Regulatory Compliance 2018

Schulte Roth & Zabel

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PRIVATE INVESTMENT FUNDS SEMINAR

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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).

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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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.

Ian earned his LL.M. from New York University School of Law and his J.D. from Emory University School of Law. He received his B.A. from Union College.

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Jacob Preiserowicz

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.

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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].

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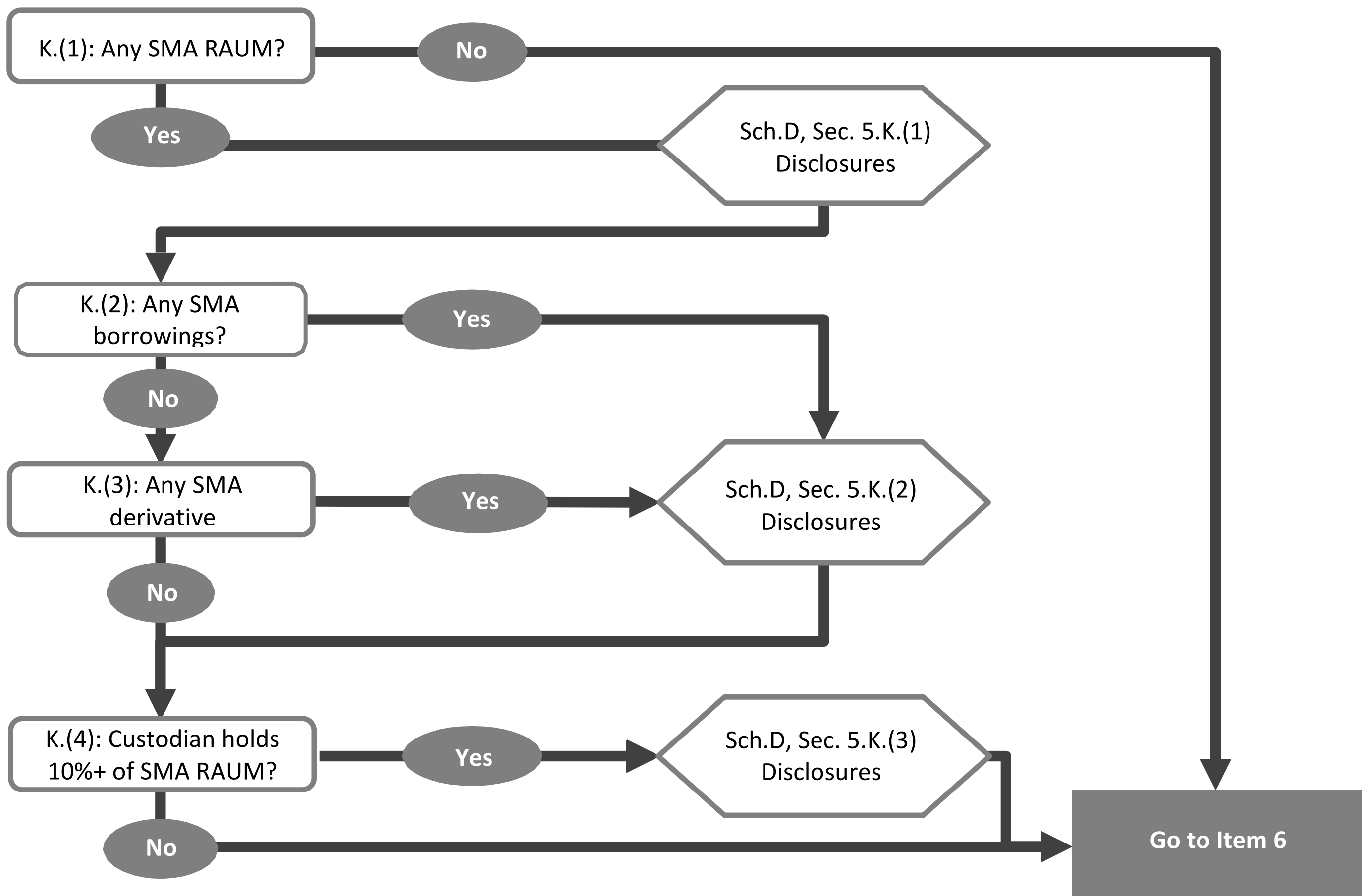

(iv) Item 5.K — The chart below is a guide to whether an adviser must fill out Item 5.K, and if so, which sections must be completed.

(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.

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(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]*

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[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."

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(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.

[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].

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(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.

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[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].

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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]

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[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].

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(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

[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).

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(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.

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(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

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[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,

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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.

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(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.

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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.

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

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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]

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[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.*

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(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).

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(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.

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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].

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(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.*

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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

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[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].

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(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.

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[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. <u>The BIC Exemption provides no relief to private funds nor their IRA and Individual Account Investors</u>

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. <u>The lack of recognition of co-investing.</u> 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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Schulte Roth & Zabel LLP

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