

1. Speaking at a securities conference, Peikin said, "[I]t may be the case that we have to be selective and bring a few cases to send a broader message rather than sweep the entire field."[9]
2. He also noted that, "I think when people resolve cases with the commission [and] neither admit nor deny but agree to all the points of relief, I don't think most people in the world say, 'Boy, they really got away with that.'"

   In contrast, under former SEC Chair Mary Jo White, an Obama appointee, the SEC sought admissions of fault by firms and individuals in select cases, rather than allowing defendants to resolve probes by paying penalties while neither admitting nor denying the allegations.

D. Foreign Corrupt Practices Act

FCPA Cases

1. There has been speculation, since this time last year, that FCPA enforcement actions would decrease in 2017. That speculation proved to be correct, with only eight FCPA actions commenced in FY 2017 compared with the record high of 27 in FY 2016. However, the SEC and DOJ have continued to indicate that FCPA enforcement remains a top priority. SEC Chairman Clayton recently said that he views "combatting corruption" as "an important governmental mission."[10] At the DOJ, acting assistant attorney general Kenneth Blanco said in a speech in April 2017 that the DOJ "remains committed to enforcing the

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[2] *Id*.

[3] *See* CFTC Releases Annual Enforcement Results for Fiscal Year 2017, *available at* http://www.cftc.gov/PressRoom/PressReleases/pr7650-17.

[4] *See* CFTC Releases Annual Enforcement Results for Fiscal Year 2016, *available at* http://www.cftc.gov/PressRoom/PressReleases/pr7488-16.

[5] *See* CFTC Releases Annual Enforcement Results for Fiscal Year 2017, *available at* http://www.cftc.gov/PressRoom/PressReleases/pr7650-17.

[6] *See* FINRA, Enforcement Department, Monthly and Quarterly Disciplinary Actions, *available at* http://www.finra.org/industry/disciplinary-actions.

[7] *Id.*

[8] *See* CFTC, Budget Request 2018, *available at* http://www.cftc.gov/reports/presbudget/2018/.

[9] Dave Michaels, "SEC Signals Pullback from Prosecutorial Approach to Enforcement," *The Wall Street Journal*, Oct. 26, 2017, *available at* https://www.wsj.com/articles/sec-signals-pullback-from-prosecutorial-approach-to-enforcement-1509055200.

[10] United States House of Representatives Committee on Banking, Housing, and Urban Affairs, Nomination of Mr. Jay Clayton, March 23, 2017.

FCPA and to prosecuting fraud and corruption more generally."[11] Attorney general Jeff Sessions has delivered the same message, stating that the DOJ "will continue to strongly enforce the FCPA . . . ."[12]

2. Last year, we saw the DOJ institute a "Pilot Program" that was meant to reward voluntary self-disclosures with decreased fines. But even after the initial one year trial (and after a change in administration) the program remains in effect today.

3. It is widely debated whether the Pilot Program truly rewards cooperation, but one important takeaway is that even where the DOJ has declined to bring a case, the SEC has sought disgorgement. Disgorgement is specifically contemplated as a condition of declination, under the Pilot Program.

E. Focus on Main Street Investors

As a guiding principal, SEC Chairman Clayton has frequently emphasized ensuring protections for retail investors.

1. SEC Chairman Clayton's testimony on "Oversight of the U.S. Securities and Exchange Commission," Washington D.C., Sept. 26, 2017:

   (a) "In particular, I have asked the Division of Enforcement to evaluate regularly whether we are focusing appropriately on retail investor fraud and investment professional misconduct, insider trading, market manipulation, accounting fraud and cyber matters. I believe our Main Street investors would want us to focus on these areas."

   (b) "[Due to] advancements in OCIE's use of technology and other efficiencies, the SEC is on track to deliver a 30 percent increase in the number of investment adviser examinations this fiscal year — to approximately 15 percent of all investment advisers."

2. SEC Chairman Clayton's remarks at PLI's 49th Annual Institute on Securities Regulation, New York, NY, Nov. 8, 2017:

   (a) "[I]t is not clear whether in our rulemaking process, the views and fundamental interests of long-term retail investors are being advocated fully and clearly, either by individual investors or groups that represent them."

   (b) "I expect that our Enforcement Division will continue to be active in pursuing cases where hidden or inappropriate fees are at issue, but we also are exploring whether more can be done to clarify fee disclosures made to retail investors and, thereby, deter and reduce the opportunities for misbehavior."

3. The Retail Strategy Task Force[13]

   (a) Dedicated to developing effective strategies and methods to identify potential harm to retail investors.

   (b) Fraud aimed at retail investors has been under particular scrutiny, and with the implementation of the Task Force this is likely to continue throughout 2018.

   (c) Examples of 2017 enforcement actions with a direct impact on retail investors.

      (i) Thirteen individuals allegedly involved in two Long Island-based cold calling scams that bilked more than 100 victims out of more than $10 million through high-pressure sales tactics and lies about penny stocks.[14]

[11] Speech, Acting Assistant Attorney General Kenneth A. Blanco Speaks at the Atlantic Council Inter-American Dialogue Event on Lessons From Brazil: Crisis, Corruption and Global Cooperation, July 19, 2017.

[12] Speech, Attorney General Jeff Sessions Delivers Remarks at Ethics and Compliance Initiative Annual Conference, April 24, 2017.

[13] *See* SEC, Division of Enforcement, Annual Report 2017, *available at* https://www.sec.gov/files/enforcement-annual-report-2017.pdf.

(ii) Twenty-seven individuals and entities behind various alleged stock promotion schemes that left investors with the impression they were reading independent, unbiased analyses on investing websites while writers actually were being secretly compensated for touting company stock.[15]

(iii) Barclays Capital for charging improper advisory fees and mutual fund sales charges to clients, who were overcharged by nearly $50 million. The firm agreed to pay more than $97 million in disgorgement and penalties to settle the Commission's claims.[16]

(iv) Three New York-based brokers for allegedly making unsuitable recommendations that resulted in substantial losses to customers and hefty commissions for the brokers. One of the brokers agreed to pay more than $400,000 to settle the charges.[17]

F. Insider Trading

1. Insider trading remained a main focus of SEC enforcement actions in 2017.

(a) A partner at a Hong Kong-based private equity firm who allegedly amassed more than $29 million in illegal profits by insider trading in advance of the April 2016 acquisition of DreamWorks Animation SKG by Comcast.[18]

(b) A former government employee turned political intelligence consultant and three others for engaging in an alleged insider trading scheme involving tips of nonpublic information about government plans to cut Medicare reimbursement rates, which affected the stock prices of certain publicly traded medical providers or suppliers.[19]

(c) The SEC announced that it used data analysis to uncover a wide-reaching insider-trading scheme involving seven individuals — even though the traders allegedly used shell companies, code words and encrypted messaging to evade detection. Specifically, the SEC claimed that it was able to detect improbably successful trading across different securities over time, and thereby discovered the scheme.[20]

2. Major case law development in 2017: *United States v. Martoma*, 869 F.3d 58 (2d Cir. 2017).

(a) The Second Circuit held that "an insider or tipper personally benefits from a disclosure of inside information whenever [1] the information was disclosed 'with the expectation that [the recipient] would trade on it' . . . and [2] the disclosure 'resemble[s] trading by the insider followed by a gift of the profits to the recipient,' . . . whether or not there was a 'meaningfully close personal relationship' between the tipper and the tippee."

(b) The majority rejected adopting a categorical rule that an insider can never personally benefit from disclosing inside information as a gift without a "meaningfully close personal relationship." In doing

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[14] *See* SEC Announces Charges in Massive Telemarketing Boiler Room Scheme Targeting Seniors, July 12, 2017, *available at* https://www.sec.gov/news/press-release/2017-124.

[15] *See* SEC: Payments for Bullish Articles on Stocks Must Be Disclosed to Investors, April 10, 2017, *available at* https://www.sec.gov/news/press-release/2017-79.

[16] *See* Barclays to Pay $97 Million for Overcharging Clients, May 10, 2017, *available at* https://www.sec.gov/news/press-release/2017-98.

[17] *See* SEC Detects Brokers Defrauding Customers, Sept. 28, 2017, *available at* https://www.sec.gov/news/press-release/2017-180.

[18] *See* SEC Charges Chinese Citizens Who Reaped Massive Profits From Insider Trading on Comcast-Dreamworks Acquisition, Feb. 10, 2017, *available at* https://www.sec.gov/news/pressrelease/2017-44.html.

[19] *See* SEC Files Charges in Trading Scheme Involving Confidential Government Information, May 24, 2017, *available at* https://www.sec.gov/news/press-release/2017-109.

[20] *See* SEC Uncovers Wide-Reaching Insider Trading Scheme, Aug. 16, 2017, *available at* https://www.sec.gov/news/press-release/2017-143.

so, the Second Circuit panel in *Martoma* expressly overruled another panel's decision on this point in *United States v. Newman.*[21]

(c) Nothing in *Martoma* undercuts the requirement that a tippee must know or have reason to know that the tipper received a legally cognizable personal benefit (whatever that benefit might be) in exchange for the tip, one of the core holdings in *Newman*.

(d) However, regulators and prosecutors are still relying on the "conscious avoidance" doctrine to establish liability.

(i) *United States v. Goffer*, Nos. 10-cr-56-1 (RJS), 10-cr-56-2 (RJS), 2017 WL 203229 (S.D.N.Y. Jan. 17, 2017).

(1) Conscious avoidance was proven on the basis that defendant "was aware of the characteristics of the conspiracy's sources, namely, that they were attorneys or similarly situated insiders." The Court noted that defendant was familiar with usage of many merger and deal-related terms because he explained them to clients. The Court used recorded conversations in which defendant refused to talk about certain topics on the phone against him, and that he took many in-person meetings with the parties involved.

(2) "The nature of the information Kimelman received, the frequency with which he received it, and his clandestine behavior when discussing or trading on this information completely undermine the hypothetical suggestions set forth in Kimelman's briefs of possible nonculpable sources for the tips, such as 'a fellow subway passenger who was unguardedly reviewing deal documents on his morning commute,' 'a neighbor who carelessly discarded confidential documents in their building's trash,' or a lawyer friend 'commiserating about work.' More to the point, a reasonable juror would have inferred from this evidence that Kimelman did not believe he was receiving inadvertently disclosed information, but rather that he knew he was receiving inside information from a lawyer or similarly situated professional who would face grave consequences if caught breaching a duty of confidentiality."

(ii) *United States v. Flom*, 256 F. Supp. 3d 253 (E.D.N.Y. Jun. 13, 2017).

This case articulates clearly that a conscious avoidance charge is appropriate where (i) the defendant asserts the lack of knowledge required for conviction; and (ii) there is a sufficient factual predicate for the charge. To prove that a sufficient factual predicate exists, the government must provide enough evidence for a rational juror to conclude beyond a reasonable doubt that (i) defendant was aware of a high probability that the securities involved in the UC Scheme were fraudulent (the "probability requirement"); and (ii) defendant consciously avoided confirming that fact (the "conscious avoidance requirement").

3. Big Data and Web Scraping

(a) Analysis of big data, some gathered through web scraping, to assist in investment decisions is an increasingly common practice for fund managers.

(b) Potential issues under federal and state law

(i) First, fund managers who obtain or receive data collected as a result of web scraping might come into possession of MNPI, or information that, when aggregated, could be considered MNPI. Risks arise if the information was provided in violation of a confidentiality obligation. Trading while in possession of such information could conceivably lead to liability under the "misappropriation theory" of insider trading, which holds that a person commits fraud in connection with a securities transaction — and thereby violates Section 10(b) of the Exchange

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

Act and SEC Rule 10b-5 — when he, she or it misappropriates confidential information for securities-trading purposes in breach of a duty owed to the source of the information. The source need not be an insider of the issuer whose securities are being traded.

(ii) Second, if the data were collected in a manner considered "deceptive," then there is a risk that trading on that information may be considered part of a fraudulent scheme in violation of the antifraud provisions under the securities laws. Behavior in violation of a duty not to mislead may violate these provisions even when the trader is under no duty to the source of the information. For example, if a manager or its agent circumvents security protocols, disguises or fails to reveal a scraper's identity on a site (where required), or otherwise deceives a website into allowing access to the site, these might be viewed as affirmative misrepresentations constituting a "deceptive device" under Section 10(b) and Rule 10b-5, which could form the basis for such a fraud claim.

(iii) Finally, even where data collectors fully comply with the terms of a site's agreements and its security protocols, state attorneys general may raise concerns under state laws about practices that take "unfair advantage" of access to information and practices that are against public policy generally.

4. "Material Fact" vs. "Guessing": Is There a Difference?

   There is a legal distinction between guessing or speculating, on the one hand, and a material fact, on the other hand, although the distinction often does not deter regulators from investigating or pursuing an insider trading charge.

   (a) *SEC v. Carroll*, 9 F. Supp. 3d 761 (W.D.K.Y. 2014) (summary judgment denied; defendant argued that tipper had communicated his "hunch" that the acquisition would occur).

   (b) *SEC v. Steffes*, Case No. 1:10-cv-06266 (N.D. Ill. Jan. 27, 2014) (verdict entered for defendant; defendant argued that he pieced together for himself what was occurring regarding a corporate transaction based on what was available to him as an employee of the company).

   (c) David Sokol Matter (2013) (SEC announced that it would not pursue insider trading charges; unclear whether corporate executive, in fact, had knowledge of the deal-making process).

5. The *Deerfield* Matter

   (a) On May 24, 2017, the U.S. Attorney's Office for the Southern District of New York and the SEC announced insider trading charges relating to a scheme in which a federal government employee is alleged to have provided confidential information involving Medicare and Medicaid reimbursement rate decisions to a political intelligence consultant, who in turn relayed the information to a hedge fund, Deerfield Management Company, that allegedly reaped $3.9 million in gains from trades made on the basis of the illicit information.[22]

   (b) The SEC's order found that Deerfield was on notice that the political intelligence analyst might be conveying MNPI. An email from the analyst said that he "heard from a reliable CMS source" that CMS was about to issue a regulation, and an internal Deerfield email noted that the analyst "has a guy" at a "closed-door" government meeting. From at least May 2012 to November 2013, Deerfield generated more than $3.9 million in trading profits based on MNPI from the political intelligence analyst. Through its management agreements with the hedge funds, including performance-based compensation, Deerfield received approximately $714,110 due to these trades.

[22] *See* Four Charged in Scheme to Commit Insider Trading Based on Confidential Government Information, DOJ, May 24, 2017, *available at* https://www.justice.gov/usao-sdny/pr/four-charged-scheme-commit-insider-trading-based-confidential-government-information.

(c) Deerfield Management agreed to pay $4.8 million to settle the charges without admitting or denying the findings.[23]

G. Electronic Communication and Cybersecurity

1. In September 2017, the SEC announced the establishment of the Cyber Unit, which targets cyber-related misconduct including:[24] [25]

(a) Hacking to obtain MNPI.

(b) Violations involving distributed ledger technology and initial coin offerings.

(c) Cyber-related threats to trading platforms and other market infrastructure.

(d) Market manipulation schemes involving false information spread through electronic media.

(e) Misconduct perpetrated using the dark web.

(f) Intrusions into brokerage accounts.

(g) 2017 SEC actions relating to cyber misconduct:

(i) Three Chinese traders for allegedly trading on hacked, nonpublic, market-moving information stolen from two prominent law firms, making almost $3 million in illegal profits; and[26]

(ii) A Virginia-based mechanical engineer for allegedly scheming to manipulate the price of Fitbit stock by making a phony regulatory filing.[27]

2. Electronic Communications

A recent "Information Request List" being used by OCIE focusing on the use of electronic communications by advisers and their employees recently became public. The list asks an adviser for: descriptions of how the adviser and its employees used electronic messaging services and through which devices; adviser's policies and procedures related to electronic messaging, including how an adviser monitors electronic messaging (e.g., exception/activity reports); the identities and responsibilities of those who oversee those policies and procedures; documentation as to any instances of unauthorized use of electronic messaging and adviser's actions in connection therewith; and summaries of any internal audits or compliance reviews in connection with electronic messaging. Information Request List items in broader examinations will overlap with many of these requests, even if electronic communications are not the sole focus of those examinations.

H. Cross Trades

1. In the current climate emphasizing complete, accurate and effective disclosure, principal trades and agency cross trades are under particular scrutiny.

Example Cases

(a) *Calvert Investment Management, Inc. ("Calvert")*, Admin. Proc. File No. 3-17630 (Oct. 18, 2016).

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[23] *See* Hedge Fund Adviser Charged for Inadequate Controls to Prevent Insider Trading, Aug. 21, 2017, *available at* https://www.sec.gov/news/press-release/2017-146.

[24] *See* SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors, Sept. 25, 2017, *available at* https://www.sec.gov/news/press-release/2017-176.

[25] *See* SEC, Division of Enforcement, Annual Report 2017, *available at* https://www.sec.gov/files/enforcement-annual-report-2017.pdf.

[26] *See* Chinese Traders Charged with Trading on Hacked Nonpublic Information Stolen from Two Law Firms (Dec. 27, 2016), *available at* https://www.sec.gov/news/pressrelease/2016-280.html.

[27] *See* SEC Charges Fake Filer with Manipulating Fitbit Stock (May 19, 2017), *available at* https://www.sec.gov/news/press-release/2017-107.

(i) Administrative order and settlement concerning Calvert, a registered investment adviser that caused RIC advisory clients to cross trade bond instruments (in addition to unrelated failures to accurately value bond instruments that resulted in Calvert being overpaid inflated asset-based fees or to properly remediate issues arising out of valuation problems for investors).

(ii) Cross trade issue was third and least significant aspect of the order.

(iii) Calvert caused the advised funds to violate Section 17(a) of the Investment Company Act by engaging in cross trades without complying with Rule 17a-7(e), which requires, among other things, that cross trade transactions be reported to and evaluated by a Fund's board of directors.

(iv) Calvert was also found to have violated Section 206(2) and (4) of the Advisers Act, and Rule 206(4)-8 thereunder, as well as Section 34(b) of the Investment Company Act, although each of those violation findings seems to have been in connection with the unrelated issues concerning the firm's NAV determinations.

(v) Calvert paid a $3.9-million monetary penalty and agreed to undertakings related to NAV reprocessing and distributions to accountholders as a result of NAV reprocessing.

(b) Aviva Investors Americas, successor to Aviva Investors North America ("AINA"), Admin. Proc. File No. 3-17567 (Sept. 3, 2016).

(i) Administrative order and settlement concerning AINA, a registered investment adviser that arranged cross trade transactions between RIC advisory client accounts, using broker-dealer as intermediary.

(ii) AINA caused registered investment company clients to conduct trades with affiliates in violation of Section 17(a) of Investment Company Act and conducted principal trades in violation of Section 206(3) of Advisers Act.

(iii) AINA interposed third-party broker-dealers into sale and repurchase transactions, which were completed overnight. The sale/repurchase transactions involved the same security, same quantity and the same price, but with a 1/8 tick markup collected by the broker-dealer. An agreement or understanding was formed between AINA and the non-affiliated broker whereby AINA agreed to repurchase the securities prior to the sale to the broker.

(1) Transactions did not qualify for Rule 17a-7 exemption because the affiliation between the clients did not arise solely due to having a common investment adviser, because the sole shareholder of the registered investment company whose clients traded was under common control with AINA. AINA's internal cross trading policy prohibited transactions under these circumstances.

(2) Even if the transactions were eligible under Rule 17a-7, they did not comply with Rule 17a-7 because they were not at the rule's mandated price (the sale/buybacks were at the same price, and independent bids were not evaluated to find the market price under the rule), and because they were made through broker-dealers that received remuneration for the transactions.

(3) Principal trades were between AINA advisory clients and insurance clients owned by Aviva plc, AINA's parent company. Because no written notification and consent were obtained from investors on a per-transaction basis for the principal trades, AINA violated Section 206 of the Advisers Act. AINA's internal policies permitted principal transactions only if the clients consented and the CCO of AINA approved it.

(iv) AINA failed to adopt and implement adequate policies and procedures to prevent unlawful cross and principal trading.

(v) AINA's compliance policy required that sale/buyback trades within a three-day period would be reviewed to ensure no violations occurred. AINA failed to detect/prevent these transactions because the review function had been delegated to a low-level administrative assistant without proper training, who looked only for same-day sale/buybacks. A trader also asked if a cross trade was permissible using a broker-dealer as intermediary, and was told that the trades were permitted as long as there was "best execution" and "pricing documentation."

(vi) AINA paid a $250,000 civil monetary penalty. AINA also was required to retain a compliance consultant to enhance detection and understanding for cross trading and principal transactions.

2. Principal trades and agency cross trades are generally prohibited in the absence of disclosure and prior client consent.

3. A sale coupled with an agreement to repurchase may constitute a cross trade.

4. SEC's Division of Enforcement is currently conducting non-public inquiries regarding cross trading of a number of different investment managers. Those inquiries are being conducted jointly by the asset management unit and the complex financial products unit.

I. Expense Allocation Policies

1. These policies have been an area of focus in 2017 and this trend will continue in 2018.

2. Misallocated "broken-deal" expenses

Platinum Equity Advisors[28]

(a) Settled action against investment adviser for charging three of its private equity fund clients with about $1.8 million in undisclosed fees.

(b) From 2004 to 2015, three private equity funds invested in 85 companies, in which co-investors connected with Platinum also invested. During this time, Platinum incurred expenses related to potential fund investments that were not ultimately made. While the co-investors participated in Platinum's successful transactions and benefited from Platinum's sourcing of private equity transactions, Platinum did not allocate any of the broken-deal expenses to the co-investors. Instead, it allocated all broken-deal expenses to the private equity funds even though the agreements governing the funds did not disclose that the funds would be responsible for anything other than their own expenses.

(c) The Commission found that from Q2 2012 to 2015, the private equity funds were allocated over $1.8 million in broken-deal expenses that were not disclosed in the fund agreements. In addition, Platinum did not adopt and implement a written compliance policy or procedure governing its broken-deal expense allocation practices.

J. "Cherry-Picking": allocating favorable trades to accounts where an adviser receives higher fees.

Licht & Howarth and Howarth Financial Services Orders[29]

1. Settled charges against two investment advisers who agreed to be banned from the securities industry and were ordered to collectively pay more than $480,000 after the agency uncovered their separate illegal cherry-picking schemes through data analysis.

2. Jeremy Licht, a California registered investment adviser doing business as JL Capital Management, and Gary Howarth, the owner and sole employee of his Oregon-based advisory firm, Howarth Financial

[28] *See* Platinum Equity Advisors, LLC, Inv. Advisers Act Release No. 4772, Sept. 21, 2017, *available at* https://www.sec.gov/litigation/admin/2017/ia-4772.pdf.

[29] *See* Investment Advisers Cheated Their Clients By Cherry-Picking Trades, Sept. 12, 2017, *available at* https://www.sec.gov/litigation/admin/2017/34-81584-s.pdf.

Services, cherry-picked profitable trades for their personal accounts to the detriment of their clients' accounts. The SEC's analysis showed that for a certain time there was less than a one-in-a-trillion chance that the outsized performance of Licht's personal account, compared to that of his clients' accounts, was due to chance, and that there was less than a one-in-a-billion chance that the difference between Howarth's returns and those of his clients was due to chance. The SEC also found that Licht falsely represented in his Forms ADV that no account would be favored over another as a result of the allocation of orders placed in the omnibus account, and that Howarth admitted in testimony to breaching his fiduciary duty to his clients when making preferential allocations of certain trades.

3. Data analytics being used to identify cherry-picking schemes.

CLOs, Warehouse Facilities and Risk Retention Vehicles

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Most recently, Jennifer was named among the world's "50 Leading Women in Hedge Funds" by *The Hedge Fund Journal*. A member of the board of directors of 100 Women in Finance, Jennifer is recognized by *The Legal 500 US, 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 attracting and retaining capital, operational due diligence, compliance issues, hedge funds and management company structures and considerations for emerging hedge fund managers.

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Craig earned his J.D., *cum laude*, from the University of Pennsylvania Law School and his undergraduate degree, *cum laude*, from Colgate University.

CLOs, Warehouse Facilities and Risk Retention Vehicles

I. Overview of U.S. Risk Retention[1]

A. "Securitizers" of asset-backed securities are required to retain 5 percent of the credit risk of the collateral.

1. Standard forms of retention interests include "eligible horizontal residual interests" and "eligible vertical interests."

   (a) Eligible horizontal residual interests must have the most subordinate claim to payments.

   (b) Eligible vertical interests must include each class of interests in an ABS transaction.

2. Sponsors may retain a combination of eligible horizontal residual interests and eligible vertical interests that combine to equal at least 5 percent.

B. Pledging or transferring any risk retention interest is generally prohibited.

1. Exception for majority-owned affiliates of the sponsor.

   (a) Majority-owned affiliates must be directly or indirectly majority controlled or under common majority control with the sponsor.

   (b) For risk retention purposes, majority control is ownership of more than 50 percent of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined under GAAP.

2. The sponsor or permitted affiliate may also pledge the retained interest as collateral for an obligation that is full recourse to the sponsor or affiliate.

II. Overview of EU Risk Retention[2]

Institutional investors in the European Economic Area may not be exposed to the credit risk of any "securitization" unless any of the sponsor, originator or original lender retains at least 5 percent of the securitized exposures.

A. The securitizer can use alternative methods to comply with EU risk retention depending on whether the retention holder is contemplated as the "sponsor" or "originator" of the transaction.

B. An entity must have the appropriate permissions under MiFID and "establish" and "manage" a securitization in order to be treated as a "sponsor" under EU risk retention rules.

C. If a securitization has multiple "sponsors," the retention interest may either be held in part by each sponsor in proportion to the number of sponsors or in full by one sponsor whose economic interest is most aligned with that of investors (as determined by the sponsors using objective factors like fee structures and credit risk exposure).

D. Under EU risk retention rules, an entity is an "originator" if it either:

1. Originates obligations in the primary market; or

2. Acquires obligations in the secondary market for its own account and securitizes them.

   (a) An "originator" must acquire loans "for its own account," for instance by entering into purchase contracts directly with brokers or sellers in the secondary market.

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[1] Credit Risk Retention, 17 C.F.R. § 246 (2014).

[2] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

(b) If a CLO has multiple originators, the retention requirement may be fulfilled by an originator who established the CLO and either contributed more than 50 percent of the total exposure or is managing the CLO.

3. Non-compliant transactions cannot be sold to EU institutional investors, but may be sold to other investors not addressed by the EU risk retention rules.

   Question of how detrimental the loss of liquidity and marketability would be.

4. Many structures have developed to allow securitizations to comply with EU risk retention, particularly the C-MOA structure discussed below.

III. Risk Retention Rules Differ as Between the United States and the European Union

A. U.S. rules apply to sponsors or securitizers, whereas EU rules apply to investors.

B. The term "sponsor" has a different meaning in U.S. rules as compared to EU rules.

   The term "sponsor" in U.S. rules has a meaning akin to the meaning of the term "originator" in EU rules.

C. U.S. rules apply to "securitization transactions," whereas EU rules apply to "securitizations," the definition of which differs substantially.

   The presence of tranches and/or subordination is an element in the EU rules definition, but not in the U.S. rules definition.

D. EU rules allow for a retention interest consisting of a random sample of the securitized exposures, whereas there is no equivalent allowance in the U.S. rules.

E. U.S. rules allow for a sunset mechanism to terminate the restrictions on hedging and transfer of the retention interests in certain cases, whereas the EU rules do not.

IV. Initial Effects of Risk Retention

A. Increased capital requirements for each transaction have increased the capital requirements for the CLO industry at large.

   1. Many CLO managers have attempted to raise risk retention capital from outside investors.

   2. Certain banks and financial institutions have begun lending money to CLO managers to purchase retention interests.

B. Uncertain whether new rules have improved the asset quality of collateral in ABS transactions.

V. Risk Retention Rules Update

A. Future implementation of U.S. risk retention regulation is uncertain.

   1. The LSTA lawsuit to invalidate the risk retention regulation for CLOs is pending a decision in the D.C. Circuit of the U.S. Court of Appeals.[3]

      (a) Question of statutory authority to impose risk retention rules on CLO managers if they are not considered "securitizers" for risk retention purposes.

      (b) Question of whether requiring 5 percent of the fair market value of a CLO rather than 5 percent of the credit risk is a misapplication of the statute.

   2. The U.S. Treasury Report proposes to maintain the risk retention requirement for CLOs, but also said that there should be an exemption for CLOs that meet certain asset quality requirements.[4]

[3] Loan Syndications & Trading Association v. Securities and Exchange Commission, 223 F. Supp. 3d 37 (2016).

[4] *See* U.S. Department of the Treasury, A Financial System That Creates Economic Opportunities: Capital Markets, Oct. 6, 2017, *available at* https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.

Recommendation to “right-size” risk retention rules rather than eliminate completely.

B. Conclusions from first year of implementation of the U.S. risk retention regulation.

1. CLO managers have created new structures that enable them to raise the capital needed to comply with U.S. risk retention.

(a) CMV and CMV feeder funds

(i) Creating a new management company

(ii) Registered investment adviser

(iii) Sole employees that are compensated by CMV

(iv) EU origination – 5-10 percent or target par at closing

(v) Shared services and employment agreement

(b) MOA fund

(i) Passive investment vehicle

(ii) Difficult to comply with EU RR

(1) Must satisfy “sole purpose” and “substance” tests

(2) Originate 50 percent over life of CLO

(c) C-MOA

(i) Relying adviser (issue if manager manages ‘40 Act funds)

(ii) Dual employees

(iii) EU Origination – 5-10 percent of target par at closing

(iv) Shared services and employment agreement

(d) Tax issues

(i) ECI/trade or business

(ii) UBTI

(e) Other legal issues

EU origination – cross transactions

2. Third-party financing has become available for risk retention.

(a) Credit facilities and repo facilities.

(b) Credit facilities often are rated by a rating agency and typically provided by insurance companies.

(c) Resecuritization programs of risk retention investments.

(d) So far, only to finance the vertical risk retention.

(e) Borrower is often a C-MOA, or sometimes an MOA.

3. Third parties have created investment funds and other capital pools to invest in risk retention for unaffiliated managers.

4. Market has become comfortable that U.S. risk retention requirements do not apply to standard warehousing structures.

(a) Revolving credit warehouse loans and swap-based warehouse facilities are not securitizations to which U.S. risk retention requirements are applicable.

(b) Senior loan/subordinated loan warehouse structure also not viewed as a securitization to which U.S. risk retention is applicable.

5. EU Risk Retention Rules

(a) U.S. managers using "origination" method to comply

(b) Dealer issues for EU origination

VI. CLO Warehousing[5]

A. Most common structures are either:

1. Revolving credit from a senior lender to the CLO with first-loss equity either from the CLO manager or a third-party equity source; or

2. Credit default swap or total return swap between the senior lender and either the CLO or an SPV to which the CLO manager has contributed "first-loss" equity, with the hedging loans held in a separate SPV that will be merged into the CLO at the closing.

B. Latest Structural Trends

1. Rated warehouses (typically credit facilities).

2. Warehouses that provide for "multiple exits" and have a longer term.

3. New sources of first-loss equity, i.e., unaffiliated investment funds, CMVs, C-MOAs and MOAs.

4. Senior loan and mezzanine loan as well as first-loss equity.

5. Increase in non-marked to market warehouses, but which still have an LTV trigger to stop the ramp up.

C. Tax Issues – Trade or Business

Although a trade or business opinion is usually only required at the CLO level, managers must ensure that tax guidelines are also followed during the warehouse phase.

D. Current Issues in CLO Warehouse Facilities

1. Conflicts can arise in the administration of the warehouse between the CLO manager, on the one hand, and the senior lender, on the other hand, if:

(a) The senior lender refuses to approve the purchase of a loan; or

(b) The senior lender refuses to approve an amendment to a loan document that the collateral manager wishes to approve.

2. Conflicts can arise between the first-loss equity provider and the arranger over whether to proceed with the pricing on terms that the first-loss equity provider does not like.

3. Main conflict occurs if an event of default or other "Liquidation Trigger" occurs. First-loss equity is concerned that the sale of a loan portfolio may cause it to lose its investment, and the CLO manager is concerned that the sale of a portfolio will prevent the completion of the CLO and damage the manager's reputation.

(a) CLO manager and the first-loss equity typically have the right to buy the portfolio at a price which repays all debt to the senior lender.

[5] *See* "Current Issues in the CLO Market: As of February 2017," *The International Comparative Legal Guide to: Securitisation 2017* (Global Legal Group).

(b) CLO manager and the first-loss equity typically have the right to bid on the portfolio in the U.C.C. foreclosure auction.

4. Ineligible loans

   (a) Ineligible loans will be excluded from the borrowing base, so that they must be funded solely with equity.

   (b) Sometimes the senior lender has the right to direct the collateral manager to sell an ineligible loan.

   (c) In any event, all ineligible loans must be sold prior to the CLO closing date.

5. Almost all warehouses provide that if there is an increase in the LTV above a specified level, the ramp up will be suspended and sometimes terminated.

6. Warehouse agreements typically provide that the senior lender has discretion to reject any loan that the CLO manager proposes to buy. The warehouse agreement typically will not impose a legal obligation on the senior lender to disclose the reason for its rejection. If there is a preapproved model portfolio, the senior lender typically has the right to remove a loan from that portfolio, so long as they give sufficient advance notice to the CLO manager.

7. M-T-M warehouses require posting of additional collateral or additional capital contributions if LTV is above a certain threshold. Failure to post or contribute capital will result in the lender's right to liquidate.

VII. CLOs – Latest Trends

A. Refinancing and Resets

1. Emergence of provisions allowing second refinancings upon the occurrence of certain changes to risk retention rules.

2. Some cases where CLO managers have issued more equity as part of a reset.

3. Exploration of AMR mechanisms in CLOs.

B. New Issues

1. European CLO volume is at an all-time post-crisis high after November 2017.

2. Question of whether loan volume will be sufficient to support further growth in the CLO market.

C. Longer Non-call Periods and Reinvestment Periods

Initial surge of non-call and reinvestment period extensions in 2015 as CLO managers began to anticipate implementation of risk retention rules.

Tax Considerations for 2018

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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. 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.

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Tax Considerations for 2018

I. Partnership Audits

A. 2018 will be the first taxable year subject to the new partnership audit tax regime created by the Bipartisan Budget Act of 2015. Under the new regime, tax adjustments and collections are made at the partnership level rather than at the partner level, unless the partnership elects to pass adjustments through to its partners.

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

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

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

2. Partnerships with partners that are other partnerships, trusts, IRAs, pension plans, disregarded entities or nominees cannot elect out.

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

4. The election must disclose the name, tax classification and taxpayer ID of each partner of the partnership, including each S corporation shareholder in the case of an S corporation partner.

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

1. The partnership representative does not need to be a partner but must have a substantial presence in the United States. This requirement is intended to ensure that the partnership representative will be available to the Internal Revenue Service ("IRS") in the United States when the IRS seeks to communicate or meet with the representative.

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

3. In the absence of a designation of a partnership representative by the partnership, the IRS has the authority to select any person as the partnership representative for a partnership.

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

1. An imputed underpayment is determined by netting all adjustments of similar items of income, gain, loss or deduction at the partnership level and multiplying by the highest tax rate for individuals or corporations for the year to which the tax audit rules relate (the "reviewed year").

(a) If an adjustment involves reallocation of an item to another partner, only the tax increase, not the net adjustment, enters into the calculation of the imputed underpayment under the statute. This could cause the same income to be taxed twice.

(b) However, under Proposed Regulations issued on June 14, 2017, a determination by the IRS that an item of income should have been allocated differently among the partners may, in certain cases, not result in the partnership incurring an imputed underpayment.

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

(a) An imputed underpayment may be reduced to the extent that it is allocable to a partner that is a "tax-exempt entity" that would not owe tax on the adjusted income (e.g., the U.S. government, a tax-exempt U.S. organization, a foreign person or entity, etc.), a partner that is a C corporation (in the case of ordinary income) or an individual with capital gains or qualified dividends. In the case of a modification requested with respect to an indirect partner, the IRS may require information related to the pass-through partner through which the indirect partner holds its interest.

(b) If any partner files an amended return for the reviewed year taking into account its allocable share of the adjustments and pays tax thereon, that payment can offset the partnership's imputed underpayment. Modification is allowed to the extent the amended returns are filed and any necessary payments are made within the 270-day time period.

F. As an alternative to the partnership paying the imputed underpayment, the partnership may elect, under Section 6226 of the Code, within 45 days following the mailing by the IRS of the notice of final partnership adjustment to pass the adjustment through to its partners who were partners for the reviewed year.

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

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

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

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

5. A partnership that passes the adjustment through to its non-U.S. partners may still be required to withhold under chapters three and four on any adjustment that would have been subject to withholding in the reviewed year.

6. Proposed Treasury Regulations released on Dec. 15, 2017, if finalized, would authorize the Section 6226 Election to be effected through partnership tiers, whereby each partnership in the chain generally may choose to either pay the tax directly or push it out to its own partners (e.g., from a master fund to its feeder fund, and then to the feeder fund's investors). Each upper-tier partnership would need to make such choice by the extended due date for the tax return for the adjustment year of the partnership that was audited.

G. A partnership can file an administrative adjustment request in the amount of one or more items of income, gain, loss, deduction or credit of the partnership for any partnership taxable year. A partnership has three years from the later of the filing of the partnership return or the due date of the partnership return (excluding extensions) to file an administrative adjustment for that taxable year. However, a partnership may not file an administrative adjustment for a partnership taxable year after the IRS has mailed notice of an administrative proceeding with respect to such taxable year.

1. Adjustments that result in underpayments will cause tax to be due at the partnership level in the year in which the administrative adjustment is filed as described above, except that certain provisions related to modifications of such underpayment will not apply. In the alternative, such tax may be passed through to the partners under the election discussed above, except that the additional interest does not apply.

2. Adjustments that result in a refund must be passed through to the partners that were partners during the year to which the adjustment relates.

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 "2015 Final Regulations" and "2015 Temporary Regulations," respectively, and, together, the "2015 Regulations") implementing Section 871(m) of the Code.

3. On Dec. 2, 2016, the IRS released Notice 2016-76, which indicated 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.

4. On Jan. 19, 2017, the Treasury issued final and temporary regulations (the "Final Regulations" and "Temporary Regulations," respectively, and, together, the "2017 Regulations") that adopted, with some modifications, the 2015 Regulations.

5. On Aug. 4, 2017, the IRS released Notice 2017-42, which further extends the phase in and delays the effective dates of certain provisions of the 2017 Regulations.

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 is 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 2017 Regulations, as modified by IRS Notice 2017-42, 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 2018, as applicable.

C. The 2017 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.

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 2017 Regulations.

For example, the 2017 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 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 ten or more underlying securities and hedges the contract with an exchange-traded security that references substantially the same underlying securities, then the short party may use the hedge security to determine the delta of the contract it is issuing.

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

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

(ii) The 2017 Final Regulations do not provide for the netting of a taxpayer's long and short positions, though the preamble to the 2015 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 this 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. Notices 2016-76 and 2017-42

1. Transactions Entered Into During Calendar Year 2017 and 2018

(a) "Delta One" Transactions

(i) The term "delta one" was not defined in either notice. However, the language of the notices 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 Notices. However, a broker acting as a short party will only need to combine over-the-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 2017 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 and 2018.

(d) "Qualified derivatives dealers" ("QDDs") will not be subject to tax on dividends and dividend equivalents received in 2017 and 2018 in their equity derivatives dealer capacity or withholding on dividends (including deemed dividends). QDDs must use good faith efforts to comply with the 2017 Regulations through the end of 2018.

2. Transactions Entered Into After 2018

   (a) All other transactions entered into after 2018 (or significantly modified after 2018) that are considered Section 871(m) Transactions under the 2017 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 2019 for Section 871(m) Transactions entered into during 2019 that are not "delta one" transactions, including whether taxpayers are properly applying the "substantial equivalence" test.

E. Possible Further Changes

   1. A Treasury official announced publicly in November 2017 that the government is considering whether or not to implement the 2017 Regulations for transactions that are "non-delta-one" transactions.

   2. The Treasury and the IRS separately are evaluating the 2017 Regulations to "consider possible agency actions that may reduce unnecessary burdens imposed by the regulations" in accordance with Executive Order 13777.

III. Cryptocurrency

A. Characterization of Virtual Currency for U.S. Federal Tax Purposes

   1. The Internal Revenue Service ("Service") provided guidance in Notice 2014-21 that virtual currency (e.g., Bitcoin, Ethereum, Litecoin, etc.) generally is treated as property for U.S. federal tax purposes and is not considered a "currency" that would trigger foreign currency gain or loss under section 988 of the Code. As property, the character of gain or loss from the sale or exchange of virtual currency generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer. Accordingly, taxpayers who hold virtual currency as a capital asset should recognize capital gain or loss on the disposition of such virtual currency.

   2. Unlike the CFTC, the Service has not clarified whether or not virtual currencies are characterized as commodities for U.S. federal tax purposes.

   3. Some virtual currency, such as Bitcoin, functions as media of exchange. Others, however, exhibit characteristics that resemble securities or otherwise function as other than a medium of exchange. The tax treatment of such virtual currencies or other such digital assets may be characterized as equity interests in an underlying constructive joint venture or association, in which case owners of such digital assets may be taxable on their share of any items of income deemed allocated or deemed distributed from the constructive joint venture or association to them.

B. Considerations for Investment Funds Investing in Virtual Currencies

   1. Publicly Traded Partnerships. Investment funds operating as partnerships for U.S. federal tax purposes generally operate in a manner so as to avoid being treated as "publicly traded partnerships" taxable as corporations ("PTPs") within the meaning of Section 7704 of the Code. Many investment funds (especially long-short equity funds) rely on the "qualifying income" exception for PTP purposes. The characterization of virtual currency as a "commodity," or otherwise, could affect an investment fund's ability to satisfy the qualifying income exception. Alternatively, virtual currency investment funds that offer frequent liquidity to their investors could restrict their investor base to fewer than 100 partners in order to satisfy the "100-partner" PTP safe harbor.

   2. Mark-to-Market Elections. The mark-to-market election under Section 475(f) of the Code could apply to virtual currencies, if virtual currencies are characterized as "securities" or "commodities."

   3. Effectively Connected Income and the Trading Safe Harbors. Investment Funds generally rely on the Section 864(b)(2) safe harbors to avoid treating income and gain from trading in securities and commodities as effectively connected with a U.S. trade or business. The Service has yet to provide

guidance on whether or not virtual currencies constitute securities or commodities. Furthermore, even if virtual currencies constitute commodities, not all commodities fall under the commodities safe harbor. Only those that are "of a kind customarily dealt in on an organized commodity exchange" and even then, only if the transactions effected in such commodities are "of a kind customarily consummated at such place." The Service currently does not offer guidance on these aspects of the commodities trading safe harbor.

4. Virtual Currencies and ICOs as Deemed Equity Interests. Virtual currencies that exhibit characteristics that resemble securities or otherwise function as other than a medium of exchange, such as certain Initial Coin Offerings ("ICOs"), may be characterized by the Service as equity interests in an underlying constructive joint venture or association for U.S. federal tax purposes. An investment in such virtual currencies or ICOs that would be treated as constructive joint ventures or associations for U.S. federal tax purposes may cause non-U.S. investors or tax-exempt U.S. investors to earn effectively connected income or unrelated business taxable income, respectively. Furthermore, if the constructive joint venture or association were regarded as a foreign corporation, U.S. investors may be subject to certain anti-deferral rules (e.g., PFIC, CFC, etc.) with respect to any income or deemed income of the constructive joint venture or association.

IV. 1 or 30 Compensation

A. General Concept. Compensation related to the investor is the greater of:

1. 1 percent of the net asset value of the interest ("NAV"); and

2. 30 percent of net capital appreciation ("NCA") for the interest for the year.

NCA would be determined without reduction for the 1 percent leg of the formula (i.e., as if the 1 percent were an advance against the 30 percent).

B. Fee vs. Allocation

1. For clients who intend to take their performance-based compensation as an allocation of profits, consider structuring the 1 percent as a fee to the investment manager and the 30 percent as an allocation of profits to the fund's general partner/managing member.

2. Given that the 1 percent is paid regardless of profits, it functions the way the typical management fee would operate. For taxpayers in New York City and other jurisdictions that have an entity level tax on business income earned by partnerships, separating the 1 percent out generally protects the 30 percent from such tax under current tax law.

3. The incentive allocation would be 30 percent of NCA minus 100 percent of the Management Fee.

C. Shortfalls

1. Example. Management Fee = 30 and NCA = 90; 100 of NCA would have been needed to achieve a performance-based profits allocation of 30, assuming no Management Fee had been paid.

2. Option 1 (investor favorable). The fund is viewed as having underperformed by 10, which would eat away at future years' 30 percent calculations.

3. Option 2 (manager favorable and more common when the carry percentage is lower than 30 percent). The excess of the 1 percent over the 30 percent is an addition to the loss recovery account. The loss recovery account ("LRA") in this example would be increased by 3.

   Note: if there is net depreciation (without giving effect to the Management Fee), the LRA typically is increased as if the Management Fee were a full advance of the carry. For example, if the Management Fee is 30 and the fund loses 70, the LRA would be increased by 170 (70 of net capital depreciation + 30/.3).

D. Beating an Index. 1 or 30 compensation deals are often present when the performance-based compensation is based on outperforming an index. Beating an index poses a separate set of tax considerations for constructing a profits allocation, but that should not be confused with the 1 or 30 construct itself.

V. Side Letter Negotiations

A. It has become common for investors to ask for side letter provisions related to investments in both private equity funds and hedge funds. Investors are requesting broader side letter provisions, including the following.

1. Investors generally do not want to directly be subject to non-U.S. taxes or non-U.S. filing requirements (other than potential filings related to withholding taxes) in non-U.S. jurisdictions. If a manager agrees to such a representation, such manager may need to consult with counsel or other advisers in the relevant non-U.S. jurisdiction when:

   (a) making investments in non-U.S. jurisdictions;

   (b) setting up offices in non-U.S. jurisdictions; or

   (c) hiring agents or employees in non-U.S. jurisdictions.

2. However, managers may not want to promise investors that they will consult with counsel or other advisers for every investment if they are making multiple investments in the same jurisdiction or otherwise are familiar with the laws of such jurisdiction. This representation is more manageable in the private equity context where there are a smaller number of investments, but this representation may be administratively burdensome and costly when a fund has numerous investments or is investing in other managers or funds.

3. Non-U.S. investors may request representations related to income effectively connected with a U.S. trade or business ("ECI") or income from commercial activities ("CAI"). If there is a fund specifically set up for non-U.S. investors that are sensitive to ECI or CAI, this representation is often rejected in any parallel vehicle as many managers do not want to limit investments in a fund that is majority owned by investors that are not sensitive to ECI or CAI. Further, if a fund is treated as a corporation for U.S. tax purposes, a manager may want to push back on an ECI or CAI representation at the fund level if they want to continue to make investments that generate ECI or CAI if managers believe the after-tax return provides for an attractive investment. Managers should note that the CAI rules may be broader than the ECI rules, so carve-outs for certain items (such as certain real estate holdings) may need to be included in a CAI representation.

4. Investors are increasingly concerned about disclosing non-public information about themselves or their beneficial owners. These requests may arise in non-tax provisions, but could have implications in complying with tax law or making appropriate tax filings. Given the increasing number of laws (such as FATCA and CRS) that require disclosure of investor information (including information regarding beneficial ownership and controlling persons), managers need to make sure that confidentiality provisions allow for disclosure of information: (i) to comply with law; and (ii) that is necessary or desirable to reduce or eliminate withholding or other taxes.

5. Investors are requesting provisions related to the partnership audit rules. In particular, tax-exempt and non-U.S. investors are requesting provisions that require a manager to endeavor to reduce any imputed underpayment as a result of the status of the investor, and, if there is a reduction, require the benefit of such reduction to be allocated to such investor. Prior to making such representation, managers must confirm that they have the flexibility to specially allocate such expenses or otherwise limit the provision so that it only applies to the extent permitted under the fund documents.

6. Investors are requesting more specialized reporting and tax information, in particular, in the context of an investor that is itself an entity that has promised specialized reporting to its underlying investors. If the tax reporting and information requests relate to compliance with non-U.S. laws, managers may want to consult with advisers in the local jurisdictions to determine how burdensome such reporting will be for

the fund and the costs of complying with such requests. Managers will often require the requesting investor to bear the costs of any investor-specific reporting. Additional reporting may significantly increase the administrative burden and costs to a fund, so managers should consider if they have appropriate resources to deal with such additional reporting and information requests prior to agreeing to such provisions.

B. In order to minimize the potential for varying provisions, certain managers have built side letter terms into the fund's offering documents to provide all investors with the same terms.

VI. Tax Reform

A. Carried Interest/Incentive Allocation

1. Changes to Taxation of Carried Interest/Incentive Allocation

(a) If an "Applicable Partnership Interest" is held by a taxpayer, then the taxpayer's long-term capital gain with respect to such interest necessitates a holding period exceeding three years.

(b) An "Applicable Partnership Interest" is a partnership interest transferred to a taxpayer in connection with the performance of substantial services by the taxpayer (or a related person) in an "Applicable Trade or Business."

(c) An "Applicable Trade or Business" is an activity conducted on a regular, continuous and substantial basis which consists of: (i) raising or returning capital; and (ii) either investing, disposing, identifying or developing "Specified Assets."

(d) "Specified Assets" are securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to the foregoing, and an interest in a partnership to the extent of the proportionate interest in any of the foregoing.

(e) An Applicable Partnership Interest does not include: (i) an interest held by a corporation; or (ii) a capital interest which provides the taxpayer with a right to share in partnership capital commensurate with (x) the amount of capital contributed (determined at the time of receipt of such interest) or (y) the value of such interest subject to tax under Section 83 upon the receipt or vesting of such interest.

2. Switching From an Incentive Allocation to an Incentive Fee

(a) Fund Tax Considerations

(i) Offshore fund generally is indifferent and may benefit in an intermediate fund structure if the intermediate fund entity is eliminated as a result.

(ii) Onshore fund appears to have only downside risk. If the fund is an "investor" or has investments that are treated as investment activities, rather than trading activities, non-corporate taxable investors would not be able to deduct the incentive fee.

(b) Benefits to Manager

(i) If the manager is a limited partnership, the manager's profits allocations to its active limited partners are currently not subject to the 3.8 percent Medicare tax or the 3.8 percent tax on net investment income (i.e., Obamacare tax). An incentive allocation remains subject to the 3.8 percent net investment income tax.

(ii) Cash method managers may get a year of deferral since the fee is typically paid in the following January, while allocation reflects income realized as of Dec. 31.

(iii) If the manager earns carry based on annual outperformance of an index, there should be no tax-based limitations on paying the fee as it is earned.

(c) Potential Problems for the Manager

(i) Side pockets and multi-year fees are generally subject to Section 457A of the Code, including potential additional taxes of 20 percent and premium interest, whereas incentive allocations are generally not subject to those rules.

(ii) Long-term capital gains treatment still exists for "qualified dividends" and 60 percent of the mark-to-market income on "Section 1256 contracts."

(iii) Fees are generally subject to state and local taxes, if any, where the manager is based (e.g., the New York City Unincorporated Business Tax).

(iv) For investments held longer term, the fee may accelerate taxation.

(v) In the case of an offshore fund, U.S. withholding tax may reduce the profits on which the incentive fee is based, whereas such tax may be recoverable by the manager earning an incentive allocation.

B. Sale of Partnership Interests by Foreign Partners

1. The IRS held in a 1991 Revenue Ruling[1] that gain on the sale of a partnership interest by a foreign partner was subject to tax in the U.S. to the extent of such partner's share of unrealized net gain in any ECI assets held by the partnership.

2. In 2017, the Tax Court held in *Grecian Magnesite*[2] that a foreign partner was not subject to U.S. federal income tax on gain from the sale of a partnership interest in a partnership conducting business in the U.S., except for gain attributable to the partnership's USRPIs. The IRS has appealed the decision of the Tax Court.

3. The Act effectively reverses *Grecian Magnesite* by revising Code Section 864(c) to provide that gain or loss realized by a foreign partner from the sale or exchange of a partnership interest occurring on or after Nov. 27, 2017 is treated as effectively connected with a U.S. trade or business to the extent that the seller of such interest would have had effectively connected gain or loss had the partnership sold all of its assets for their fair market value as of the date of the sale or exchange.

4. The Act adds a new Code Section 1446(f), which requires the buyer of a partnership interest to withhold 10 percent tax on the amount realized by the seller on the sale or exchange of a partnership interest occurring after Dec. 31, 2017 if any portion of the seller's gain on the sale of the interest would be effectively connected income under revised Code Section 864(c), unless the seller certifies that the seller is non-foreign. In the event the buyer fails to withhold the correct amount of tax, the partnership shall deduct and withhold from distributions to the buyer an amount equal to the tax that the buyer failed to withhold from the seller.

5. The IRS issued Notice 2018-08 on Dec. 29, 2017, which suspends withholding under Code Section 1446(f) on the transfer of any interest in a PTP as defined in Code Section 7704(b) until regulations or other guidance have been issued under Code Section 1446(f).

C. Deductibility Issues

1. Limitation on Deductibility of Business Interest Expense

(a) Section 163(j) of the Code limits the deduction of business interest expense attributable to a trade or business generally to the sum of the taxpayer's (x) business interest income and (y) 30 percent of adjusted taxable income relating to a trade or business (calculated by excluding business interest expense and business interest income). For these purposes, business interest expense and business

[1] Rev. Rul. 91-32

[2] *Grecian Magnesite Mining* v. *Commissioner*, 149 T.C. No. 3 (July 13, 2017).

interest income do not include "investment interest" or "investment income," respectively, within the meaning of Section 163(d) of the Code.

(b) Any business interest expense not deductible pursuant to the foregoing limitation is treated as business interest expense of an eligible taxpayer that carries forward to succeeding taxable years, subject to the same limitation.

(c) The limitation on the deductibility of business interest expense does not apply to interest attributable to an electing real property trade or business and certain other businesses.

(d) In the case of a partnership, the limitation is determined at the partnership level. To the extent the limitation applies at the partnership level to reduce the business interest expense deductible for a year, such excess shall carry forward to succeeding years and, subject to certain limitations, may be deducted by an eligible partner to the extent the partnership has sufficient excess taxable income that was not offset by business interest expense in such year. Any amount not utilized will form part of the investor's adjusted basis in its interest in the partnership only at the time such investor disposes of its interest.

2. Limitation on Deductibility of Excess Business Losses; Changes to Rules on NOLs

(a) Under a new provision (Section 461(l) of the Code) applying to noncorporate taxpayers, if a trade or business activity generates losses in excess of a taxpayer's trade or business income, a maximum of $250,000 ($500,000 if filing a joint return) of the losses can be used to offset investment income for the year.

(i) Any excess business losses that are disallowed by this provision cannot be used to offset tax liability on investment income, but rather will be carried forward as net operating losses ("NOLs") that can be used in subsequent years.

(ii) This provision is not permanent; it applies only for taxable years beginning after Dec. 31, 2017 and before Jan. 1, 2026.

(b) For losses arising in taxable years beginning after Dec. 31, 2017, a deduction for NOLs is limited to 80 percent of taxable income.

(i) Any unused NOLs can be carried forward indefinitely.

(ii) NOLs can no longer be carried back (except for certain losses incurred in a farming trade or business).

(iii) NOLs carried forward from taxable years beginning before Jan. 1, 2018 are not subject to this new 80 percent limitation.

3. Suspension of Miscellaneous Itemized Deductions

Miscellaneous itemized deductions for individuals under Section 67 of the Code are suspended for any taxable year beginning after Dec. 31, 2017, and before Jan. 1, 2026.

4. Reduction in Corporate Tax Rate and Limitation on Deductibility of State and Local Taxes

(a) The corporate income tax rate is reduced from 35 percent to 21 percent for taxable years beginning after Dec. 31, 2017.

(b) For individual taxpayers, the amount of state and local taxes (including income and property taxes) permitted to be deducted is limited to $10,000 (aggregated).

The $10,000 aggregate limitation is scheduled to sunset in 2026; it applies only to tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026.

5. Deduction for Qualified Business Income of Pass-Thru Entities

   (a) Twenty percent deduction for taxpayers other than "C" corporations for Qualified Business Income ("QBI") and certain other income.

   (b) QBI deduction means the sum of the:

      (i) Lesser of either the taxpayer's "Combined QBI" amount or 20 percent of the taxpayer's ordinary income (excluding capital gains and qualified cooperative dividends); plus

      (ii) Lesser of either 20 percent of the taxpayer's qualified cooperative dividends or taxpayer's ordinary income (excluding capital gains).

   (c) Combined QBI means the sum of the:

      (i) Lesser of either taxpayer's QBI from a qualified trade or business, or a combination of a percentage of W-2 wages and/or basis of depreciable property; plus

      (ii) Twenty percent of the total "qualified REIT dividends" and "qualified PTP income."

   (d) Investment management and most investing funds are not "qualified trades or businesses." Funds whose trade or business does qualify (e.g., certain lending funds) generally do not pay W-2 wages.

      (i) For most investment funds and investment managers, the first clause of Combined QBI will be $0.

      (ii) Funds can still benefit from the QBI deduction from "qualified REIT dividends" and "qualified PTP income."

D. Controlled Foreign Corporations ("CFCs")

   1. Modification of definition of United States Shareholder.

      The definition of "United States Shareholder" of a CFC is amended to include U.S. persons that own 10 percent or more of the total value of shares of all classes of stock of a foreign corporation.

   2. Elimination of requirement that corporation must be controlled for 30 days before Subpart F inclusions apply.

      Amendment eliminates requirement that 10 percent U.S. shareholders of a foreign corporation must only include their pro rata share of Subpart F income of a foreign corporation that was a CFC for an uninterrupted period of 30 days or more during any taxable year. 10 percent U.S. shareholders must now include their allocable share of Subpart F income if the foreign corporation has been a CFC at any time during any taxable year.

   3. Both CFC amendments effective for taxable years of foreign corporations beginning after Dec. 31, 2017, and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

E. New Excise Tax on Certain Private Colleges and Universities; UBTI

   1. Excise Tax Based on Investment Income of Private Colleges and Universities

      Net investment income of certain private colleges and universities is subject to a 1.4 percent tax. Such income is calculated in the same manner in which private foundations calculate their net investment income. Effective for taxable years beginning after Dec. 31, 2017.

   2. UBTI

      Under a new provision (Section 512(a)(6) of the Code), UBTI must be calculated separately with respect to each separate trade or business with losses usable only against the applicable related trade or business and not against all UBTI generally.

F. Accounting Methods – Certain Special Rules for Taxable Year of Inclusion

1. New Section 451(b) provides that accrual basis taxpayers must include certain types of income in gross income when an item of income (or portion thereof) is taken into account as revenue in an “applicable financial statement” of the taxpayer. Does not apply with respect to items of gross income for which a taxpayer uses a “special method of accounting” (other than one in Sections 1271 through 1288). The period for taking into account any Section 481 adjustments with respect to income from a debt instrument with OID is six years.
2. New Section 451(c) provides that accrual method taxpayers can elect to defer the inclusion of income associated with certain advance payments to the end of the tax year following the tax year of receipt if such income is also deferred for financial statement purposes.
3. Effective for taxable years beginning after Dec. 31, 2017 (Dec. 31, 2018 for instruments with OID).

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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. 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 US*, *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 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 2017 conference in New York and Goldman Sachs' 15th Annual Hedge Fund Seminar. 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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Stephanie is co-head of the firm's Investment Management Group and a member of the firm's Executive Committee and Operating 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 funds of funds and other institutional investors in connection with their investment activities, including blockchain technology and virtual currency offerings and transactions.

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 US* (Hall of Fame), *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 "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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Aneliya S. Crawford

Aneliya represents hedge funds and other large investors in matters concerning shareholder activism, proxy contests, hostile takeovers, corporate governance and mergers and acquisitions. Aneliya is one of the leading attorneys representing activist investors globally, with close to 200 major shareholder activism contests, including campaigns in the United States, United Kingdom, Canada, Australia and Latin America. Aneliya has extensive experience providing strategic guidance to investors on activist strategies, including proxy contests, settlement negotiations, corporate governance, consent solicitations, letter-writing campaigns, hostile takeovers and M&A transactions. She provides counsel to clients on their equity investments in public companies, and she also represents public and private companies in mergers and acquisitions and asset purchase and stock purchase transactions.

Most recently, Aneliya represented Trian Fund Management in the largest proxy contest to date. The successful campaign sought the addition of Trian CEO and founding partner Nelson Peltz to the Board of Directors of Procter & Gamble. Aneliya has been named a New York "Rising Star" by *Super Lawyers* magazine each year since 2014 for her shareholder activism and M&A practice.

Aneliya earned her J.D. from Benjamin N. Cardozo School of Law, her M.L.A. in management (extension studies) from Harvard University and her B.A. from American University in Bulgaria.

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Practices

Regulatory & Compliance

Blockchain Technology & Digital Assets

Cybersecurity

Energy

Hedge Funds

Investment Management

Private Equity

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*, *Chambers USA*, and *The Legal 500 US* list Brian as a "leading individual" in investment funds. In addition to hosting SRZ webinars, participating in firm-sponsored seminars and workshops, and authoring *SRZ Client Alerts* and *SRZ White Papers*, he authored "Cross-Border Implementation of MiFID II Research Provisions – SEC No-Action Relief to Investment Advisers and Broker-Dealers and European Commission Guidance," published in *The Hedge Fund Journal*, among others. Brian was also quoted in the articles, "SEC Warns on Common Advertising Violations," published in *Compliance Reporter* and "SEC Waits on Sidelines as New Bitcoin Market Opens," published in *Bloomberg BNA*. His recent speaking engagements addressed topics including MiFID II, Python for compliance personnel and the legal and operational aspects of potential blockchain applications in the derivatives market. Brian also taught 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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Practices

Investment Management

Financial Institutions

Hedge Funds

Private Equity

Shareholder Activism

Josh Dambacher

Josh is the co-head of the firm's London office. He focuses his practice on corporate, securities and regulatory matters and primarily represents institutional and entrepreneurial investment managers, financial services firms and private investment funds in all aspects of their business. Josh's experience includes structuring investment management firms, hedge funds, private equity funds, hybrid funds and funds of funds and structuring and negotiating seed and strategic investments. He also regularly advises investment management firms and their principals on U.S. and U.K. regulatory compliance, acquisitions and reorganizations of investment management firms and restructuring proprietary trading desks into independent investment management firms.

Josh previously led the U.S. Financial Reforms Working Group for the Alternative Investment Management Association. He is listed as a leading investment management lawyer by *Chambers Europe*, *Chambers UK*, *IFLR1000*, *The Legal 500 UK* and *Who's Who Legal: The International Who's Who of Private Funds Lawyers*, and he was listed in the *Financial News 40 Under 40 Rising Stars of Hedge Funds 2012* and *Financial News 40 Under 40 Rising Stars of Legal Services 2013*. Josh is also a frequent speaker and author on issues facing the investment management industry, including, most recently, on the current regulatory landscape for hedge funds, the proposed EU Directive on Alternative Investment Fund Managers and the U.S. Dodd-Frank Act.

Josh holds a J.D. from the University of Michigan Law School and an M.B.A. in finance from Purdue University, where he was elected to Phi Beta Kappa.

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Practices

Investment Management

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.

Most recently, Jennifer was named among the world's "50 Leading Women in Hedge Funds" by *The Hedge Fund Journal*. A member of the board of directors of 100 Women in Finance, Jennifer is recognized by *The Legal 500 US, 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 attracting and retaining capital, 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

Investment Management

Hedge Funds

Regulatory & Compliance

David J. Efron

David is co-head of the Investment Management Group and focuses his practice 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 US* and *Who's Who Legal: The International Who's Who of Private Funds Lawyers*. A recognized thought leader, David was recently quoted in the article "Divorcing Your Seeder: Exit Strategy Considerations for Hedge Fund Managers Entering Seeding Arrangements" in the *Hedge Fund Legal & Compliance Digest*" and the articles "Schulte Roth Partners Discuss Hedge Fund Seeding" and "Co-Investments with SRZ's Leading Fund Formation Group," both published in *The Hedge Fund Journal*. David also contributed to "Hedge Fund Employee Compensation," published by *Practical Law and co-authored Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). He is 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 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., *cum laude*, 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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Regulatory & Compliance

Blockchain Technology & Digital Assets

Cybersecurity

Energy

Hedge Funds

Investment Management

Litigation

Private Equity

Marc E. Elovitz

Marc is the chair of the 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 recently presented on whistleblowing, regulatory and compliance issues for private funds and SEC inspections and examinations of hedge funds and private equity funds. *Chambers USA, The Legal 500 US*, *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. 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.

A recognized thought leader, Marc is regularly interviewed by leading media outlets, including *Bloomberg*, *HFMWeek*, *HFM Compliance*, *Compliance Reporter*, *IA Watch*, *Private Funds Management* and *Law360*, among many others. He is also an accomplished author. Most recently, Marc co-authored "Complying on Pay-to-Play: Tips for CCOs," published in *Compliance Reporter*, "Second Circuit, in Split Decision, Overrules Limitation on Insider Trading Liability Established in *U.S. v. Newman*," and "Cross-Border Implementation of MiFID II Research Provisions – SEC No-Action Relief to Investment Advisers and Broker-Dealers and European Commission Guidance," which were published in *The Hedge Fund Journal* and "Sovereign Immunity Implications for Investment Advisers," published in *Compliance Corner*. He is 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

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Hedge Funds

Private Equity

Regulatory & Compliance

Daniel F. Hunter

Dan has more than 15 years of experience guiding investment management firms, including advising private fund managers with billions of dollars in assets under management to counseling emerging managers who are spinning out from other well-known investment management firms.

Dan's practice focuses on credit fund and hedge fund formation (open, hybrid and closed-end fund structures). He also provides day-to-day regulatory, operational, M&A and restructuring advice to his investment management clients. He has extensive experience advising on "seed capital" negotiations, and he is an expert on change of control laws and succession planning.

Dan has been recognized in *The Legal 500 US* in the Investment Fund Formation and Management and Private Equity Funds categories. A sought-after speaker, he recently presented on a range of topics, including the structuring and management of funds, compliance and regulatory issues and ERISA's impact on private equity and hedge funds. Dan discussed "Succession Planning" at the Goldman Sachs 20th Annual Hedge Fund Conference, presented an SRZ webinar on "Insurance-Dedicated Funds: Tax and Corporate Issues" and spoke 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 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). In addition, 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

Hedge Funds

Private Equity

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 as a leading lawyer by *Chambers USA*, *The Legal 500 US*, *IFLR1000* and *New York Super Lawyers*. Jason publishes and speaks often on topics of concern to private investment funds. Jason 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*. A recognized thought leader, he was quoted in the articles "Schulte Roth Partners Discuss Hedge Fund Seeding" and "Co-Investments with SRZ's Leading Fund Formation Group," both published in *The Hedge Fund Journal*. Jason was also quoted in the *Financial Times FundFire* article "Hedge Fund Co-Investing Picks Up Steam." A sought-after speaker, he presented at the Goldman Sachs Annual Hedge Fund Conference, Financial Executives Alliance's Regulatory Hot Topics for Private Equity Firms conference and at ALM's 2017 Hedge Fund General Counsel & Compliance Officer Summit.

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 is the co-chair of the firm's global Shareholder Activism Group and he serves on the firm's Executive Committee. He practices in the areas of shareholder activism, mergers and acquisitions, securities law and regulatory compliance. He represents activists and companies in matters ranging from corporate governance and control to proxy contests and defensive strategies. His recent representations have included Trian Fund Management, Elliott Management in Marathon Petroleum and PulteGroup, Jana Partners in Whole Foods, Bristol-Myers Squibb and Tiffany, Greenlight Capital in General Motors, Cevian Capital in ABB and LM Ericsson, Starboard Value in Stewart Title, Blue Harbour in Investors Bancorp, venBio Select Advisor in Immunomedics, Saba Capital in First Trust, Oasis Capital in Stratus Properties, Altimeter Capital Management in United Continental Holding, SRS Investment Management in Avis Budget Group and Clinton Group in Campus Crest Communities. Ele is also well-known for his expertise since the early 1990s in 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. Ele works on numerous activist campaigns, regulatory and reporting matters 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.

Ele is recognized as a leading lawyer by *Chambers USA*, *The Legal 500 US*, *New York Super Lawyers — New York Metro Top 100* and *Super Lawyers Business Edition*. He has served as a moderator and speaker at numerous conferences and events addressing shareholder activism, regulatory and reporting issues, PIPEs, M&A deals, the capital markets and other topics of interest to the alternative investment management industry. He contributed to *The Activist Investing Annual Review 2017* (Activist Insight, in association with SRZ) and authored the "Transaction Reporting" chapter in *Investment Management: Law and Practice* (Oxford University Press) covering Schedules 13D and 13G and Section 16 filings.

Ele received his J.D. from Yale Law School and his B.S., *summa cum laude*, from Brooklyn College of the City University of New York.

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Practices

Investment Management

Cybersecurity

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 SRZ, 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. She is admitted to practice in England and Wales and New York.

A "Recommended" lawyer recognized in *The Legal 500 UK*, Anna was named among the world's "50 Leading Women in Hedge Funds" by *The Hedge Fund Journal*. Anna frequently speaks on a wide range of topics, including MiFID II, market abuse and insider dealing, as well as systematic and quantitative strategies for funds. A sought-after thought leader, Anna recently worked with AIMA to produce "MiFID2 – A Guide for Investment Managers" and authored the "Insider Trading Law in the United Kingdom" chapter in *Insider Trading Law and Compliance Answer Book* (Practising Law Institute). She also co-authored "Brexit: What Alternative Asset Managers Can Expect," and "Cross-Border Implementation of MiFID II Research Provisions — SEC No-Action Relief to Investment Advisers and Broker-Dealers and European Commission Guidance," both published in *The Hedge Fund Journal*.

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

Bank Regulatory

Blockchain Technology & Digital Assets

Financial Institutions

Regulatory & Compliance

Donald J. Mosher

Don is the head of the firm's Bank Regulatory Group and he focuses his practice on the regulation of banks, thrifts and licensed financial services providers, and specifically, the regulation, acquisition and sale of payments companies and money transmitters, and the laws and practices applicable to mobile, digital, virtual, electronic, paper- and card-based payment products and systems. Don has represented leading banks, payments companies, card associations, money transmitters and private equity firms in transactional and regulatory matters associated with payments, prepaid cards, digital currencies and money transmission, including the negotiation of payments products and processing agreements. Don recently served as regulatory counsel to Travelex Group, the world's largest foreign exchange company, in connection with its acquisition by a consortium led by the owner of UAE Exchange, a leading global money transfer and foreign exchange provider, and Centurion Investments, an Abu Dhabi-based private equity firm; Priority Payments, in its merger with Cynergy Data, creating one of the largest merchant acquirers in the nation; and Securus Technologies in its acquisition of JPay Inc., the market-leading technology company that introduced electronic payments to the corrections space. Don has also acted as regulatory counsel to Western Union in its acquisition of Vigo Remittance, Custom House and Travelex Global Business Payments, and to Western Union and Green Dot in their initial public offerings. In recognition of Don's role as banking and payments law regulatory counsel for First Data Corp. in connection with its acquisition by an investor group for $29 billion, *IFLR* awarded SRZ the prestigious Americas Private Equity Deal of the Year Award.

Don has been recognized as a leading lawyer by *IFLR1000*, *The Legal 500 US* and *New York Super Lawyers* in the areas of banking, mergers and acquisitions and consumer law. He is a frequent author and public speaker on topics of interest to the prepaid card industry. Recently, Don spoke on investing in digital assets and blockchain technology during an SRZ webinar, as well as on "Payment Processing – A Deep Dive," at the Money Transmitter Regulators Association's 2017 Annual Conference & Examiners School. He also discussed "State Money Transmitter Licensing Laws: Are They Killing Payments Industry Innovation?" at the Money20/20 Conference. At recent ACI forums, he addressed "State Regulatory and Enforcement Efforts Including Latest Challenges Associated With Money Transmitter Licensing Enforcement" and "Ensuring Compliance With the State Regulatory and Enforcement Framework Governing Payment Systems and FinTech." His recent publications include co-authoring "OCC Issues Draft Guidance and Requirements for FinTech Charter Applications" in the *Bloomberg BNA – Banking Report* and "FinCEN Issues Assessment Against Virtual Currency Exchange – the First Enforcement Action Against a Foreign-Located Money Services Business" in *PaymentsJournal.*

Don earned his J.D., *cum laude*, from St. John's University School of Law, and his B.A. from the State University of New York at Stony Brook.

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Practices

Investment Management

Hedge Funds

Private Equity

Energy

Financial Institutions

David Nissenbaum

David is co-head of the Investment Management Group and a member of the firm's Executive Committee. 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 US* 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 highly sought-after writer and speaker. He has addressed a wide range of topics at conferences and seminars, including co-investment vehicles, investing in the oil and gas sector, liquidity events, exits and succession planning, among many others. He was quoted in the articles "Schulte Roth Partners Discuss Hedge Fund Seeding" and "Co-Investments with SRZ's Leading Fund Formation Group," both published in *The Hedge Fund Journal*. In addition, David has authored or co-authored numerous publications, including 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.

David earned his J.D. from Brooklyn Law School and his B.A. from State University of New York at Albany.

Chief Executive Officer and Founding Partner

Trian Fund Management, L.P.

Nelson Peltz

Nelson is Chief Executive Officer and a Founding Partner of Trian Fund Management, L.P. Founded in 2005, Trian is a multi-billion dollar investment management firm that invests in underperforming and undervalued public companies. Trian then works constructively with the management and Boards of Directors of those companies to create shareholder value through a combination of strategic re-direction, improved operational execution, more efficient capital allocation and stronger focus.

In addition, Nelson serves as the non-executive Chairman of The Wendy's Company and as a Director of Mondelēz International, Inc., Sysco Corporation and The Madison Square Garden Company. He previously served as a Director of H. J. Heinz Company from September 2006 to June 2013, Legg Mason, Inc. from October 2009 to December 2014 and Ingersoll Rand plc from August 2012 to June 2014. Nelson was recognized by the National Association of Corporate Directors in 2010 to 2012 as among the most influential people in the global corporate governance arena. From April 1993 through June 2007, he served as Chairman and Chief Executive Officer of Triarc Companies, Inc., which during that period of time owned Arby's Restaurant Group, Inc. and the Snapple Beverage Group, as well as other consumer and industrial businesses. Nelson was Chairman and Chief Executive Officer and a Director of Triangle Industries, Inc. from 1983 until December 1988, the largest packaging company in the world and a Fortune 100 industrial company, when that company was acquired by Pechiney, S.A., a leading international metals and packaging company.

A supporter of many philanthropic causes, Nelson serves as Honorary Co-Chairman of the Board of Trustees and Chairman of the Board of Governors of the Simon Wiesenthal Center. He is also a member of the Board of Overseers of the Weill Cornell Medical College and Graduate School of Medical Sciences, a member of the Intrepid Advisory Council, a former member of the Board of Trustees of the Intrepid Museum Foundation and an Advisor and a member of the Executive Council of No Labels.

Nelson attended The Wharton School of the University of Pennsylvania.

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Practices

Investment Management
Hedge Funds
Mergers & Acquisitions
Private Equity
Regulatory & Compliance
Securities & Capital Markets

Paul N. Roth

Paul is a founding partner of the firm and chair of the 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 is also recognized by *Chambers Global*, *Chambers USA* and *The Legal 500 US*, as well as many other ranking publications. Paul was honored at *The Hedge Fund Journal* Awards for his outstanding achievements 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. In addition, he was 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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Practices

Litigation

Complex Commercial Litigation

Securities Enforcement

Securities Litigation

Shareholder Activism

Michael E. Swartz

Michael focuses his practice on complex commercial litigation and antitrust, particularly as it relates to mergers and acquisitions. His litigation practice includes shareholder activist litigation, M&A litigation and other corporate control disputes, as well as securities litigation. Michael has particular experience with matters involving Sections 10(b), 13(d), 14(a), 16(b) and 20(a) of the Securities Exchange Act.

Most recently, Michael represented Trian Fund Management LP in its proxy contest with Procter & Gamble, and achieved a series of victories on behalf of venBio Select Advisor LLC in its proxy campaign at Immunomedics Inc. Among other things, for venBio, he obtained a TRO blocking the closing of a global license agreement, which effectively would have amounted to a sale of the company. The Immunomedics board of directors had entered into that agreement in an effort to entrench themselves in office; following the TRO, the parties to the licensing agreement abandoned it. Michael's other recent litigation experience includes activist litigation for Land & Buildings, Villere & Co. and representations of several boards and companies in M&A- and proxy-related litigation, and obtaining dismissal of several Section 16(b) actions brought against investment advisers and the funds they manage, seeking disgorgement of alleged short-swing trading profits. Michael served as trial counsel to the former Vivendi Universal CFO in a four-month securities class action jury trial. The jury returned a verdict of no liability for SRZ's client for securities fraud. He also represented The Children's Investment Fund in a trial involving proxy litigation commenced by CSX Corporation and served as trial counsel to the former chief legal officer of media giant Hollinger Inc. in a four-month criminal trial. Michael also represented Cerberus Capital Management LP in its $9.2-billion acquisition of Safeway Inc.

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 US* and *New York Super Lawyers* in the area of business litigation. His litigation victories have been featured in *The Hedge Fund Journal* ("Immunomedics Proxy Contest: SRZ Achieves Unprecedented Litigation Victories") and *Hedge Fund Legal and Compliance Digest* ("Schulte's Michael Swartz Discusses Section 16(b) Litigation, Exemptions and Strategies for Hedge Fund Managers to Reduce Risks of Non-Compliance"). In addition, Michael's recent publications include contributing to *The Activist Investing Annual Review 2017* (Activist Insight, in association with SRZ) and co-authoring the "Information Sharing with Market Professionals" chapter in the *Insider Trading Law and Compliance Answer Book 2018* (Practicing Law Institute). He is currently the regional vice chair for the mid-Atlantic region of the Lawyers' Committee for Civil Rights Under Law, and he is also a member of the ABA's Litigation and Antitrust sections. Michael is a former law clerk to the Hon. Irving R. Kaufman, Circuit Judge for the U.S. Court of Appeals for the Second Circuit.

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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Recognized as a leader in his field by *Chambers USA*, *The Best Lawyers in America*, *The Legal 500 US* 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. In addition, he has published on a range of topics, including FATCA provisions, FIRPTA and REIT rules, and compliance requirements for hedge funds. Most recently, he co-authored “Twilight of the Deferred Fees: Planning for 2017,” published in *The Hedge Fund Journal* and *Hedge Funds: Formation, Operation and Regulation*, published by ALM Law Journal Press.

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Craig is recognized as a leading litigation lawyer in *Benchmark Litigation: The Definitive Guide to America's Leading Litigation Firms and Attorneys*, *The Legal 500 US* and *New York Super Lawyers*. He is a former law clerk to the Honorable Lawrence M. McKenna of the U.S. District Court for the Southern District of New York. Craig has written about enforcement actions against hedge funds and other industry-related topics, and has spoken on attorney-client privilege. Most recently, he was interviewed for the article "Execution Enforcement Actions Escalate," published in *The Hedge Fund Journal*.

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Tom lectures on matters relating to the mortality and longevity markets, and he writes on topics involving life settlements and securities, as well as the financial aspects of alternative energy and climate change disclosures. Most recently, he was interviewed for the article "Life Settlements and Longevity Swaps: Opportunities for Investors, Individuals, Insurers and Pension Funds," published in *The Hedge Fund Journal.*

Tom earned his J.D. from Columbia Law School, where he was a Harlan Fiske Stone Scholar and note editor of the *Columbia Journal of Environmental Law*. He earned his B.S., *magna cum laude*, from Yeshiva University.

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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. For nearly two decades, 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 US*, *Washington D.C. Super Lawyers*, *Washingtonian's* "Washington's Top Lawyers" and *The Washington Post*. Pete was featured in "Trial Pros: Schulte's Peter White," published by *Law360*, and co-authored 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.

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Ji Hye focuses her practice on commercial and corporate finance transactions and representation of private equity funds, hedge funds, investment banks and borrowers in a wide range of domestic and cross-border financing transactions, including acquisition and leveraged finance facilities, working capital facilities, syndicated credit facilities and subordinated debt financings.

Ji Hye focuses her practice on representing agents, lenders and borrowers in a variety of complex financings in a wide range of business industry sectors. Her recent transactions include representing an investment firm in connection with a $195-million senior secured credit facility to finance construction of the high-profile New York Wheel project in Staten Island, which was provided contemporaneously with a $150-million EB-5 mezzanine financing. Ji Hye is recognized as a leading lawyer in the industry and she was named a “Rising Star” by *New York Super Lawyers*. In addition, she was selected to be a member of the “Young Lawyer Editorial Board” of *The American Lawyer* magazine.

Ji Hye received her J.D. from Fordham University School of Law and her B.S., *with distinction*, from Cornell University.

Tax Reform

I. Carried Interest/Incentive Allocation

A. Changes to Taxation of Carried Interest/Incentive Allocation

1. If an "Applicable Partnership Interest" is held by a taxpayer, then the taxpayer's long-term capital gain with respect to such interest necessitates a holding period exceeding three years.
2. An "Applicable Partnership Interest" is a partnership interest transferred to a taxpayer in connection with the performance of substantial services by the taxpayer (or a related person) in an "Applicable Trade or Business."
3. An "Applicable Trade or Business" is an activity conducted on a regular, continuous and substantial basis which consists of: (i) raising or returning capital; and (ii) either investing, disposing, identifying or developing "Specified Assets."
4. "Specified Assets" are securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to the foregoing, and an interest in a partnership to the extent of the proportionate interest in any of the foregoing.
5. An Applicable Partnership Interest does not include: (i) an interest held by a corporation; or (ii) a capital interest which provides the taxpayer with a right to share in partnership capital commensurate with (x) the amount of capital contributed (determined at the time of receipt of such interest) or (y) the value of such interest subject to tax under Section 83 upon the receipt or vesting of such interest.

B. Switching From an Incentive Allocation to an Incentive Fee

1. Fund Tax Considerations
   (a) Offshore fund generally is indifferent and may benefit in an intermediate fund structure if the intermediate fund entity is eliminated as a result.
   (b) Onshore fund appears to have only downside risk. If the fund is an "investor" or has investments that are treated as investment activities, rather than trading activities, non-corporate taxable investors would not be able to deduct the incentive fee.
2. Benefits to Manager
   (a) If the manager is a limited partnership, the manager's profits allocations to its active limited partners are currently not subject to the 3.8 percent Medicare tax or the 3.8 percent tax on net investment income (i.e., Obamacare tax). An incentive allocation remains subject to the 3.8 percent net investment income tax.
   (b) Cash method managers may get a year of deferral since the fee is typically paid in the following January, while allocation reflects income realized as of Dec. 31.
   (c) If the manager earns carry based on annual outperformance of an index, there should be no tax-based limitations on paying the fee as it is earned.
3. Potential Problems for the Manager
   (a) Side pockets and multi-year fees are generally subject to Section 457A of the Code, including potential additional taxes of 20 percent and premium interest, whereas incentive allocations are generally not subject to those rules.
   (b) Long-term capital gains treatment still exists for "qualified dividends" and 60 percent of the mark-to-market income on "Section 1256 contracts."

(c) Fees are generally subject to state and local taxes, if any, where the manager is based (e.g., the New York City Unincorporated Business Tax).

(d) For investments held longer term, the fee may accelerate taxation.

(e) In the case of an offshore fund, U.S. withholding tax may reduce the profits on which the incentive fee is based, whereas such tax may be recoverable by the manager earning an incentive allocation.

II. Sale of Partnership Interests by Foreign Partners

A. The IRS held in a 1991 Revenue Ruling[1] that gain on the sale of a partnership interest by a foreign partner was subject to tax in the U.S. to the extent of such partner's share of unrealized net gain in any ECI assets held by the partnership.

B. In 2017, the Tax Court held in *Grecian Magnesite*[2] that a foreign partner was not subject to U.S. federal income tax on gain from the sale of a partnership interest in a partnership conducting business in the U.S., except for gain attributable to the partnership's USRPIs. The IRS has appealed the decision of the Tax Court.

C. The Act effectively reverses *Grecian Magnesite* by revising Code Section 864(c) to provide that gain or loss realized by a foreign partner from the sale or exchange of a partnership interest occurring on or after Nov. 27, 2017 is treated as effectively connected with a U.S. trade or business to the extent that the seller of such interest would have had effectively connected gain or loss had the partnership sold all of its assets for their fair market value as of the date of the sale or exchange.

D. The Act adds a new Code Section 1446(f), which requires the buyer of a partnership interest to withhold 10 percent tax on the amount realized by the seller on the sale or exchange of a partnership interest occurring after Dec. 31, 2017 if any portion of the seller's gain on the sale of the interest would be effectively connected income under revised Code Section 864(c), unless the seller certifies that the seller is non-foreign. In the event the buyer fails to withhold the correct amount of tax, the partnership shall deduct and withhold from distributions to the buyer an amount equal to the tax that the buyer failed to withhold from the seller.

E. The IRS issued Notice 2018-08 on Dec. 29, 2017, which suspends withholding under Code Section 1446(f) on the transfer of any interest in a PTP as defined in Code Section 7704(b) until regulations or other guidance have been issued under Code Section 1446(f).

III. Deductibility Issues

A. Limitation on Deductibility of Business Interest Expense

1. Section 163(j) of the Code limits the deduction of business interest expense attributable to a trade or business generally to the sum of the taxpayer's (x) business interest income and (y) 30 percent of adjusted taxable income relating to a trade or business (calculated by excluding business interest expense and business interest income). For these purposes, business interest expense and business interest income do not include "investment interest" or "investment income," respectively, within the meaning of Section 163(d) of the Code.

2. Any business interest expense not deductible pursuant to the foregoing limitation is treated as business interest expense of an eligible taxpayer that carries forward to succeeding taxable years, subject to the same limitation.

3. The limitation on the deductibility of business interest expense does not apply to interest attributable to an electing real property trade or business and certain other businesses.

4. In the case of a partnership, the limitation is determined at the partnership level. To the extent the limitation applies at the partnership level to reduce the business interest expense deductible for a year,

[1] Rev. Rul. 91-32

[2] *Grecian Magnesite Mining* v. *Commissioner*, 149 T.C. No. 3 (July 13, 2017).

such excess shall carry forward to succeeding years and, subject to certain limitations, may be deducted by an eligible partner to the extent the partnership has sufficient excess taxable income that was not offset by business interest expense in such year. Any amount not utilized will form part of the investor's adjusted basis in its interest in the partnership only at the time such investor disposes of its interest.

B. Limitation on Deductibility of Excess Business Losses; Changes to Rules on NOLs

1. Under a new provision (Section 461(l) of the Code) applying to noncorporate taxpayers, if a trade or business activity generates losses in excess of a taxpayer's trade or business income, a maximum of $250,000 ($500,000 if filing a joint return) of the losses can be used to offset investment income for the year.

(a) Any excess business losses that are disallowed by this provision cannot be used to offset tax liability on investment income, but rather will be carried forward as net operating losses ("NOLs") that can be used in subsequent years.

(b) This provision is not permanent; it applies only for taxable years beginning after Dec. 31, 2017 and before Jan. 1, 2026.

2. For losses arising in taxable years beginning after Dec. 31, 2017, a deduction for NOLs is limited to 80 percent of taxable income.

(a) Any unused NOLs can be carried forward indefinitely.

(b) NOLs can no longer be carried back (except for certain losses incurred in a farming trade or business).

(c) NOLs carried forward from taxable years beginning before Jan. 1, 2018 are not subject to this new 80 percent limitation.

C. Suspension of Miscellaneous Itemized Deductions

Miscellaneous itemized deductions for individuals under Section 67 of the Code are suspended for any taxable year beginning after Dec. 31, 2017, and before Jan. 1, 2026.

D. Reduction in Corporate Tax Rate and Limitation on Deductibility of State and Local Taxes

1. The corporate income tax rate is reduced from 35 percent to 21 percent for taxable years beginning after Dec. 31, 2017.

2. For individual taxpayers, the amount of state and local taxes (including income and property taxes) permitted to be deducted is limited to $10,000 (aggregated).

The $10,000 aggregate limitation is scheduled to sunset in 2026; it applies only to tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026.

E. Deduction for Qualified Business Income of Pass-Thru Entities

1. Twenty percent deduction for taxpayers other than "C" corporations for Qualified Business Income ("QBI") and certain other income.

2. QBI deduction means the sum of the:

(a) Lesser of either the taxpayer's "Combined QBI" amount or 20 percent of the taxpayer's ordinary income (excluding capital gains and qualified cooperative dividends); plus

(b) Lesser of either 20 percent of the taxpayer's qualified cooperative dividends or taxpayer's ordinary income (excluding capital gains).

3. Combined QBI means the sum of the:

(a) Lesser of either taxpayer's QBI from a qualified trade or business, or a combination of a percentage of W-2 wages and/or basis of depreciable property; plus

(b) Twenty percent of the total "qualified REIT dividends" and "qualified PTP income."

4. Investment management and most investing funds are not "qualified trades or businesses." Funds whose trade or business does qualify (e.g., certain lending funds) generally do not pay W-2 wages.

(a) For most investment funds and investment managers, the first clause of Combined QBI will be $0.

(b) Funds can still benefit from the QBI deduction from "qualified REIT dividends" and "qualified PTP income."

IV. Controlled Foreign Corporations ("CFCs")

A. Modification of definition of United States Shareholder.

The definition of "United States Shareholder" of a CFC is amended to include U.S. persons that own 10 percent or more of the total value of shares of all classes of stock of a foreign corporation.

B. Elimination of requirement that corporation must be controlled for 30 days before Subpart F inclusions apply.

Amendment eliminates requirement that 10 percent U.S. shareholders of a foreign corporation must only include their pro rata share of Subpart F income of a foreign corporation that was a CFC for an uninterrupted period of 30 days or more during any taxable year. 10 percent U.S. shareholders must now include their allocable share of Subpart F income if the foreign corporation has been a CFC at any time during any taxable year.

C. Both CFC amendments effective for taxable years of foreign corporations beginning after Dec. 31, 2017, and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

V. New Excise Tax on Certain Private Colleges and Universities; UBTI

A. Excise Tax Based on Investment Income of Private Colleges and Universities

Net investment income of certain private colleges and universities is subject to a 1.4 percent tax. Such income is calculated in the same manner in which private foundations calculate their net investment income. Effective for taxable years beginning after Dec. 31, 2017.

B. UBTI

Under a new provision (Section 512(a)(6) of the Code), UBTI must be calculated separately with respect to each separate trade or business with losses usable only against the applicable related trade or business and not against all UBTI generally.

VI. Accounting Methods – Certain Special Rules for Taxable Year of Inclusion

A. New Section 451(b) provides that accrual basis taxpayers must include certain types of income in gross income when an item of income (or portion thereof) is taken into account as revenue in an "applicable financial statement" of the taxpayer. Does not apply with respect to items of gross income for which a taxpayer uses a "special method of accounting" (other than one in Sections 1271 through 1288). The period for taking into account any Section 481 adjustments with respect to income from a debt instrument with OID is six years.

B. New Section 451(c) provides that accrual method taxpayers can elect to defer the inclusion of income associated with certain advance payments to the end of the tax year following the tax year of receipt if such income is also deferred for financial statement purposes.

C. Effective for taxable years beginning after Dec. 31, 2017 (Dec. 31, 2018 for instruments with OID).

Cryptocurrency, Alternative Data and Blockchain

I. Fund Products

A. Wallet Funds

1. The basic vehicle that is offered is essentially a wallet. A wallet fund invests in cryptocurrency and pays cash back to investors when they decide to redeem. These funds provide value to investors by buying and storing digital assets safely, but the fund does not make the strategic decision of when to trade in and out.

2. The terms for these vehicles typically include:

   (a) Frequent (if not daily) liquidity;

   (b) Modest management fees; and

   (c) No incentive fee.

B. Funds That Invest in Multiple Cryptocurrencies

1. More recent products strategically invest in multiple cryptocurrencies. These funds allow managers to diversify their portfolio and make strategic bets on particular currencies. Funds also may be able to short cryptocurrencies that the sponsor thinks are overvalued.

2. Fund terms:

   (a) An incentive fee may be charged; and

   (b) Liquidity will likely be no more frequently than quarterly.

C. Funds That Invest in Venture Capital Companies

Funds may also invest in blockchain technology. Funds that invest in blockchain-related venture companies cannot provide liquidity and cannot easily justify charging fees based on mark-to-market values. Instead, they will probably be written to hold assets for a period of years and then pay investors out as assets are offered through an IPO or sold.

D. Initial Coin Offerings ("ICOs")

1. ICOs are not really a single asset class. If an ICO is offered for a cryptocurrency, it can potentially be held by the same type of liquid fund that holds other already traded cryptocurrencies. However, if the ICO does not allow immediate trading, or if it will take a while for an active trading market to develop, frequent liquidity rights will not be available.

2. The risks of ICOs are greater because they are not yet tested in the market. The Bitcoin protocol has been used globally for an extended period of time. On the other hand, newer currencies and their underlying protocols are more speculative, and generally the ICO is issued before the cryptocurrency it represents has been launched. U.S. Securities and Exchange Commission ("SEC") Chairman Jay Clayton, in a public statement addressing cryptocurrencies and ICOs, noted the concern that there is less investor protection and more opportunities for fraud and manipulation.[1]

3. If the underlying asset in an ICO is a token, it is important to think about what that token represents. A token that functions like stock of an ICO issuer will be a security, with its own layers of regulation. A token that can be converted into a precious metal may be a commodity. A Simple Agreement for Future

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[1] *See* Public Statement, "Statement on Cryptocurrencies and Initial Coin Offerings" (Dec. 11, 2017) *available at* https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11.

Tokens ("SAFT") is a contract to buy crypto assets in the future. Depending on what will be bought, a SAFT could be a derivative, a security or neither.

E. Audit Issues

Other issues to think about when raising or investing in digital asset funds are how to structure a fund so that it is not a cryptocurrency exchange, and how crypto assets should be stored, audited and traded. Given the complexity and volatility of crypto assets, many accounting firms have refrained from auditing crypto assets.

II. Regulatory Aspects

A. Are Digital Currencies Securities?

1. The issue is what is meant by "currency." The Commodity Futures Trading Commission ("CFTC") has asserted jurisdiction over pure play digital currencies, such as Bitcoin, but the SEC has asserted jurisdiction over "digital coins" or "digital tokens." In July 2017, the SEC released a Report of Investigation on an offering of digital tokens by an entity called "The DAO."[2] After examining The DAO's digital tokens under the *Howey* test, the SEC concluded that The DAO tokens were securities under the Securities Act of 1934 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"), as the tokens essentially looked like the issuance of stock. In a recent order, the SEC explained that a token can be a security based on the long-standing facts and circumstances test, which includes assessing whether investors' profits are to be derived from the managerial and entrepreneurial efforts of others.[3]

2. In determining whether digital currencies are securities, regulators seem to be applying a functional and resemblance approach. Where a digital asset looks more like an investment contract or another variety of security (e.g., if it is an investment in a common enterprise with an expectation of profits to be derived from the efforts of others) the SEC will expect the requirements of the Securities and Exchange Acts to be followed.

B. Registration Issues

If a fund manager is advising others on trading digital assets that are securities, they may have to register with the SEC as an investment adviser. If a manager is required to register it will have to comply with the custody rule, which requires client funds and securities to be maintained with qualified custodians in an account either under the client's name or under the name of an agent or trustee of the client.

C. SEC Jurisdiction

Vehicles such as ETFs holding digital currencies clearly fall within the jurisdiction of the SEC. The SEC has rejected applications for Bitcoin on the basis of the fact that there is too much room for manipulation in the underlying instruments (a factor the SEC must consider before approving an ETF) given the largely unregulated nature of Bitcoin exchanges. However, Bitcoin futures are now being issued on major exchanges such as the Chicago Mercantile Exchange ("CME") and the Chicago Board Options Exchange ("CBOE"). A more robust futures market may ease the SEC's concerns about potential market manipulation. Since the launch of futures contracts by the CME and CBOE, several more applications for Bitcoin ETFs have been filed with the SEC.

D. SEC Enforcement

1. In December 2014, the SEC brought an enforcement action against an individual and his business for operating as an unregistered exchange and an unregistered broker-dealer.[4] The defendant operated two separate online securities exchanges that were denominated in Bitcoin and Litecoin that allowed users to issue stock and secondary offerings of Bitcoin and Litecoin.

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[2] *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Release No. 81207 (July 25, 2017).

[3] *See* In the Matter of Munchee Inc., File No. 3-18304 (Dec. 11, 2017).

[4] *See* In the Matter of BTC Trading, Corp. and Ethan Burnside, File No. 3-16307 (Dec. 8, 2014).

2. In June 2017, the SEC obtained a final judgment against two Bitcoin mining companies for defrauding investors. [5] The defendants offered shares to investors in their mining operation, but the defendants did not own enough computing power for the mining they promised to conduct. The U.S. District Court for the District of Connecticut enjoined the defendants from violating Sections 5 and 17(a) of the Securities Act and Section 10(b) of the Exchange Act, and ordered each defendant to pay disgorgement and civil penalties.

3. In September 2017, the SEC charged an individual and two companies with defrauding investors through the offering of ICOs backed by investments in real estate and diamonds. In the charges, the SEC alleged that the underlying coins did not actually exist.[6]

4. In December 2017, the SEC ordered a company to halt its ICO and refund investor proceeds after the SEC found that the ICO constituted the offer and sale of unregistered securities.[7] During the course of the ICO, the company emphasized that investors could expect that efforts by the company and others would lead to an increase in the value of the tokens, and that the company would create and support a secondary market for the tokens. As a result, the SEC found that investors would form a reasonable belief that their investment tokens could generate a return on investment.

E. CFTC Regulation

1. In a ruling in 2015, the CFTC issued an order against an online platform and its CEO for facilitating the trade of Bitcoin options contracts. [8] The key takeaway from the order was that the CFTC asserted that virtual currencies are considered commodities. This assertion is meaningful in three ways.

   (a) First, it means that the CFTC considers itself to have jurisdiction over virtual currency derivatives, as they could now be considered “commodity futures” or “commodity options.”

   (b) Second, it means that the CFTC has jurisdiction over virtual currency OTC instruments such as “swaps.”

   (c) Third, while the CFTC does not have jurisdiction over trading of digital assets, it can still assert jurisdiction over this spot market if it believes that manipulation of the spot market will affect the derivatives markets. The CFTC has historically brought enforcement actions for manipulation of the spot FX and agricultural markets — markets it technically does not have direct jurisdiction over. The CFTC could do the same for digital assets if it believes that it is affecting the derivatives market.

2. Impact on fund managers

   (a) Funds that are holding digital currency derivatives will be considered “commodity pools” and will need to either ensure that the Commodity Pool Operator *de minimis* exemption works for them or otherwise register with the CFTC.

   (b) While funds that are currently only holding digital assets but are not trading any CFTC-regulated instruments would not be commodity pools, those fund managers should also consider whether they need the capability to hedge this exposure with derivatives in the future.

   (c) Firms that offer to buy and sell Bitcoin derivatives will be considered a “futures exchange,” which would require the firm to be registered with the CFTC as a derivatives contract market.

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[5] *See* Litigation Release No. 23852 (June 5, 2017).

[6] *See* Press Release, SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds (Sept. 29, 2017); *available at* https://www.sec.gov/news/press-release/2017-185-0.

[7] *See* In the Matter of Munchee Inc., File No. 3-18304 (Dec. 11, 2017).

[8] *See* In the Matter of Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan (Sept. 17, 2015).

III. Tax Aspects

A. Characterization of Virtual Currency for U.S. Federal Tax Purposes

1. The Internal Revenue Service ("Service") provided guidance in Notice 2014-21 that virtual currency (e.g., Bitcoin, Ethereum, Litecoin, etc.) generally is treated as property for U.S. federal tax purposes and is not considered a "currency" that would trigger foreign currency gain or loss under Section 988 of the Code. As property, the character of gain or loss from the sale or exchange of virtual currency generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer. Accordingly, taxpayers who hold virtual currency as a capital asset should recognize capital gain or loss on the disposition of such virtual currency.

2. Unlike the CFTC, the Service has not clarified whether or not virtual currencies are characterized as commodities for U.S. federal tax purposes.

3. Some virtual currencies, such as Bitcoin, function as media of exchange. Others, however, exhibit characteristics that resemble securities or otherwise function as other than a medium of exchange. The tax treatment of such virtual currencies or other such digital assets may be characterized as equity interests in an underlying constructive joint venture or association, in which case owners of such digital assets may be taxable on their share of any items of income deemed allocated or deemed distributed from the constructive joint venture or association to them.

B. Considerations for Investment Funds Investing in Virtual Currencies

1. Publicly Traded Partnerships. Investment funds operating as partnerships for U.S. federal tax purposes generally operate in a manner so as to avoid being treated as "publicly traded partnerships" ("PTPs") taxable as corporations within the meaning of Section 7704 of the Code. Many investment funds (especially long-short equity funds) rely on the "qualifying income" exception for PTP purposes. The characterization of virtual currency as a "commodity," or otherwise, could affect an investment fund's ability to satisfy the qualifying income exception. Alternatively, virtual currency investment funds that offer frequent liquidity to their investors could restrict their investor base to fewer than 100 partners in order to satisfy the "100-partner" PTP safe harbor.

2. Mark-to-Market Elections. The mark-to-market election under Section 475(f) of the Code could apply to virtual currencies, if virtual currencies are characterized as "securities" or "commodities."

3. Effectively Connected Income & the Trading Safe Harbors. Investment funds generally rely on Section 864(b)(2) safe harbors to avoid treating income and gain from trading in securities and commodities as effectively connected with a U.S. trade or business. The Service has yet to provide guidance on whether or not virtual currencies constitute securities or commodities. Furthermore, even if virtual currencies constitute commodities, not all commodities fall under the commodities safe harbor — only those that are "of a kind customarily dealt in on an organized commodity exchange" and even then, only if the transactions effected in such commodities are "of a kind customarily consummated at such place." The Service currently does not offer guidance on these aspects of the commodities trading safe harbor.

4. Virtual Currencies and ICOs as Deemed Equity Interests. Virtual currencies that exhibit characteristics that resemble securities or otherwise function as other than a medium of exchange, such as certain ICOs, may be characterized by the Service as equity interests in an underlying constructive joint venture or association for U.S. federal tax purposes. An investment in such virtual currencies or ICOs that would be treated as constructive joint ventures or associations for U.S. federal tax purposes may cause non-U.S. investors or tax-exempt U.S. investors to earn effectively connected income or unrelated business taxable income, respectively. Furthermore, if the constructive joint venture or association were regarded as a foreign corporation, U.S. investors may be subject to certain anti-deferral rules (e.g., PFIC, CFC, etc.) with respect to any income or deemed income of the constructive joint venture or association.

IV. Money Transmission

A. Fund managers that manage funds that invest in digital assets directly, or invest in companies that issue, sell or exchange digital assets, should be aware of the potential applicability of state and federal money transmission laws.

B. State Regulation

1. Nearly all U.S. states regulate money transmission, typically defined as: receipt of money or monetary value for transmission; sale or issuance of payment instruments; or sale or issuance of stored value that can be redeemed for cash or at multiple, unaffiliated merchants (commonly referred to as "open-loop" stored value). Many states also regulate currency exchange under money transmission regulations.

2. An increasing number of states, by statute or guidance, have interpreted monetary value, "money or its equivalent" or similar terms to include certain digital assets, including virtual currency, that function as a medium of exchange. Accordingly, transmitting digital assets to a third party, issuing digital assets or storing digital assets for others, may require a state money transmission license.

3. For example, the New York State Department of Financial Services has adopted regulations requiring a license (commonly known as a "BitLicense") for any person engaged in virtual currency business activity, which is defined as:

   (a) Receiving virtual currency for transmission or transmitting virtual currency (subject to an exception for transactions undertaken for non-financial purposes and not involving a transfer of more than a nominal amount of virtual currency);

   (b) Storing, holding or maintaining custody or control of virtual currency on behalf of others;

   (c) Buying and selling virtual currency as a customer business;

   (d) Performing exchange services as a customer business; or

   (e) Controlling, administering or issuing a virtual currency.

C. Federal Regulation

1. On March 18, 2013, the Financial Crimes Enforcement Network ("FinCEN") issued guidance entitled "Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies," clarifying how the Bank Secrecy Act implementing regulations ("BSA Regulations") apply to "users," "administrators" and "exchangers" of "convertible virtual currency," which is defined as virtual currency that "has either an equivalent value in real currency, or acts as a substitute for real currency."

2. The guidance provides that an "administrator" or "exchanger" that (i) accepts and transmits a convertible virtual currency or (ii) buys or sells convertible virtual currency for any reason is a money transmitter and therefore a "money services business" ("MSB") under the BSA Regulations, subject to any applicable limitation or exemption.

   (a) An "administrator" of virtual currency under the guidance is defined as "a person engaged as a business in issuing (putting into circulation) a virtual currency, and who has the authority to redeem (to withdraw from circulation) such virtual currency."

   (b) An "exchanger" of virtual currency is defined as "a person engaged as a business in the exchange of virtual currency for real currency, funds or other virtual currency."

   (c) The guidance also provides that "users" of convertible virtual currency are not considered MSBs under the BSA Regulations.

3. The BSA Regulations require all MSBs to establish and maintain an effective written anti-money laundering program reasonably designed to prevent the MSB from being used to facilitate money laundering and the financing of terrorist activities. Accordingly, any fund manager or fund engaged in

activities involving convertible virtual currencies should assess the impact of the guidance on their obligations under the BSA Regulations.

D. Evaluation of the application of state and federal money transmission laws to activities involving digital assets, such as virtual currencies, and to the persons or companies, issuing, selling or exchanging such assets is an important component of investor diligence and as part of the fund's comprehensive compliance program. Fund managers should conduct diligence on all parties involved in the issuance, sale or exchange of digital assets (including digital assets created via ICOs) to ensure that all parties have the appropriate licenses/registrations. In addition, each fund engaging in activities involving digital assets will need to evaluate its own activities to ensure that the fund does not engage in activity that requires a money transmission license/registration. In this context, important questions to consider are whether the fund is:

   1. Holding digital assets (that function as a medium of exchange) on behalf of others, or for its own account;

   2. Performing exchange services for investors, or if it is only accepting investments in real currency for interests in the fund and redeeming those interests for the same type of real currency; or

   3. Buying and selling digital assets (that function as a medium of exchange or convertible virtual currency) as a business, or solely as an investor.

E. Fund managers should also be aware that an investment of the fund in any company that is engaging in, or proposes to engage in, a licensable activity, that aggregates to ownership interest in such a company of 10 percent or more, may require the fund to register as a "control person" under state money transmission laws. Such registration may require the provision of background, biographical and/or financial information to states. Ownership may be by shares or digital assets representing an ownership interest.

V. Alternative Data

A. By some estimates, spending on alternative data sources is growing by 20 percent per year and is expected to reach $7 billion by 2020.[9] Alternative data raises certain practical and fiduciary issues, including:

   1. Underestimating the cost and expense of proper amounts of "data scrubbing";

   2. The need to perform a sophisticated assessment of the data and its usefulness; and

   3. The fiduciary ramifications of "plug and play" errors if sufficient scrubbing and testing is not performed and an alternative data set is incorporated into the investment program.

B. Alternative data usage also raises the possibility of trading on the basis of material nonpublic information. Managers therefore should look at questions such as:

   1. Is the purchased data nonpublic information?

   2. Does the manager have the right to use the data

   3. What is the level of insider trading comfort for the use of alternative data in trading in non-U.S. markets?

C. Market Manipulation Concerns

   1. To the extent that alternative data approaches the level of perfect information with respect to an issuer, manipulation concerns could increase.

   2. In addition, purchasing data from alternative data providers on an "exclusive" or "quasi-exclusive" basis could result in group-like activity that (in addition to insider trading concerns) gives rise to enforcement inquiries under a manipulation theory.

[9] *See* "Alternative Data – The New Frontier in Asset Management" (March 31, 2017) *available at* http://www.opimas.com/research/217/detail/.

Fund Economics

I. Introduction

A. Managers and investors continue to find (or accept) new and creative ways to structure management fees and incentive compensation.

B. While there is some sentiment about management fee rates per se, investors often are more wary that managers should not profit from excess management fees (the argument being that the manager should focus more on increasing the value of its assets under management than on gathering assets under management). Consequently, managers must be prepared to justify their fees as compared to their expenses.

C. An accelerating 2017 trend that is expected to continue into 2018 is experimentation with fee structures and a variety of relationship-driven negotiations in a bid to attract and retain investors. Managers should expect significant negotiations with investors on fee structures and rates.

D. If a new manager wants a flexible fee structure, we believe it is most practical to first set a “rack rate,” which is a realistic rate that will support the manager’s operations and, at the same time, is reasonably attractive to the average investor. Then, managers can use that rack rate to guide the range of fee options they will offer to investors (i.e., seed investor rates, founders’ class rates).

II. Fee Trends for Hedge Funds

A. Large Investor Discounts

1. Some managers will take into account the size of an investor’s investment on an aggregate basis across all of the funds and accounts managed by the same manager.
2. Giving fee breaks to large investors is relationship-driven.
3. Aggregators and intermediaries, such as consultants, funds of funds and wealth platforms, often seek to use their bargaining power to negotiate lower management fees and incentive compensations for their clients. It is important for managers who negotiate with such aggregators to disclose in their offering materials and cover “MFN” provisions that any references to “investors” for purposes of fee breaks and differing terms in general include such aggregators or intermediaries and any client of an aggregator or intermediary which has negotiated such terms.
4. Large investors often ask for access to co-investment opportunities at low or no fees as another way of lowering their overall fees.

B. Loyalty Discounts

As an incentive to retain assets and/or to remain competitive, a few managers have reduced fees for investors who have continuously maintained investment in the manager’s fund for specified periods.

C. Founders’ Classes

1. Managers launching new funds continue to offer “founders’ classes” to entice early investment in a fund (e.g., for the first six months after launch). Founders’ classes discount the management fee and usually discount the incentive compensation.
2. In exchange for such discounts, investors in founders’ classes sometimes have to agree to lock-up periods during which they are either unable to redeem or are able to redeem, subject to a redemption charge. Founders’ classes usually do not require a minimum investment (above the fund’s general minimum investment requirement).
3. There are no standard or market terms for founders’ classes; they vary widely.

(a) Founders' class terms sometimes have an expiration that is tied to the fund or the firm (or both) reaching a certain level of assets under management or a time period. For example, a founders' class may expire when the firm reaches $250 million in assets under management or six months after the initial closing 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.

(c) 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.

(d) A manager will typically show the terms of founders' classes in the fund's confidential memorandum (as opposed to a supplement or side letter), which provides transparency to all investors.

D. 1 or 30 Fee Structure

1. The 1 or 30 fee structure is a compensation arrangement that was initially proposed by the Teacher Retirement System of Texas and its consultant Albourne Partners with the goal of better aligning the interests of investors and managers.

2. Under this structure, a manager is paid annually the greater of: (i) 1 percent of the net asset value of the fund; or (ii) 30 percent of net capital appreciation (over a high water mark and a benchmark) for the year over an agreed upon benchmark. The concept is that in the higher performing, pre-crisis "2/20" years, the "all-in" profit split between investors and manager was 70-30 and that 1 or 30 would replicate that split.

3. The 1 percent is paid regardless of profits and is structured as a management fee.

4. The 30 percent is calculated as 30 percent of net capital appreciation without reduction for the management fee. Proponents of this fee structure view the management fee as an advance against the Incentive Allocation.

5. Variations of the 1 or 30 fee structure have quickly emerged, such as "1 or 20" and the exclusion of the "benchmark."

E. Tiered Incentive Compensation Rates

Incentive compensation has not been subject to as much compression pressure as management fees. Investors remain willing to reward managers for performance, and some managers have added tiers to their incentive compensation rates (i.e., charging higher rates for higher performance).

F. Many hedge fund managers offer (or are ordered to offer) co-investment opportunities to large investors at low (or no) management fee and incentive allocation rates. These investors expect to be offered such opportunities (or take excess capacity available in a position) and view these arrangements as a way to receive reduced fees on a blended basis.

G. Funds That Are Below High Water Marks

1. To encourage investors to retain their investments in a fund that is below its high water mark, a few fund managers have been willing to suspend incentive compensation on new capital until the high water mark for existing capital is surpassed. This has yet to become a trend.

2. To address the investor concern that the management fee not turn into a profit center, a few existing managers and start-up managers have agreed to a management fee structure that ratchets down when certain milestones for assets under management are met. This has yet to become a trend.

III. Fee Trends for Hybrid Funds, Private Equity Funds and Co-Investment Vehicles

A. Management Fees

By and large, the usual range of management fees remains unchanged. There is less pressure on incentive compensation rates than in the hedge funds because the 20 percent carried interest is based on realized gains only after an 8 percent preferred return is paid to the limited partners.

1. For funds which use subscription lines or leverage to make investments before drawing down capital, there is an "ask" in the marketplace by institutional investors for the 8 percent preferred return to commence as soon as the fund borrows, but it remains to be seen if this request will catch on.
2. There is an "ask" by some managers for a 6 percent preferred return rather than the standard 8 percent preferred return. However, this change has yet to become a trend.
3. The carried interest catch up to the general partner continues to be 100 percent or 80 percent.

B. Blending Approach/Co-Investment Vehicles

Like hedge funds, many hybrid and private equity funds have started to broadly offer co-investment opportunities to their limited partners at low or no fees so that investors can benefit from lower overall fees on a blended basis.

C. First-Close/Early-Close Discounts

1. Founders' class discounts are becoming increasingly popular with start-up funds. Inspired by that model, some private equity fund and hybrid fund managers have been successful in offering 25 to 50 basis point discounts to investors that commit capital either in the first closing or within a specified period of time after the first closing (e.g., three months).
2. There are pros/cons to this approach. The pro is to attract capital early to a manager who may be launching its first hybrid or private equity fund. The con is that often a large investor will insist on a fee break whether or not it participates in the first (or an early) closing.
3. Similar to founders' class discounts, first-close/early-close discounts are often disclosed in the offering materials rather than in privately negotiated side letters.
4. Some institutional investors will analyze whether a new fund manager should offer any discount at all if the resulting management fees would compromise the manager's ability to cover its costs.

D. Commitment/Relationship Size Discounts

Similar to fee discounts offered based on the timing of a capital commitment, managers frequently offer scaled fee breaks determined by the size of a particular capital commitment or based on the size of an investor's aggregate capital commitments to various funds and accounts sponsored by the manager.

E. Back-Ended (aka European) Waterfalls

1. For private equity funds, hybrid funds and co-invest vehicles, back-ended or "European"-style waterfalls are the carried interest structure preferred by investors. Although the risk is not eliminated completely, the use of a European waterfall greatly reduces the risk of a clawback at the end of the life of a fund (as compared to the likelihood of a clawback associated with a deal-by-deal waterfall).
2. The difficulty for managers in offering a European-style waterfall is how to compensate employees and partners in the early years of the fund. This can be especially difficult for managers that have investment professionals who are accustomed to earning annual incentive compensation and sometimes results in the manager looking at a modified deal-by-deal waterfall.

IV. Seed Investor Economics

A. Typical Seed Investor Deals

1. The trend of launching a hedge fund with a seed investment in place continues. Seed investments are challenging to find.

(a) This is due to the number of seed investors ready to commit capital to a first-time manager with a strong pedigree or track record, and the dearth of early capital from other sources (e.g., many institutional investors and consultants will not even consider investing with a manager until it has a two- or three-year track record).

(b) Many seed investments we see range from $50 million to $200 million and are subject to a two- or three-year lock-up on the seeder's capital (subject to certain negotiated early redemption rights).

2. We continue to observe seed investment transactions that are based on a percentage of gross revenue rather than on net income.

3. Seeder participation tends to range from 10 percent to 20 percent.

B. Working Capital Deals

1. For the first time in many years, we are seeing a number of working capital investments in new managers. Some are part of seed deals; some do not provide seed capital.

2. Managers are experimenting with different working capital deal structures.

(a) The purpose of the working capital is to show investors that the start-up manager has a "runway" on which to build its business and attract talent. This will entice capital to invest with the manager knowing that it has adequate operating capital.

(b) In particular, we see working capital transactions with managers in the quantitative trading space. Personnel, technology, data processing equipment and data sets themselves can be expensive and require significant up-front capital to get started.

(c) Some start-up managers are looking for working capital investments in the management company in exchange for a percent of management fees. Other managers are offering up a small share of the gross revenue in return for working capital investments.

(d) Working capital deals can also vary in terms of their lifespan. For example, such deals can: (i) be perpetual (a percentage of management fees or gross revenue in perpetuity throughout the life of the fund or existence of the manager); (ii) remain in place a fixed number of years; or (iii) remain in place until the revenue share and capital appreciation of the working capital investor's investment reaches a certain amount or rate of return.

3. Seed investors and working capital investors typically pay the highest fee rates. However, some seed and working capital investors pay the founders' class fee rates. In cases where seed and working capital investors pay the founders' class fee rates and receive a share of gross revenues, managers should carve out the discounted fees from the calculation of the gross revenue share.

V. Other Considerations Related to Fund Economics

A. Fund Expenses

1. The costs of starting a hedge fund or private equity fund business continue to rise (e.g., due to regulatory costs, data costs, retaining talent and paying for office space).

2. Even as management fees are compressed, the list of permitted fund-operating expenses grows. Investors are often willing to permit a growing list of fund expenses, but they pay attention to the expense ratio.

B. Fee and Expense Disclosures

Not only have fee structures and rates been gaining more attention from investors, but the SEC closely scrutinizes disclosures on fees and fund expenses. Managers should pay special care to ensuring their marketing and offering documents are accurate, consistent and carefully drafted.

C. MFNs

1. Managers should be careful when giving fee breaks and agreeing to different fee structures that their "most-favored-nation" covenants are written in a manner that interpretation is clear and necessary carve-outs are made (e.g., for seed deals, founders' classes clients of aggregators and intermediaries).

2. Conduit Funds

   (a) Some larger managers continue 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-nation covenant interpretation, as the conduit fund may not pay fees at the underlying fund level.

Regulatory Outlook

I. Electronic Communications, Texts, Chats and Personal Email

A. Legal Framework

1. Rule 204-2 of the Investment Advisers Act of 1940 (“Advisers Act”) – Recordkeeping[1]
2. Section 203 of the Advisers Act – Duty to Supervise[2]
3. Rule 206(4)-7 of the Advisers Act – Reasonably designed compliance program[3]
4. Section 204A of the Advisers Act – Reasonably designed policies and procedures to prevent insider trading[4]

B. Significant Risk Factors

1. MNPI/insider trading
2. Securities on the restricted list
3. Conflicts of interest
4. Information security
5. Gifts and entertainment
6. Political contributions
7. Errors or discrepancies
8. Communications with other advisers
9. Use of expert networks and consultants
10. Personal email use

C. Potentially Applicable Legal Provisions:

1. The Electronic Communications Privacy Act generally prohibits private entities from wiretapping unless certain conditions are met.[5]

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[1] “Every investment adviser registered or required to be registered under section 203 of the Act (15 U.S.C. 80b-3) shall make and keep true, accurate and current the following books and records relating to its investment advisory business . . . (7) Originals of all written communications received and copies of all written communications sent by such investment adviser relating to: (i) Any recommendation made or proposed to be made and any advice given or proposed to be given; (ii) Any receipt, disbursement or delivery of funds or securities; (iii) The placing or execution of any order to purchase or sell any security; (iv) The performance or rate of return of any or all managed accounts or securities recommendations . . . .” Advisers Act 1940 Rule 204-2, 17 CFR 275.204-2.

[2] Section 203(e)(6) of the Advisers Act provides for the imposition of a sanction against an investment adviser who has failed reasonably to supervise, with a view to preventing violations of the securities laws, another person who commits such a violation, if such other person is subject to its supervision. Advisers Act § 203(e)(6), 15 U.S.C. § 80b-3(e)(6).

[3] “If you are an investment adviser registered or required to be registered under section 203 of the Investment Advisers Act of 1940, it shall be unlawful within the meaning of section 206 of the Act for you to provide investment advice to clients unless you…[a]dopt and implement written policies and procedures reasonably designed to prevent violation, by you and your supervised persons, of the Act and the rules that the Commission has adopted under the Act[.]” Advisers Act Rule 206(4)-7.

[4] “Every investment adviser subject to section 204 of this title shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such investment adviser’s business, to prevent the misuse in violation of this Act or the Securities Exchange Act of 1934, or the rules or regulations thereunder, of material, nonpublic information by such investment adviser or any person associated with such investment adviser.” Advisers Act § 204A.

[5] 18 U.S.C. §§ 2510 – 2522.

2. The Stored Communications Act makes it a crime to gain surreptitious access to stored communications such as email, social media messages (in certain circumstances) and text messages.[6]

3. The Computer Fraud and Abuse Act prohibits anyone from intentionally accessing a computer without authorization, such as when an employer accesses employees' personal phones, devices or accounts without authorization.[7]

4. Twenty-four states have passed so-called "anti-snooping" laws prohibiting employers from demanding passwords to access personal email and social networking sites.[8]

D. Examples of steps taken by firms to address these issues include: obtaining advance authorization to access and wipe the firm's information stored on employee-owned mobile devices; considering mobile management software that can separate firm information from personal information; clearly delineating where work cannot be done (e.g., prohibiting firm work on personal email accounts); and crafting 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.

E. Elements of a "BYOD" and Electronic Messaging Policy

1. Restrictions on access, data use and encryption

2. Identification of approved tools and devices

3. Monitoring devices and applications

4. Coordination with other HR policies

5. Record-keeping obligations

F. Two-device policies — requiring employees to use separate devices for business and personal communications — may be simple from a compliance perspective, but more cumbersome for employers.

G. Unmonitored Electronic Communications in U.S. Securities and Exchange Commission ("SEC") Exams Conducted by the Office of Compliance Inspections and Examinations ("OCIE")

1. OCIE has started to investigate more closely certain communication platforms. This is consistent with the SEC's broader uptick in inquiries regarding how certain electronic communications are being used by advisers and their employees.

2. In particular, OCIE's concerns regarding messaging and text platforms are that:

(a) More employees are regularly using these systems;

(b) Messages are generally unmonitored and not archived;

(c) Some messages are encrypted (e.g., WhatsApp, iMessage); and

(d) Some messages are encrypted and "self-destructing" (e.g., Confide, Signal).

3. A recent "Information Request List" being used by OCIE focusing on the use of electronic communications by advisers and their employees recently became public. The list asks an adviser for: descriptions of how the adviser and its employees used electronic messaging services and through which devices; adviser's policies and procedures related to electronic messaging, including how an adviser monitors electronic messaging (e.g., exception/activity reports); the identities and responsibilities of

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[6] 18 U.S.C. §§ 2701 – 2711.

[7] *See*, *e.g.*, *Rajaee v. Design Tech Homes, Ltd.*, No. H-13-2517, 2014 WL 5878477 (S.D. Tex. Nov. 11, 2014).

[8] 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.

those who oversee those policies and procedures; documentation as to any instances of unauthorized use of electronic messaging and adviser's actions in connection therewith; and summaries of any internal audits or compliance reviews in connection with electronic messaging. Information Request List items in broader examinations will overlap with many of these requests, even if electronic communications are not the sole focus of those examinations.

II. Material Non-Public Information ("MNPI"): Policies & Procedures and Failure to Supervise Firm Personnel

A. Inadequate MNPI policies and procedures

On Aug. 21, 2017, Deerfield Management Company, L.P. consented to the entry of an order under which the SEC found that Deerfield willfully violated Section 204A of the Advisers Act.[9] The SEC ordered Deerfield to pay more than $4.6 million to settle charges that it failed to establish, maintain and enforce policies reasonably designed to prevent the misuse of inside information.[10]

1. Current and former Deerfield analysts, a political intelligence analyst and a government employee at the Centers for Medicare & Medicaid Services (CMS) were charged separately in a scheme to commit insider trading. In their scheme, the political intelligence analyst obtained MNPI from the CMS employee in advance of market moving events and then passed that information to the Deerfield analysts who recommended trades based on that information. Deerfield allegedly reaped more than $3.9 million in profits. [11]

2. Deerfield regularly engaged political research firms in connection with forthcoming regulatory and legislative decisions. Deerfield had policies and procedures in place that only required an initial review, updated "from time to time," of the engaged research firm's own policies and procedures regarding MNPI. Deerfield then relied on its own employees to self-evaluate and self-report any potential receipt of MNPI. But Deerfield allegedly failed to adopt policies and procedures to ensure that its employees actually did so. In addition, contrary to its own policies just described, Deerfield allegedly failed to review the policies and procedures of one of its political intelligence analyst's research firms that Deerfield retained from 2009 until 2013.[12]

3. Moreover, despite "red flags" that the political intelligence analyst was conveying MNPI to its analysts, Deerfield "continued to retain the political intelligence analyst's research firms and did not address the weaknesses in its [own] policies and procedures."[13]

   (a) One "red flag" the SEC identified in the order was that, upon finally reviewing the policies and procedures of the research firm whose policies Deerfield had allegedly previously failed to review, Deerfield continued to retain the firm even though the firm had disclosed in its own Form ADV (it was also a registered investment adviser) that "the political intelligence analyst also served as the research firm's Chief Compliance Officer."[14] The SEC found that "the conflict of interest posed by a

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[9] Section 204A states, in part: "Every investment adviser subject to section 204 of this title shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such investment adviser's business, to prevent the misuse in violation of this Act or the Securities Exchange Act of 1934, or the rules or regulations thereunder, of material, nonpublic information by such investment adviser or any person associated with such investment adviser."

[10] *Deerfield Management Company, L.P.*, Advisers Act Release No. 4749, Administrative Proceeding No. 3-18120 (Aug. 21, 2017); *see also* Press Release, U.S. Sec. & Exch. Comm'n, Hedge Fund Adviser Charged for Inadequate Controls to Prevent Insider Trading (Aug. 21, 2017), *available at* https://www.sec.gov/news/press-release/2017-146.

[11] Press Release, U.S. Dep't. of Justice, Four Charged In Scheme to Commit Insider Trading Based on Confidential Government Information (May 24, 2017), *available at* https://www.justice.gov/usao-sdny/pr/four-charged-scheme-commit-insider-trading-based-confidential-government-information.

[12] *Deerfield*, Advisers Act Release No. 4749.

[13] *Id.*

[14] *Id.*

Chief Compliance Officer overseeing his own work . . . involved a risk of obtaining [MNPI] and providing such information to his investment adviser clients."[15]

(b) Other "red flags" involved communications received by Deerfield's analysis and, in some cases, Deerfield's senior management, from the political intelligence analyst containing potential MNPI (e.g., indications from CMS personnel about if and when regulations would pass). The SEC found that, despite the emails, Deerfield did not take any actions to prevent the potential misuse of MNPI.[16]

B. Failure to reasonably supervise

On Oct. 13, 2016, Artis Capital Management, L.P. and Michael Harden, a senior analyst at Artis Capital, consented to the entry of an order under which the SEC found that Artis Capital and Mr. Harden failed to reasonably supervise an Artis Capital employee within the meaning of Section 203(e)(6) of the Advisers Act.[17] The SEC alleged that Mr. Harden failed reasonably to supervise Matthew Teeple, an Artis employee who procured MNPI from an insider at a public company. Mr. Teeple communicated the MNPI 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. In addition, Mr. Harden was suspended from association with any broker, dealer, investment adviser, municipal securities dealer or transfer agent for 12 months and fined was $130,000. Artis Capital agreed to settle the SEC's charges by disgorging the illicit trading profits that Teeple generated for the firm totaling $5,165,862, plus interest of $1,129,222 and a penalty of $2,582,931.[18]

In Artis Capital, the individual charged was the business supervisor who failed to reasonably supervise a junior analyst. This underscores the principle that compliance is the responsibility of all members of a firm and cannot be solely delegated to compliance personnel.

C. General update on the legal landscape of insider trading law

1. Major development in 2017: *United States v. Martoma*[19]

(a) The Second Circuit held that "an insider or tipper personally benefits from a disclosure of inside information whenever: [1] the information was disclosed 'with the expectation that [the recipient] would trade on it' . . . and [2] the disclosure 'resemble[s] trading by the insider followed by a gift of the profits to the recipient,' . . . whether or not there was a 'meaningfully close personal relationship' between the tipper and the tippee."[20]

(b) In light of the Supreme Court's 2016 decision in *Salman v. United States*, 137 S.Ct. 420 (2016), the majority in *Martoma* rejected "the categorical rule that an insider can *never* personally benefit from disclosing inside information as a gift without a 'meaningfully close personal relationship.'"[21]

2. As a result of the Second Circuit's decision in *Martoma*, firms are more or less back in the pre-*Salman* world of the Supreme Court's analysis from its 1983 decision in *Dirks v. SEC*, 463 U.S. 646 (1983).

[15] *Id.*

[16] *Id.*

[17] The SEC found that Artis Capital also violated Section 204A of the Advisers Act.

[18] *Artis Capital Management, LP*, Advisers Act Release No. 4550 Administrative Proceeding No. 3-17624 (Oct. 13, 2016).

[19] *United States v. Martoma*, 869 F.3d 58 (2d Cir. 2017).

[20] *Id.* at 70.

[21] *Id.at 71.*

(a) In *Dirks*, the Supreme Court ruled that a "tippee" — someone who receives confidential information from an insider and then uses the information to trade — can be held liable under insider trading laws when the insider violates his duty to shareholders by disclosing the information, which in turn depends on whether the insider receives "a direct or indirect personal benefit from the disclosure."[22] The court in that case noted that jurors could infer a "personal benefit" when the insider either receives something of value in exchange for the tip or "makes a gift of confidential information to a trading relative or friend."[23]

(b) If the decision in *Martoma* stands and is adopted elsewhere, a pecuniary or consequential benefit is no longer needed regardless of the nature of the relationship between the tipper and the tippee, as long as the inside information "was disclosed 'with the expectation that [the recipient] would trade on it' . . . and the disclosure 'resemble[s] trading by the insider followed by a gift of the profits to the recipient.'"[24]

3. Key defenses remain intact

Neither the Supreme Court's decision in *Salman* nor the Second Circuit's decision in *Martoma* undercut the Second Circuit's principal holding in *United States v. Newman* that a tippee must know or have reason to know that the tipper breached his or her duty by providing inside information in exchange for a legally cognizable personal benefit (whatever that benefit might be) in exchange for the tip.[25]

D. From a compliance perspective, investment advisers must conduct regular and periodic trainings for employees concerning insider trading laws and policies. 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.

E. Exams: Insider Trading

1. Some recent examinations have focused 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.

2. 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.

3. Examination staff have taken the position in recent examinations that advisers should create and maintain logs of meetings with company management and industry experts in order to investigate certain trades.

4. OCIE has continued its recent focus on buy-side firms' reliance on alternative data to inform investment decisions. The use of big data raises potential concerns, including contractual issues, privacy and data security laws, as well as insider trading liability.

(a) Securities laws issues can arise if data was collected in a manner considered "deceptive," as there is a risk that trading on that information may be considered part of a fraudulent scheme in violation of the antifraud provisions under the securities laws. Certain actions (e.g., circumventing security protocols, disguising or not revealing a scraper's identity on a site where required to do so, or otherwise deceiving a website to gain entry) might be viewed as affirmative misrepresentations

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[22] *Dirks v. SEC*, 463 U.S. 646, 663 (1983).

[23] *Dirks*, 463 U.S. at 664.

[24] *United States v. Martoma*, 869 F.3d 58, 70 n.8 (citations omitted).

[25] *See United States v. Newman*, 773 F. 3d 438 (2d Cir. 2014) *cert denied,* 136 S.Ct. 242 (2015).

constituting a "deceptive device" under Section 10(b) and Rule 10b-5, which could form the basis for a fraud claim.

(b) Policies covering the collection and use of alternative data may include policies regarding: abiding by website terms; following technological protocols; avoiding collecting expressive or proprietary content; and appropriate recordkeeping.

III. Privilege in SEC Examinations and Enforcement Actions

A. The Attorney-Client Privilege

"Full and Frank Communication"

1. U.S. law has long recognized that "sound legal advice or advocacy . . . depends upon the lawyer's being fully informed by the client."[26]

2. A lawyer can't be fully informed if the client is wary of sharing confidential or sensitive information for fear of it being disclosed to third parties. By protecting such communications, the attorney-client privilege "encourage[s] full and frank communication between attorneys and their clients."[27]

B. Elements of the Privilege

1. Communication made between an attorney and a client;

2. Communication made in confidence; and

3. Communications made for the purpose of seeking or providing legal advice.

Note that facts themselves are not privileged.

C. Privilege Over Work Product

Documents prepared in anticipation of litigation may also be privileged.

D. Waiver of Privilege

1. Communications shared with third parties outside the attorney-client relationship.

2. Voluntary disclosure of privileged communications to the SEC may waive the attorney client privilege as to a third party seeking those communications.

(a) In *Gruss v. Zwirn*, the court held that a former employee suing a hedge fund manager was entitled to obtain copies of internal investigation materials the firm had turned over to the SEC pursuant to a confidentiality agreement.[28]

(b) A more recent case found that lawyers who provided the SEC with a verbal presentation of information the lawyers obtained as part of an internal investigation waived work-product protection with regard to interview memos and interview notes that would normally be protected by the work-product doctrine.[29]

(c) Steve Peikin, co-director of the Division of Enforcement, however, has expressed his concern about this topic and has asked that he or his senior staff be alerted if and when investigative staff are seeking a work-product waiver concerning interview memos and/or notes, or the production thereof.

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[26] *See Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981).

[27] *See id.*

[28] *Gruss v. Zwirn*, No. 09 Civ. 6441, 2013 WL 3481350 (S.D.N.Y. July 10, 2013).

[29] *See SEC v. Herrera*, No. 1:17-CV-20301, 2017 WL 6041750 (S.D. Fla. Dec. 5, 2017).

3. Reliance on advice of counsel defense.

   In *Gray Financial Group, Inc.*, respondents — a registered investment adviser and two of its officers — asserted a reliance on advice of counsel defense in a proceeding alleging violations of Section 206(1) and 206(2) of the Advisers Act for recommending, offering and selling investments in their fund of funds to public pension clients despite the fact that they allegedly knew (or should have known) that the investments did not comply with state law. Respondents waived attorney-client privilege as to communications with their prior counsel, who respondents subbed out for new counsel before the time when their public pension clients either committed to investing or did invest in the fund of funds. Nonetheless, and in fact importantly because the crucial events, which were the subject of the proceeding, occurred after respondents engaged new counsel, the administrative law judge found that respondents impliedly waived privilege as to the latter counsel. Though not identically situated, first and second counsel were similarly situated enough that waiver was implied to prevent respondents from abusing the attorney-client privilege.[30]

E. Maintaining Privilege When Utilizing Non-Lawyer Consultants

1. Attorneys may retain consultants to assist attorneys in providing legal advice to clients.
2. Tax consultants. *United States v. Kovel*, 296 F.2d 918 (2d Cir. 1961).
3. Public relations agents. *In re Copper Market Antitrust Litigation*, 200 F.R.D. 213 (S.D.N.Y. 2001); *In re Grand Jury Subpoenas Dated March 24, 2003*, 265 F. Supp. 2d 321 (S.D.N.Y. 2003).
4. Independent contractors acting like employees. *Twentieth Century Fox Film Corp. v. Marvel Enterprises, Inc.*, No. 01-Civ-3016, 2002 WL 31556383 (S.D.N.Y. Nov. 15, 2002).

F. Special Issues for In-House Counsel

1. Who is the client: "the firm" vs. individual partners or employees.

   (a) Generally, communications between in-house counsel and a corporate employee for the purpose of providing legal advice to the corporation and concerning areas within the scope of that employee's duties are covered by the corporation's attorney-client privilege.[31] The corporation, therefore, also controls the decision of whether or not to waive the attorney-client privilege over those communications. But, if an employee can demonstrate that it took affirmative steps to establish a personal attorney-client relationship with corporate counsel,[32] then that employee might be able to assert a personal attorney-client privilege over certain communications and thus inhibit a company's ability to waive the attorney-client privilege over those communications.

   (b) To reduce the appearance of a personal attorney-client privilege in situations where an in-house (or external) counsel interviews an employee on behalf of his or her employer, both the Supreme Court's decision in *Upjohn* and the rules of professional responsibility require corporate counsel to explain to an employee that corporate counsel represents the corporation, not the individual, and that any communications or interviews provided by the corporation's employee to corporate counsel are for the purpose of providing legal advice to the company, not the employee.[33] Companies generally memorialize the provision of an *Upjohn* warning to their employees to limit the risk of any

[30] *Gray Financial Grp.*, Release No. 4619, Administrative Proceeding No. 3-16554 (U.S. Sec. & Exch. Comm'n Feb. 22, 2017).

[31] *See Upjohn*, 449 U.S. at 394-95.

[32] For example, approaching corporate counsel for the purpose of seeking legal advice in their individual, not representative capacities, and clearly indicating so; demonstrating that corporate counsel thought it appropriate to communicate with the employee in his or her individual capacity; proving that the conversations with counsel were confidential; and demonstrating that the substance of the communications did not concern the affairs of the corporation. *See In re Bevill, Bresler & Schulman Asset Mgmt. Corp.*, 805 F.2d 120, 123 (3d Cir. 1986) (internal citation omitted); *see also United States v. Int'l Bhd. of Teamsters,* 119 F.3d 210 (2d Cir. 1997).

[33] *See generally Upjohn*, 449 U.S. 383; *see also* Model Rules of Prof'l Conduct r. 1.13; Model Rules of Prof'l Conduct r. 4.3.

showing that a personal attorney-client privilege was created in regard to any communications between in-house counsel and the corporation's employees.

2. Does the particular communication reflect legal advice or business advice (or both)?

   (a) Business advice, even from a lawyer, is not protected. *U.S. Postal Serv. v. Phelps Dodge Refining Corp.*, 852 F. Supp. 156, 160 (E.D.N.Y. 1994).

   (b) A combination of legal and business advice may be covered. *Rossi v. Blue Cross & Blue Shield*, 542 N.Y.S.2d 508, 511 (1989).

   (c) In-house lawyers with titles that include non-legal terms may indicate that the attorney is acting in a non-legal function. *TVT Records v. Island Def Jam Music Group*, 214 F.R.D. 143 (2003).

   (d) The practice of "cc'ing" lawyers on business emails does not confer privilege upon them. *Phelps Dodge Refining Corp.*, 852 F.Supp. at 163.

   (e) In-house counsel conducting a negotiation may be acting in a business, not legal, capacity. *See Georgia-Pac. Corp. v. GAF Roofing Mfg. Corp.*, No. 93-civ-5125, 1996 WL 29392 (S.D.N.Y. Jan. 25, 1996) (finding communications not privileged where in-house counsel acting as negotiator in business capacity); *Note Funding Corp. v. Bobian Inv. Co.*, No. 93-civ-7427, 1995 WL 662402 (S.D.N.Y. Nov. 9, 1995) (finding communications privileged where counsel's performance in negotiation depended primarily on knowledge or application of legal requirements or principles, as opposed to expertise in commercial practice).

G. Special Issues for Chief Compliance Officers Who Are Licensed Attorneys

1. In 2017, this was an area in which OCIE continued to show interest during their examinations.

2. Generally, the SEC is suspect of privilege assertions involving CCOs who are attorneys.

3. But CCOs who also serve the role of an attorney at their firms do have ethical obligations as legal counsel to their firms. In addition, the SEC has its own ethical obligations as to the information it seeks from CCOs of registered investment advisers who are also attorneys.

4. Non-legal and compliance-related functions performed by CCOs who are attorneys are not presumptively covered by the attorney-client privilege or the work-product doctrine. But an attorney's role as a CCO to an adviser does not prevent him or her from giving legal advice to the firm and its employees. Often CCOs who are attorneys clearly indicate that they are providing legal advice on any document or communication related to such legal advice. Many firms also have policies in place delineating in what respects an attorney CCO acts as legal counsel to the firm and in what respects an attorney CCO acts as compliance officer to the firm.

H. SEC Approach to Attorney Client Privilege

1. OCIE acknowledges the applicability of the attorney-client privilege in its examinations of registered investment advisers.[34]

2. The SEC Division of Enforcement recognizes the importance of the attorney-client privilege and instructs its staff accordingly. The SEC Division of Enforcement 2017 Enforcement Manual specifies:

   (a) "The staff must respect legitimate assertions of the attorney-client privilege";[35]

[34] *See, e.g.*, U.S. Sec. & Exch. Comm'n, Letter to Industry Regarding Presence Exams (Oct. 9, 2012), *available at* https://www.sec.gov/about/offices/ocie/letter-presence-exams.pdf (noting that while advisers are required to provide examiners with access to all requested advisory records maintained by the firm, certain documents may remain private under the attorney-client privilege).

[35] Office of Chief Counsel, U.S. Sec. & Exch. Comm'n Div. of Enf't, Enforcement Manual (Nov. 28, 2017), at 75, *available at* https://www.sec.gov/divisions/enforce/enforcementmanual.pdf.

(b) "As a matter of public policy, the SEC wants to encourage individuals, corporate officers and employees to consult counsel about the requirements and potential violations of the securities laws";[36] and

(c) "The staff should not ask a party to waive the attorney-client privilege or work product protection without prior approval of the Director or Deputy Director."[37]

3. The Enforcement staff does not typically ask a party to waive the attorney-client privilege. In fact, the staff are required under the Enforcement Manual to get prior approval to do so from the Enforcement Division Director or Deputy Director.

4. The Enforcement staff are instructed that a legitimate claim of attorney-client privilege "will not negatively affect that party's claim to credit for cooperation" with the SEC.[38]

5. Privilege logs. The SEC's OCIE and Enforcement staffs expect a privilege log to accompany any claim of attorney-client privilege. In connection with document productions as part of routine examinations, OCIE has requested from advisers detailed privilege logs, providing information about several categories of information, including: (i) a document's author/creator; (ii) a document's recipients or those informed of its substance; (iii) the document's creation date; (iv) a general description of the document, including its subject-matter; (v) the reason the document is not being produced, including the specific privilege being claimed (e.g., attorney-client privilege or work-product privilege); and (vi) the specific examination request to which the document relates.

IV. Conflicts of Interest Policies and Procedures

A. Fiduciary Duty

1. Advisers must take their fiduciary duty seriously, in acting in their clients' best interests, providing them a duty of loyalty and utmost good faith, employing full and fair disclosure and identifying and mitigating any activity which poses a conflict of interest.

2. In information provided to Newly-Registered Investment Advisers, the SEC has said:

(a) "You must eliminate, or at least disclose, all conflicts of interest that might incline you — consciously or unconsciously — to render advice that is not disinterested. If you do not avoid a conflict of interest that could impact the impartiality of your advice, you must make full and frank disclosure of the conflict."[39]

(b) "[Y]ou should analyze your individual operations and identify conflicts and other compliance factors that create risks for your firm and then design policies and procedures that address those risks."[40]

B. Policies and Procedures

1. While conflicts of interest can take infinite permutations, and it is incumbent upon management to set a tone at the top that conflicts should be appropriately identified and addressed, written policies and procedures are nevertheless critical to guide advisory personnel through identifying and managing conflicts.

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[36] *Id.*

[37] *Id.* at 76 (emphasis in original).

[38] *Id.* at 76.

[39] The Staff of the U.S. Sec. & Exch. Commission's Div. of Inv. Mgmt. and OCIE, Information for Newly-Registered Investment Advisors (Nov. 23, 2010), *available at* https://www.sec.gov/divisions/investment/advoverview.htm.

[40] *Id.*

2. Many advisers have broad conflicts of interest policies stating that advisory personnel should be aware of the fiduciary duty to clients, and work closely with legal or compliance departments to identify and mitigate conflicts. However, a broad policy will not identify and provide guidance for advisory personnel regarding specific conflicts already known to the adviser.

3. Form ADV Part 2 requires advisers to disclose conflicts of interest in major areas of their business operations.[41] This disclosure can form the basis of a more robust conflicts of interest policy.

C. Enforcement

1. On July 19, 2017, KMS Financial Services, Inc. consented to the entry of an order under which the SEC found that KMS violated Sections 206(2), 206(4) and Rule 206(4)-7 thereunder, and 207 of the Advisers Act.[42] Section 206(2) makes it unlawful for any registered investment adviser to partake in any transaction that operates as a fraud upon any client. Section 206(4) is also an anti-fraud provision and Rule 206(4)-7 thereunder requires registered investment advisers to, in part, "[a]dopt and implement written policies and procedures, reasonably designed to prevent violation" of the Advisers Act and its rules. And Section 207 makes it unlawful for any person to make an untrue statement of a material fact or omission in a registration statement or report filed with the SEC. According to the SEC's order, KMS's clearing broker offered a program whereby it agreed to share with KMS revenues the clearing broker received from certain mutual funds. The SEC found that the payments provided a financial incentive for KMS to favor the mutual funds participating in the program over other investments when advising its clients, thereby creating a conflict of interest.[43] KMS disclosed neither the program nor the resulting conflict of interest. KMS consented to a censure and the payment of disgorgement of $382,568.64 plus prejudgment interest, and a $100,000 penalty.

2. On July 28, 2017, Columbia River Advisors, LLC and its two co-founders and principals consented to the entry of an order under which the SEC found that all three violated Section 206(2) of the Advisers Act by failing to disclose conflicts of interest to investors in an investment fund they managed.[44] According to the SEC's order, Columbia River and the two principals failed to disclose to their investors that the fund they managed made large investments in a second fund they created that then loaned money back to Columbia River, which was the general partner and investment adviser to the funds. Columbia River then used the money to acquire other advisory firms' books of business (i.e., grow Columbia River's investment advisory business — and its potential profits). The SEC found that those investments constituted conflicts of interest, which should have been disclosed.[45] Columbia River agreed to pay a civil money penalty of $80,000. One of the principals agreed to pay a $25,000 penalty, and the other, a $30,000 penalty. In addition, Columbia River was required to retain an independent consultant to review Columbia River's compliance policies and procedures. The independent consultant was to prepare a written report of its findings to Columbia River and the SEC. Any recommendations contained therein Columbia River then had to adopt.

[41] Form ADV Uniform Application for Investment Adviser Registration, p .6, http://www.sec.gov/about/forms/formadv-part2.pdf.

[42] *KMS Financial Services, Inc.*, Advisers Act Release No. 4730, Administrative Proceeding No. 3-18068 (July 19, 2017).

[43] U.S. Sec. & Exch. Comm'n, SEC Charges Investment Adviser for Failing to Disclose Conflict of Interest Arising from Revenue Sharing Arrangement and Failure to Seek Best Execution (July 19, 2017), *available at* https://www.sec.gov/litigation/admin/2017/34-81169-s.pdf.

[44] *Columbia River Advisors, LLC*, Advisers Act Release No. 4734, Administrative Proceeding No. 3-18084 (July 28, 2017).

[45] The SEC also found that Columbia River Advisors willfully violated, and its principal who was CCO and later CEO caused Columbia River's violations of, Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder, which is the SEC's investment adviser custody rule.

V. Trends and Outlooks

A. Cryptocurrencies

1. On July 25, 2017, the SEC released an investigative report in which the SEC concluded that coins offered to investors in initial coin offerings ("ICOs") might be securities and subject to regulation by the Securities Act and the Securities Exchange Act.[46]

2. Chairman Clayton has asked retail investors to exercise "extreme" caution in regard to cryptocurrency and initial coin offering markets.[47]

   The SEC is wary of cryptocurrency and ICO markets because the lack of investor protection in those markets provides greater opportunities for fraud and manipulation.

3. On Sept. 29, 2017, the SEC charged two companies and the sole owner of those companies with defrauding investors by selling cryptocurrency tokens to investors that were purportedly backed by investments in real estate and diamonds, as well as with the unlawful sale and offer to sell unregistered securities.[48]

4. On Dec. 11, 2017 a California-based company selling digital tokens to its investors to raise funds for a blockchain-based food review service consented to an order finding that it violated Sections 5(a) and (c) of the Securities Act by selling and offering to sell unregistered securities.[49]

5. In any transactions touching the cryptocurrency and ICO markets, advisers need to be sure that, as Chairman Clayton said, "any such activity that involves an offering of securities [is] accompanie[d] by the important disclosures, processes and other investor protections that [the] securities laws require." The SEC appears skeptical of cryptocurrencies and views most ICOs as securities offerings. Thus, those that effect or facilitate transactions in these markets might be aiding and abetting the sale of unregistered securities or operating unregistered exchanges or broker-dealers in violation of the Securities Exchange Act.

B. Outlook for SEC Examinations

1. Over the past several years, the OCIE had substantially grown in size and budget. But this year, it will be operating on a leaner budget.

2. Each year, the SEC must provide a budget request and justification to Congress. For fiscal year 2018, the SEC requested [and was thereafter granted] a $1.602 billion budget. Approximately $340 million was earmarked for OCIE, which was down from $346 million last year.

3. The SEC was on track to deliver a 20-percent increase in the number of investment adviser examinations in fiscal year 2017, and, in fiscal year 2018, anticipated being able to deliver a further 5 percent increase in the number of investment adviser examinations, despite the leaner budget and hiring freezes.[50]

4. Chairman Clayton testified that in fiscal year 2018, OCIE planned to increase its number of inspections to: (i) assess compliance with SEC rules designed to ensure that cybersecurity infrastructures are secure; and

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[46] U.S. Sec. & Exch. Comm'n, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017), *available at* https://www.sec.gov/litigation/investreport/34-81207.pdf; *see also* U.S. Sec. & Exch. Comm'n, Investor Bulletin: Initial Coin Offerings (July 25, 2017), *available at* https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings.

[47] Clayton, Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017), *available at* https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11.

[48] Complaint, *SEC v. Recoin Grp. Found.*, No. 17-civ-05725 (E.D.N.Y. Sept. 29, 2017).

[49] Press Release, U.S. Sec. & Exch. Comm'n., Company Halts ICO After SEC Raises Registration Concerns (Dec. 11, 2017), *available at* https://www.sec.gov/news/press-release/2017-227.

[50] Clayton, Testimony on the Fiscal Year 2018 Budget Request, *available at* https://www.sec.gov/news/testimony/testimony-fiscal-year-2018-budget-request.

(ii) continue to "bolster [OCIE's] risk-based approach to exam selection through the continued development of data analytics tools."[51]

C. Individual Accountability

1. On Nov.15, 2017, the SEC's Enforcement Division issued a report highlighting its priorities for 2018 as well as a review of its enforcement actions from 2017.[52]

   (a) Co-directors Avakian and Peikin highlighted a focus on individual accountability as one of their priorities that will guide the Enforcement Division's decision-making in 2018.[53]

   (b) Avakian and Peikin stated that they believed individual accountability more effectively deters wrongdoing, and "must be the key feature of any effective enforcement program."[54]

   (c) Per the SEC's 2017 Annual report, 73 percent of the SEC's standalone actions included charges against individuals.[55]

2. Individual accountability was certainly a priority in 2017 as well (e.g., SEC's action against Potomac Asset Management and its president, founder and ultimate control person principal relating to the improper allocation of fees and expenses to two private equity fund clients. In the action, the SEC found that both violated 206(2) of the Advisers Act, both violated 206(4) and Rule 206(4)-8 thereunder, Potomac willfully violated, and Byron caused Potomac's violations of, Section 206(4) of the Advisers Act and Rules 206(4)-2 and 206(4)-7 thereunder, as well as section 207).

D. Enforcement Approach

1. In Oct. 2017, co-director Peikin indicated that the SEC might move away from the "broken windows" strategy of prosecuting numerous cases involving minor violations — an approach the SEC pursued after the financial crisis.[56]

2. Peikin also suggested SEC might retreat from trying to make some companies admit to wrongdoing as a condition of settling with the SEC. (Though, between 2014 through 2017, only about 2 percent of the cases filed involved admissions.)[57]

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[51] *Id.*

[52] U.S. Sec. & Exch. Comm'n Div. of Enf't, Annual Report: A Look Back At Fiscal Year 2017 (Nov. 15, 2017), *available at* https://www.sec.gov/files/enforcement-annual-report-2017.pdf [hereinafter "2017 Annual Report"].

[53] U.S. Sec. & Exch. Comm'n, SEC Enforcement Division Issues Report on Priorities and FY 2017 Results (Nov. 15, 2017), *available at* https://www.sec.gov/news/press-release/2017-210.

[54] 2017 Annual Report, *supra* note 52.

[55] *Id.*

[56] Dave Michaels, "SEC Signals Pullback from Prosecutorial Approach to Enforcement," *The Wall Street Journal* (Oct. 26, 2017, 6:00 PM EST), *available at* https://www.wsj.com/articles/sec-signals-pullback-from-prosecutorial-approach-to-enforcement-1509055200.

[57] *Id.*

Shareholder Activism

I. The State of Shareholder Activism

A. Activists deployed more capital in 2017 than ever before.

1. In 2017, activists poured $62 billion into campaigns.[1]
2. For the entirety of 2016, activists allocated $30.9 billion to their positions.
3. Eleven activists allocated over $1 billion to their activist positions in 2017; those funds are:
   (a) Elliott Management, Pershing Square Capital Management, Third Point Management, Trian Fund Management, JANA Partners, TCI Fund Management, Corvex Management, ValueAct Capital Management, Cevian Capital, Starboard Value and Icahn Capital.
   (b) Of those, only Elliott, JANA and Starboard Value launched more than five campaigns.
   (c) Activists show their conviction with giant stakes, including:
      (i) Third Point amassing a $3.5 billion stake in Nestlé; and
      (ii) Trian taking a $3.3 billion stake in Procter & Gamble.

B. Major activist funds turned to mega-cap companies with very large positions.

1. Market reminded that no company is immune to activism.
2. As assets under management continue to grow at the premiere activist funds, more large- and mega-cap companies will become activist targets.
3. Activists launched campaigns at many companies with market capitalizations over $50 billion, including: Samsung Electronics, Nestlé, Procter & Gamble, General Electric, Honeywell International, BHP Billiton, Bristol-Myers Squibb, General Motors and ADP.

C. Many companies have mounted zealous defenses against activist campaigns.

1. P&G reportedly spent $100 million in an effort to block Trian's Nelson Peltz from winning a board seat before ceding the seat to Mr. Peltz.[2]
2. ADP defeated Pershing Square's bid to put three nominees on the board by:
   (a) Pointing to ADP's healthy stock performance;
   (b) Shifting the focus to Pershing Capital's goal and performance; and
   (c) Arguing that Bill Ackman was a bad fit for ADP.
3. Arconic's CEO was ousted for sending an inappropriate letter to Elliott.
4. SandRidge Energy adopted a poison pill to protect its heavily criticized deal to buy Bonanza Creek Energy.
5. Taubman Centers amended its bylaws and installed severance plans for key executives to protect management from Land and Buildings Investment Management, pressing for improved governance.

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[1] Lazard's Shareholder Advisory Group, "2017 Activism Year in Review," January 2018 (all data is for companies with market capitalizations greater than $500 million at time of campaign announcement).

[2] Tiffany Hsu, "Nelson Peltz Appointed to P&G Board, After All," The New York Times, Dec. 15, 2017.

D. Activists are increasingly winning the support of institutional investors, proxy advisory firms and retail investors by:

1. Focusing more on operational changes;
2. Being skilled at identifying and exposing ineffective CEOs and entrenched boards;
3. Displaying expertise in selecting CEO and director replacements with relevant experience;
4. Pressing for fair M&A pricing;
5. Using websites, social media posts and TV interviews to reach investors directly with their position; and
6. Crafting clear and simple messages about how target companies can improve their performance.

E. U.S. activists allocated more capital to large-cap European campaigns; overall European activism volume was steady.

1. U.S. activists accounted for over half of the $21.6 billion in capital deployed in activist campaigns in Europe.[3]
2. The United Kingdom remained the busiest market for activists in Europe followed by Germany, France, Italy and Switzerland.
   (a) Those five countries combined for 66 percent of the European activity, down from 70 percent from 2013 to 2016.[4]
   (b) Noteworthy campaigns in this region included:
      (i) Elliott and AkzoNobel settling after two legal battles and the appointment of a new CEO;
      (ii) Corvex and 40 North seeking to halt Clariant from merging with Huntsman;
      (iii) Third Point taking a $3.5 billion stake in Nestlé and calling for buybacks and a sale of its L'Oréal stake; and
      (iv) Elliott pushing Bain & Company and Cinven to pay a fairer price for Stada Arzneimittel in Germany's largest take-private transaction.

II. Trian Waged the Largest Proxy Fight in History at Procter & Gamble

A. Trian invested $3.3 billion in P&G,[5] which has a market cap of over $230 billion.

B. P&G and Trian reportedly combined to spend over $125 million.[6]

C. Trian felt confident that Nelson Peltz could catalyze change at P&G with a single board seat.

D. Proxy voting system and review channels may need to be revamped to provide clearer results in close contests.

1. P&G claimed an initial victory.
2. Inspector of elections preliminarily found Nelson Peltz secured a slight majority of the vote.
3. Later, P&G claimed to have a slight margin of the vote.

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[3] Lazard, supra note 1.

[4] "Activist Investing in Europe: A Special Report," Activist Insight, Oct. 2017.

[5] Trian Fund Management, L.P., Quarterly Report Filed by Institutional Managers, Holdings (Form 13F-HR) (May 12, 2017).

[6] Ian Bezek, "What You Need To Know About Procter & Gamble After Its Boardroom Battle, InvestorPlace, Nov. 13, 2017.

E. P&G ultimately awarded a board seat to Nelson Peltz for this term and committed to nominating him at the next annual meeting.[7]

F. Trian also won a board seat at industrial giant General Electric last fall.

III. Elliott Management Launched the Most Large-Cap Campaigns and Allocated the Most Capital in 2017

Elliott launched 19 new campaigns and allocated more than $13 billion to those contests.

Including campaigns in Australia, Germany, Greece, Ireland, Japan, Netherlands, South Korea and the United Kingdom.

A. Elliott showed the breadth of its playbook, which included the following strategies: Replacing CEOs, securing board seats and proposing operational changes, advocating for strategic sales and spin-offs, buying a company itself, advocating for fairer M&A pricing and using litigation and bankruptcy as tools.

1. Elliott has its own private equity fund (Evergreen Coast Capital Partners).

(a) The fund made its first solo purchase this year when it acquired Gigamon.

(b) Elliott appears willing to invest significant capital and time into its positions through this pairing of its activist practice with its private equity arm.

2. Elliott and Bluescape Energy Partners invested in NRG Energy as a group.

(a) Rarely seen pairing of a hedge fund with a private equity fund in an activist investment.

(b) Combines activist's strategic expertise with PE fund's industry knowledge.

(i) Elliott secured board seats at NRG for Bluescape Energy's chairman and another industry veteran.

(ii) Elliott and Bluescape helped NRG launch a transformation plan targeted at overhauling the company through operational changes and strategic divestments.

(c) Club deals among funds are fairly common in the PE field and an analog could emerge as a strategy in shareholder activism.

B. Elliott raised $5 billion in 24 hours this year[8] and is on track for another year of strong performance.

IV. Cevian Capital has Stuck With its Constructivist Investment Approach to Become a Sizable and Top-Performing European Activist Investor

A. Cevian's approach calls for:

1. Investing only on its home turf in Europe, where:

(a) Rules are favorable for shareholders;

(b) Companies are transparent and known entities;

(c) Its network of executives and experts are located and can be called on; and

(d) It knows the culture and how to relate to target executives, shareholders and stakeholders.

2. Building a stake only when deep — often months or years of — research supports its campaign;

3. Holding a small, concentrated portfolio so every investment gets proper attention;

4. Committing to long holding periods;

[7] Procter & Gamble Co., Current Report (Form 8-K) (Dec. 15, 2017).

[8] Lawrence Delevingne, "Paul Singer's Elliott Management raises $5 billion in 24 hours," Reuters, May 5, 2017.

5. Preferring private conversations to public campaigns, but being prepared to escalate pressure if necessary; and

6. Getting board seats and putting its research into action to unlock value.

B. Sample Investments

1. Volvo Group

(a) Invested in the company when its organizational structure was jumbled and Volvo had lost focus on its core business and profitability back in 2006.

(b) Helped Volvo revamp its top management positions and board.

(c) Pushed for significant cost savings, divestment of non-core units and boosting profitability on core truck sales.

(d) Still invested and continuing to increase its Volvo stake after more than a decade of strong performance.

2. Cookson Group

(a) Took a board seat and split the British industrial firm into Alent, a performance materials company, and Vesuvius, a ceramics firm.

(b) Shareholders got one share in each of the two new entities and their initial investments quickly doubled in value.

V. venBio Select Advisor LLC: The Reluctant Activist

A. Passive investors can successfully turn to the activist playbook when a board becomes an obstacle to value realization.

1. Immunomedics, Inc. long delayed in bringing a promising new drug to market.[9]

2. venBio announced its intent to nominate a majority slate of four directors at the 2017 Annual Meeting.

3. Immunomedics board licensed the drug to bidder Seattle Genetics in an effort to end venBio's proxy challenge.

4. Immunomedics adjourned its annual meeting for two weeks after announcing the deal to try to drum up support for the incumbent directors at the annual meeting.

B. venBio took action to protect shareholder rights.

1. venBio enlisted SRZ to challenge the licensing agreement as an entrenchment mechanism aimed at thwarting venBio's likely victory in the proxy contest.

(a) SRZ alleged that licensing Immunomedics' only viable product to Seattle Genetics was an act of entrenchment and amounted to a sale of the company.

(b) SRZ litigators successfully prevented Immunomedics from moving its record and annual meeting dates.

2. SRZ's litigation team also obtained a temporary restraining order enjoining the Seattle Genetics licensing transaction from closing.

3. The parties settled.

(a) Seattle Genetics agreed to terminate the licensing agreement.

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[9] Hamlin Lovell, "Immunomedics Proxy Contest," The Hedge Fund Journal, June 2017 <https://www.srz.com/images/content/1/5/v2/151484/The-Hedge-Fund-Journal-Immunomedics-Proxy-Contest-June-2017.pdf>.

(b) Immunomedics' CEO and CSO resigned.

(c) The investment banker waived its fees for the terminated licensing transaction.

4. venBio won four board seats.
5. New leadership at Immunomedics now aiming to get its drug fully approved in early 2018.
6. From the launch of venBio's proxy fight on Nov. 16, 2016 to the end of 2017, Immunomedics' stock price had more than quintupled.[10]

C. A strong litigation team can be pivotal in proxy fights and the most hostile campaigns.

1. Litigators can challenge and defeat entrenchment devices.
2. Prudent use of lawsuits can deliver victory for an activist.
3. The Delaware Court of Chancery can be receptive to novel arguments that align with the domicile's commitment to advance the shareholder franchise.
4. An integrated activism and litigation strategy can surmount a company's scorched earth defensive tactics.

The activist's litigation expenses are generally reimbursed following a settlement or win in court.

VI. Funds and Co-Investments

A. Activist-Focused Funds

1. To match fund terms with their investment mandate, activist-focused funds tend to have longer lock-ups and less liquidity, notwithstanding that investments will be made in liquid securities.
2. Liquidity is limited by multi-year lockups, followed by redemptions that are limited by investor level gates.
3. Additional liquidity constraints include rights to limit withdrawals when the fund is restricted by law or contract from selling (due to insider status or otherwise), if the manager has stated its intention to or is engaged in a proxy or if selling would require public disclosure.
4. Funds that are more concentrated (activist only) and/or deploying over time are using commitment structures to draw down capital.
5. Some new activist funds are being set up as closed-ended with two- to three-year investment periods and five-year terms.
6. Funds with longer dated liquidity are matching the performance compensation with the liquidity with multi-year performance periods, clawback mechanics and back-ended realized carry structures (for closed-ended funds).

B. Co-Investments

1. According to a survey of 460 investors by Deutsche Bank in 2017, approximately one-third said they already co-invest with hedge fund managers, and of those that had not been active, approximately 15 percent said they plan to make first-time allocations to co-investments.
2. Activist strategies tend to result in more co-investment opportunities than other hedge fund strategies.

(a) Activist-focused funds may need to take bigger positions to effect their strategy and accordingly need more capital than the primary fund can provide due to a number of reasons, including:

[10] Immunomedics' stock closed at $2.77 on Nov. 16, 2016, when venBio announced it was running a slate of four directors. The parties first settled on May 3, 2017, and the Seattle Genetics transaction was terminated on May 4. Immunomedics' stock closed at $5.44 and $5.41 on those days, respectively. On 2017's last trading day (Dec. 29), Immunomedics' stock closed at $16.16.

(i) limited available capital in the primary fund;

(ii) limitations on the primary fund's investment parameters (such as concentration limits); or

(iii) constraints presented by pending or potential withdrawals.

(b) Co-investments tend to have limited liquidity, which allows for the manager to pursue a campaign with a longer time horizon.

3. Managers use co-investments to generate goodwill and build stronger relationships with existing or prospective investors and other strategic parties. Investors seek out co-investments because fee terms are often lower than primary fund fees. Investors want access to the manager's best or "high conviction" ideas.

4. Co-investment structures

(a) Co-investment structures include both single investment funds for multiple investors, managed accounts and funds of one and shelf vehicles that can invest in co-investment ideas in different classes or series.

(b) Factors that drive the co-investment structure include: (i) the number and nature of investors (i.e., tax or regulatory status of the particular investors); (ii) tax and regulatory concerns regarding the investment; (iii) time constraints and the speed with which documentation must be finalized to get the capital deployed; and (iv) the anticipated length that the investment(s) will be held.

5. Fees and expenses

(a) Management fees for co-investments may be charged on capital commitments or capital contributions. Co-investment vehicles structured to invest in multiple co-investment opportunities may accept capital commitments from investors and charge fees on those commitments. Co-investment vehicles that make a single investment are more likely to charge on contributed capital (or net asset value), even if investors make capital commitments instead of a one-time contribution.

(b) Performance fees and allocations with respect to co-investments vary on a case-by-case basis, but they often take the form of a multi-year performance calculation or back-ended private equity carry structure. Such compensation needs to be structured carefully to take into account tax considerations, both from the manager's standpoint and an investor's standpoint.

(c) Time sensitivity: Co-investment opportunities often present themselves on a relatively short time frame, particularly where publicly traded securities are involved. If a co-investment opportunity is time sensitive and the manager needs to raise co-investment capital quickly, the manager may offer lower fees to attract capital quickly.

(d) Expenses that are specific to a particular co-investment vehicle (such as the vehicle's organizational costs) will generally be borne by the investors in such vehicle. If the expenses are common to the co-investment vehicle and the main fund (and other funds), each vehicle typically will bear its pro rata share of such common expenses. Expenses attributable to a particular opt-in co-investment opportunity are typically borne by the investors that opt into that particular opportunity.

C. Conflicts and Regulatory Issues

1. Offering co-investments to investors

(a) Investors in the primary fund may request the right to participate in co-investment opportunities offered by a manager. Managers should consider contractual obligations, investor relations concerns and fiduciary concerns when determining the allocation of co-investment opportunities across funds and investors.

(b) Fund documents typically provide managers with broad discretion to allocate co-investment opportunities and contain the allocation methodology for determining when an investment may be allocated to a sidecar.

2. Allocation of purchases and sales

(a) From a conflicts perspective, it would be ideal to buy and sell assets at the same time in all vehicles — and co-investors often request this — but simultaneous transactions are often not achievable.

(b) Funds may have investment restrictions and guidelines in their governing documents that limit potential exposure to illiquid investments. These provisions guide the allocation of purchases of investments. For instance, if a fund has reached its limit with respect to a particular investment opportunity, it may cease purchasing an investment while the sidecar continues to purchase the same investment.

(c) Differing terms between a fund and a co-investment vehicle (e.g., liquidity provisions, investment periods) may result in a manager pursuing different exit strategies, even though both vehicles own the same asset. For instance, a manager may be forced to sell an investment in the fund in order to meet withdrawal requests, while the co-investment vehicle that holds the same investment may not have the same liquidity considerations.

(d) A manager may sell an investment on behalf of a co-investment vehicle at the end of its term, while the manager's primary fund may not be required to liquidate the position because it is evergreen.

(e) Managers often reserve the right to run multiple funds side-by-side and allocate investment opportunities across funds and investors. Managers should have a clearly written allocation policy that describes how such opportunities will be allocated across the manager's funds and investors. In some cases, managers may choose to structure a sidecar outside of the main funds in order to make a co-investment.

3. Regulatory scrutiny

(a) Regulators have focused on the allocation of co-investment opportunities and expenses related to co-investments in their examination activities. In particular, regulators have focused their attention on whether the governing documents of a fund address co-investments, noting that governing documents often lack clearly defined protocols for mitigating conflicts of interest associated with co-investments.

(b) The allocation of co-investment opportunities to some, but not all, investors in the main fund and disclosures related thereto.

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