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JANUARY 22, 2019

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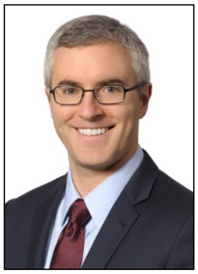
Regulatory Compliance 2019



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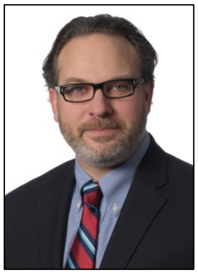
Bill focuses his practice on transactional and regulatory matters related to broker-dealers, hedge funds and other financial institutions. He advises clients in connection with mergers and acquisitions involving broker-dealers, the regulation of alternative trading systems, and best execution practices at broker-dealers.

Bill received his J.D. from Washington University School of Law, *cum laude*, his MBA from Washington University, Olin School of Business, and his B.A., *cum laude*, from Tufts University.



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Brad focuses his practice on counseling hedge and private equity funds on operational, regulatory and compliance matters. He represents clients on a broad range of issues, including those related to the U.S. Investment Advisers Act, other federal, state and self-regulatory organization requirements and securities trading rules in the United States. Brad also provides guidance to clients with operations in Hong Kong, Japan and other markets throughout Asia and the United Kingdom with respect to regulatory, compliance, trading and operations. Prior to joining SRZ, 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 has 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*. He received his J.D., *cum laude*, from Boston College Law School and a B.A., *magna cum laude*, from Georgetown University.

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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 SEC, the CFTC and the NFA. 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 advisors.

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. *Chambers Global* and *Chambers USA* list Brian as a “leading individual” in investment funds. In addition, Brian is a member of the Managed Funds Association’s Outside Counsel Forum and its CTA/CPO Forum (of which he was formerly a Steering Committee member) and of the CFTC Working Group of the Alternative Investment Management Association. He formerly was a member of the New York City Bar Association’s Private Investment Funds Committee and the MFA’s General Counsel Forum, its CTA, CPO & Futures Committee, and its Investment Advisory Committee. In addition to his legal practice, Brian taught legal ethics at Yale Law School. Brian received his J.D., with distinction, from Stanford Law School.

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Marc E. Elovitz

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

Marc is frequently invited to discuss current industry-related topics of interest at leading professional and trade association events. He has presented on whistleblowing, regulatory and compliance issues for private funds and SEC inspections and examinations of hedge funds and private equity funds, among many other topics. *Chambers USA*, *Chambers Global*, *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 has been 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*, to name a few. Marc 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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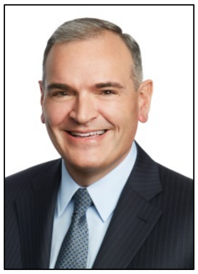
Melissa advises banks, broker-dealers, hedge funds, investment advisers, money transmitters, virtual currency and global marketplace businesses on the anti-money laundering and sanctions regulations, rules and related issues governing their banking, investment and business activities. She has particular expertise with issues arising out of the USA PATRIOT Act and the Bank Secrecy Act. Prior to joining SRZ, Melissa was an attorney advisor with the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN). At FinCEN, Melissa assisted in the development of several anti-money laundering regulations. Additionally, she was lead counsel on several enforcement actions involving issues such as failure to implement and maintain an adequate anti-money laundering compliance program and failure to file suspicious activity reports.

In recognition of her significant accomplishments during her Treasury career, Melissa received the Secretary's Meritorious Service Award, which honors individuals whose achievements are substantial and significantly advance the Treasury Department's mission. Melissa is listed in *Washington, DC Super Lawyers* as a "Rising Star." She received her J.D. from Fordham University School of Law and her B.S., with honors, from Cornell University.



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Mergers & Acquisitions

Regulatory & Compliance

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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 has been quoted in articles published by *Bloomberg* and *The Washington Post.* He co-authored the *SRZ Alert* "DOL Fiduciary Duty Rule Officially Dead" and he discussed "ERISA: The M&A Transactional Practice" at the PLI's *ERISA: The Evolving World Seminar*. Ian serves as a member on the Advisory Board and as chair of the Center for Transactional Law and Practice Advisory Board at the Emory University School of Law. He also serves as an adjunct professor at New York Law School. Ian earned his LL.M. from New York University School of Law, his J.D. from Emory University School of Law and a B.A. from Union College.

Regulatory Compliance 2019

I. Proposed Fiduciary Standards

A. On April 18, 2018, the U.S. Securities and Exchange Commission issued three proposals addressing the duties and standards applicable to broker-dealers and investment advisers:

1. "Regulation Best Interest" — would require registered broker-dealers and their associated persons to act in the best interest of retail investors when recommending investment strategies or securities transactions to retail customers.[1]

2. Form CRS — "Customer Relationship Summary"— would be provided by registered investment advisers and registered broker-dealers to retail investors.[2]

3. A proposed interpretation of the fiduciary duty that an investment adviser owes to its clients ("Proposed Fiduciary Interpretation").[3]

B. Disclosure and Conflicts of Interest in the Proposed Fiduciary Interpretation

1. While focusing mostly on the adequacy of disclosure of conflicts, the Proposed Interpretation also indicates that in some circumstances disclosure is insufficient to satisfy an adviser's fiduciary obligations. The Proposed Interpretation indicates that "[d]isclosure of a conflict alone is not always sufficient to satisfy the adviser's duty of loyalty and section 206 of the Advisers Act," and consent would not be effective where "the material facts concerning the conflict could not be fully and fairly disclosed."[4]

2. When describing an investment adviser's fiduciary duty of loyalty, the Proposed Interpretation indicates that "an adviser must *seek to avoid* conflicts of interest with its clients, and, at a minimum, make full and fair disclosure of all material conflicts of interest that could affect the advisory relationship."[5]

3. The Proposed Interpretation identifies "informed consent" as the basis for permitting a conflict of interest, but does not articulate a standard for informed consent.

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[1] Regulation Best Interest, Exchange Act Release No. 83062, 83 Fed. Reg. 21574 (Apr. 18, 2018).

[2] Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles, Exchange Act Release No. 83062, Advisers Act Release No. 4888, 83 Fed. Reg. 21416 (Apr. 18, 2018).

[3] *See* Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, Advisers Act Release No. IA-4889, 83 Fed. Reg. 21203 (Apr. 18, 2018) [hereinafter, "Proposing Release"].

[4] Proposing Release, *supra* note 3, at 17, 18 ("For example, in some cases, conflicts may be of a nature and extent that it would be difficult to provide disclosure that adequately conveys the material facts or the nature, magnitude and potential effect of the conflict necessary to obtain informed consent and satisfy an adviser's fiduciary duties. In other cases, disclosure may not be specific enough for clients to understand whether and how the conflict will affect the advice they receive. With some complex or extensive conflicts, it may be difficult to provide disclosure that is sufficiently specific, but also understandable, to the adviser's clients. In all of these cases where full and fair disclosure and informed consent is insufficient, we expect an adviser to eliminate the conflict or adequately mitigate the conflict so that it can be more readily disclosed.").

[5] Proposing Release, *supra* note 3, at 15-16 (emphasis added). In other contexts, however, the Proposed Interpretation quotes the "eliminate, or at least … expose" language from *SEC v. Capital Gains*. *Id.* at 6 (quoting *SEC v. Capital Gains*, 375 U.S. 180, 191 (1963)).

4. The Proposed Interpretation does not differentiate between fiduciary duties in the context of retail investors and institutional investors.

5. The public comment period for the proposals closed on Aug. 7, 2018, and final rules and interpretations have yet to be adopted, however they are expected by September 2019.

II. Current Trends in SEC Examinations

A. Current State of the Investment Adviser Examination Program – The Office of Compliance Inspections and Examinations ("OCIE") completed 2,114 investment adviser examinations in FY 2017 and estimates that is has completed 2,120 in FY 2018. In its 2019 budget request, OCIE is seeking to restore 13 investment adviser examiner positions so that it can examine a total of 2,160 investment advisers in FY 2019. The budget request noted that OCIE staffing has not kept pace with industry growth as over the last five years "the number of registered advisers has grown by over 15 percent and the assets under management of these firms has increased by more than 40 percent." According to the staff, 35 percent of all registered investment advisers have not yet been examined.[6]

B. Most Common Deficiencies – The most frequently cited deficiencies identified by the examination staff in the New York Regional Office during the 2017 Fiscal Year were:

   1. Compliance Policies and Procedures Insufficient or Not Reasonably Tailored to the Adviser's Business. Identified in 49 percent of examinations. The examination staff found that these deficiencies typically fell into four categories: [7]

      (a) Policies and procedures were incomplete or inaccurate. Typically this deficiency was cited because either a policy was inconsistent with disclosure in the adviser's offering documents or Form ADV, or the adviser's legal and compliance personnel did not have a complete understanding of what front office or operational personnel were doing in practice.

      (b) Policies and procedures were not modified in light of new business practices or products.

      (c) Policies and procedures were not adequately documented.

      (d) Policies and procedures were outdated. To the examination staff, this reflects that the adviser is not reviewing its policies regularly. Examination staff will cite advisers for compliance failures when they also cite an adviser for related substantive deficiencies, noting that the substantive deficiency highlights an insufficiency in the adviser's policies and procedures (e.g., an adviser might be cited for an expense allocation error and having insufficient policies and procedures regarding expense allocations). Examination staff will also cite advisers for the insufficiency of their policies and procedures where no substantive deficiency has been identified, but where the examination staff believes there could be significant risk of such a lapse in the future.

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[6] U.S. Securities and Exchange Commission, Congressional Budget Justification Annual Performance Plan 27 (2018), available at https://www.sec.gov/files/secfy19congbudgjust.pdf.

[7] *New York Regional Office Investment Adviser Compliance Outreach Netcast, Part 1*, U.S. Securities and Exchange Commission (Sept. 12, 2018), https://www.sec.gov/info/complianceoutreach/webcasts.htm.

2. ADV Issues. Identified in 46 percent of examinations. Examiners tended to find issues related to conflicts of interest disclosure; specifically identified were side-by-side management and shared office space as areas where advisers had inaccurate or incomplete disclosure. Further, examiners found that advisers often did not have sufficient documentation under Rule 204-2 to support the RAUM calculations in their Form ADV.[8] Examination staff will look across fund organizational documents, firm policies and procedures, and Form ADV to confirm that disclosures are consistent, and in certain instances challenge the sufficiency of disclosure related to conflicts of interests.

3. Code of Ethics Issues. Identified in 21 percent of examinations. Examiners found that advisers often failed to identify all access persons subject to their code of ethics and failed to timely acquire reporting and certification required under their code of ethics. The frequency with which the examination staff has cited these deficiencies highlights that advisers should make additional efforts to shore up their recordkeeping as it relates to their code of ethics.

4. The examination staff also identified as frequent deficiencies insufficient recordkeeping (identified in 15 percent of examinations) and the failure to conduct an annual compliance review or a general lack of compliance testing (identified in 15 percent of examinations).

5. Though not included in the top five most frequently cited deficiencies, examination staff indicated that the custody rule continues to be a consistent source of deficiencies for advisers. For those advisers that rely on the "private fund exemption" under Rule 206(4)-2(b)(4), they often fail to confirm that the auditing firm used for their funds' annual audits is registered with the Public Company Accounting Oversight Board, or fail to distribute their audited financial statements within 120 days of a fund's fiscal year end.

C. Increasing Number of Deficiencies – Those areas where an uptick in deficiencies was identified by the examination staff in the New York Regional Office during the 2017 Fiscal Year were:

1. Regulation D Filings. Examiners found that advisers do not file Form D, often are late in filing Form D, do not complete the form according to its instructions, or that the information contained therein is inconsistent with the advisers' other filings (e.g., Form ADV).

2. Whistleblower Rules. Many of the issues identified in the Oct. 24, 2016 Risk Alert issued by the Office of Compliance Inspections and Examinations on compliance with Rule 21F-17 continue to be a source of deficiencies for advisers. An uptick of deficiencies in this area is not altogether unsurprising as the Risk Alert stated that, "OCIE is including in certain examinations a review of registrants' compliance with rules impacting whistleblowers and potential whistleblowers that arose out of the Dodd Frank Act."

3. The examination staff also noted an increase in deficiencies for advisers who did not meet the eligibility requirements for the internet adviser registration exception under Rule 203A-2(e), and for advisers who failed to keep written cash solicitation agreements in accordance with Rule 206(4)-3.[9]

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[8] *Id*.

[9] *See Investment Adviser Compliance Issues Related to the Cash Solicitation Rule, infra* note 40.

D. Examination Process[10]

1. Reasons advisers are examined:

   (a) The adviser's risk profile meets that which the examination staff is concerned about at a given time.

   (b) The examination staff received a tip, complaint or referral regarding the adviser.

   (c) The examination staff is reviewing a specific compliance area which may be a risk for the adviser.

   (d) The adviser was randomly selected for examination. Examination staff will not inform advisers why they are being examined, or into which of the above categorizations they fit. However, as the examination progresses the adviser can glean the examination staff's focus based on the subject matter of the materials requested and questions asked during interviews and phone calls.

2. Tips from examination staff on how to make examinations run more smoothly:

   (a) Have a first-day presentation ready to identify and describe key risks and key personnel.

   (b) Update your compliance program regularly and document any testing or review, including the annual review. Having this documentation will help expedite the examination staff's review of an adviser's process.

   (c) Ensure that books and records are up-to-date so that you can respond to the examination staff's requests promptly.

   (d) Keep in communication with the examination staff during the examination process, make sure responses are complete and unambiguous, and be forthcoming and transparent with the examination staff.

   First-day presentations are an important first step in opening an adviser's dialogue with the examination staff. They are an opportunity to present an affirmative case as to the strength of the adviser's internal controls, recordkeeping and compliance program, rather than just responding to the staff's requests.

E. National Exam Analytics Tool ("NEAT")

1. In FY 2014, the Quantitative Analytics Unit ("QAU") of the SEC developed NEAT, a data analytics tool, which allows the staff to review trading and other data in a time-efficient manner rather than engaging in labor-intensive manual review.

2. Examiners use NEAT to analyze trading data during examinations, including the trade blotter, restricted list and holdings reports. The tool is used to identify potential insider trading, front running client accounts, cross trades, principal trades, window dressing and the misallocation of investment opportunities, among other issues.

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[10] For this section, *see generally New York Regional Office Investment Adviser Compliance Outreach Netcast*, *supra* note 7.

3. Principal trades and cross trades are the types of transactions that can be identified by NEAT, and so they are squarely in the examination staff's analytical capabilities. If an adviser engages in principal or cross trades, the examination staff may focus on the pricing of these transactions and what if any conflict of interest disclosure or policy governs such transactions.

III. CFTC Update

A. NFA Issues Internal Controls Guidance for CPOs Handling Customer Funds

1. On Dec. 10, 2018, the National Futures Association ("NFA") issued a new interpretive notice, *NFA Compliance Rule 2-9: CPO Internal Control Systems*,[11] providing advice to NFA member Commodity Pool Operators ("CPOs") with control over customer funds on how to design and implement an adequate system of internal controls, as well as concerning essential components that must be included in a control system for such a CPO.

2. Recognizing that size and operational differences among CPOs require a degree of flexibility for self-determinations as to what constitutes an "adequate" control system, the NFA nonetheless offers a number of specific recommendations, including:

   (a) *Separation of Duties*. To the extent possible, no single employee should be in a position to both carry out and conceal errors or fraud or have control over any two phases of a transaction or operation covered by the NFA's interpretive notice.

   (b) *Pool Subscriptions, Redemptions and Transfers*. Controls should include verification of proper account custody, periodic reconciliation of ledgers, step-by-step confirmation of the redemption process and verified compliance with Rule 2-45 (prohibition on direct or indirect loans from pool to CPO).

   (c) *Risk Management, Investment and Valuation of Pool Funds*. The NFA regards investment as a high-risk area for internal controls, and encourages verification of liquidity to meet financial obligations, ongoing counterparty diligence, explicit verification of investment valuation and consistency with pool strategy, and trading principles' engagement in the control process.

   (d) *Use of Administrators*. Third-party administrators should be subject to appropriate diligence (including auditors' reports) to confirm performance and capability.

   (e) *Self-Assessment*. The NFA's list is not a replacement for a CPO's necessary evaluation of its unique risks and required controls. Familiar touchstones for an effective internal controls system also continue to apply — comprehensive written policies, clear lines of reporting and escalation, regular control policy review for effectiveness and new risks, evident management commitment and reliable recordkeeping.

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[11] For this section, *see generally* Carol Wooding, *National Futures Association: Proposed Interpretive Notice "NFA Compliance Rule 2-9: CPO Internal Controls Systems,"* National Futures Association (2018), https://www.nfa.futures.org/news/PDF/CFTC/Interp-Notc-CR-2-9-CPO-Internal-Controls-System.pdf.

B. NFA Amends Information Security Systems Programs Interpretive Notice

1. On Dec. 4, 2018, the NFA released amendments to its interpretive notice *NFA Compliance Rules 2-9, 2-36 and 2-49: Information Systems Security Programs*.[12] The original notice[13] prescribes that NFA members create a written framework of supervisory practices to address unauthorized access risks, and establishes general requirements relating to such programs, but leaves the exact form of the ISSP up to each member. The amendments strengthen and clarify the NFA's guidance in key areas including:

    (a) *ISSP Approval*. The NFA has clarified that the firm's ISSP must be approved by either a senior level officer with primary responsibility for IT security (such as a CTO) or a senior official who is listed as a principal and has authority to supervise the NFA member's execution of the ISSP. If the member participates in a consolidated entity ISSP approved at the parent company level, a member's CEO, principal or chief security officer must approve the appropriateness of the policies.

    (b) *NFA Notification Requirements*. A member must have procedures in place to promptly notify the NFA of a cybersecurity incident related to its commodity interests.

    (c) *Other Regulatory Regimes*. The member firm should be familiar with notice requirements under the data security/privacy laws of other applicable U.S. and non-U.S. laws and regulations.

    (d) *IT Training*. The amendments require that members provide IT security training for their employees on both an initial and annual basis, and that the firm specify covered topics.

    (e) *Best Practices*. As an aid to development of an appropriate ISSP, members are now referred to practices and standards promulgated by various professional associations identified in the NFA's Frequently Asked Questions on Cybersecurity.

C. CFTC Proposes Codification of 18-96 Relief

1. On Oct. 9, 2018, as part of a wide-ranging notice of proposed rulemaking under the CFTC's "Project KISS" initiative, the CFTC proposed a new 4.13(a)(4) exemption to codify and supersede Advisory 18-96,[14] which has provided a means for registered CPOs who operate certain offshore commodity pools to obtain relief from various disclosure, reporting and recordkeeping requirements of Part 4.

    (a) Rule 4.13(a)(4) would serve as an exemption from substantive CFTC reporting requirements, including CPO-PQR. Unlike 18-96, 4.13(a)(4) can operate both to permit qualifying unregistered CPOs to remain exempt from CFTC registration as well as to eliminate, for registered CPOs, reporting obligations for qualifying commodity pools.

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[12] For this section, *see generally* Carol Wooding, *National Futures Association: Proposed Amendments to NFA's Interpretive Notice: NFA Compliance Rules 2-9, 2-36 and 2-49: Information Systems Security Programs*, National Futures Association (2018), https://www.nfa.futures.org/news/PDF/CFTC/Interp-Notc-NFA-CR-2-9-2-36-and-2-49-Information-Systems-Security-Programs.pdf.

[13] *See* National Futures Association, *NFA Compliance Rules 2-9, 2-36 and 2-49: Information Systems Security Programs*, National Futures Association Rulebook (Aug. 2015), https://www.nfa.futures.org/rulebook/rules.aspx?RuleID=9070&Section=9.

[14] For this section, *see generally* Registration and Compliance Requirements for Commodity Pool Operators and Commodity Trading Advisors, 17 C.F.R. pt. 4 (proposed Oct. 9, 2018), https://www.cftc.gov/sites/default/files/2018-10/Federalregister100918.pdf.

(b) Rule 4.13(a)(4) would, however, require that:

(i) As with 18-96, the funds operated by the CPO have no U.S. persons as investors;

(ii) Unlike 18-96, the funds would have to satisfy an additional requirement that no capital be contributed directly or indirectly from a source in the United States;

(iii) Disclosure language be provided to investors concerning the lack of CFTC oversight and the basis for the exemption being relied upon (similar to what is required under current Rule 4.13(a)(3)); and

(iv) Notice be filed with the National Futures Association and be reaffirmed annually.

(c) The proposed Rule 4.13(a)(4) retains the 18-96 requirement that a fund not hold meetings or conduct administrative activities within the United States.

D. Statutory Disqualifications from Rule 4.13

1. In the same Oct. 9, 2018 notice of proposed rulemaking,[15] the CFTC also proposed to apply a statutory disqualification provision, which is currently found in 18-96, to all Rule 4.13 exemptions (other than the family office exemption), including current Rule 4.13 exemptions such as the Rule 4.13(a)(3) *de minimis* exemption.

2. This would mean that any individual or entity claiming a Rule 4.13 exemption, with limited exceptions already present in Advisory 18-96, will need to represent that none of that person or any of its principals is subject to any statutory disqualification under Sections 8a(2) or 8a(3) of the Commodity Exchange Act.

(a) The exceptions would permit statutory disqualifications that were previously disclosed in registration applications that were granted, or that were disclosed more than 30 days prior to the claim of exemption.

(b) Firms that already have made Rule 4.13 filings would need to satisfy this new requirement in a reaffirmation; CPOs filing new claims of a Rule 4.13 exemption would be required to comply with the prohibition upon filing, if and when the CFTC's proposal is adopted and effective.

IV. Trading Compliance

A. Equity Options Position Limits

1. U.S. options exchanges have rules regarding the maximum number of options that a single investor or a group of investors acting in concert or under common control may hold. While the rules are generally directly applicable to exchange members such as a fund's brokers, and not the funds themselves, brokers may contractually obligate their customers to stay below these thresholds. Brokers may also be required to reduce any positons that they believe are above such thresholds without first notifying the customer.

[15] *Id*.

2. FINRA Rule 2360 sets out applicable position limits for options.[16] The rule classifies equity options as standardized, conventional or FLEX. Standardized and FLEX equity options are exchange-traded and conventional options trade OTC.[17] FINRA Rule 2360(b)(3)(A) imposes a position limit on the number of equity options contracts in each class,[18] on the same side of the market that are held or written by a firm, a person associated with a firm, a customer or a group of customers.[19] If a person or group of persons holds an aggregate position in option contracts in excess of the allowed position limits, or if effecting a transaction would cause the person or group of persons to have a position in excess of a limit, no broker or dealer may affect an opening transaction on behalf of that entity or group without an exemption from the applicable position limit.

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

4. Position Limit Exemptions

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

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

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

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

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

      (iv) Conversions are short call positions accompanied by long put positions where the short call expires with the long put, and the strike price of the short call and long put is equal, and where

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

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

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

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

each short call and long put position is hedged with 100 shares (or other adjusted number of shares) of the underlying security or securities convertible into such underlying security.

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

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

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

B. Regulation SHO – Rule 203(b) ("Locate Rule")

1. Pursuant to Rule 203(b)(1),[20] no broker or dealer may accept a short sale order in an equity security unless the broker or dealer has:

   (a) Borrowed the security, or entered into a bona-fide arrangement to borrow the security; or

   (b) Reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due.

2. When a broker or dealer relies on Rule 203(b)(1)(ii),[21] the broker-dealer may be required by either a self-regulatory organization or the SEC to demonstrate that its reliance on a customer's representations is reasonable. Generally, brokers and dealers rely on a customer's delivery history to demonstrate that its reliance is reasonable. As a result, customers that fail to timely settle transactions may find that their broker or dealer is unwilling to accept sale orders or that the customer is required to pre-borrow securities sold short prior to submitting an order.

3. While the Locate Rule does not apply directly to persons that are not brokers or dealers, the SEC's antifraud provisions were expanded in 2008 when the SEC adopted Rule 10b-21.[22] Rule 10b-21, referred to as the "naked" short selling antifraud rule, exposes short sellers who mislead their broker or dealer regarding their ability or intention to deliver securities in time for settlement to liability under the Exchange Act's antifraud provisions should they then fail to deliver securities in time for settlement.

[20] 17 CFR 242.203(b)(1).

[21] 17 CFR 242.203(b)(1)(ii).

[22] 17 CFR 240.10b-21.

V. Cybersecurity

A. The SEC has continued to examine advisers' policies and procedures with respect to cybersecurity. In December 2018, OCIE issued its 2019 Examination Priorities, specifically citing cybersecurity as a priority for its upcoming examinations. OCIE specifically cited the following areas of focus regarding cybersecurity for investment advisers:[23]

1. Cybersecurity practices for investment advisers with multiple branch offices;
2. Proper configuration of network storage devices;
3. Governance and risk assessment;
4. Access rights and controls;
5. Data loss prevention;
6. Vendor management;
7. Training; and
8. Incident response.

B. The SEC's staff have previously emphasized the need for comprehensive records related to the implementation and operation of cybersecurity policies and procedures. This has been reflected in examination requests related to "[t]he Firm received fraudulent emails, purportedly from customers, seeking to direct transfers of customer funds or securities," or when "[a]ccess to a Firm web site or network resource was blocked or impaired by a denial of service attack." [24]

C. State Law Notification Requirements

At present, 48 states (all but Alabama and South Dakota), as well as Washington, DC, Puerto Rico, Guam and the Virgin Islands, have data breach notification laws requiring that businesses notify residents when the residents' personal information is breached. In general, these laws extend to all businesses that possess data of residents from the jurisdiction; the business need not have other ties to the jurisdiction. Some define a breach as the unauthorized acquisition of the data, but others as mere unauthorized access to the data. Further, some states not only require notification of residents, but also of law enforcement.

D. Efforts to Combat Money Laundering in Cyber Sector – "Cyber-SAR" Filing Requirement.

On Oct. 25, 2016, FinCEN issued an advisory stating that all BSA-regulated financial institutions (which does not yet include private fund managers or RIAs) must also file a SAR when it "knows, suspects, or has reason to suspect that a cyber-event was intended, in whole or in part, to conduct, facilitate, or affect a transaction

[23] *See* Office of Compliance Inspections and Examinations, *2019 Examination Priorities* (2019), https://www.sec.gov/files/OCIE%202019%20Priorities.pdf.

[24] *See* Office of Compliance Inspections and Examinations, *OCIE Cybersecurity Initiative*, IV National Exam Program Risk Alert 1, (2014), https://www.sec.gov/ocie/announcement/Cybersecurity-Risk-Alert--Appendix---4.15.14.pdf.

or series of transactions." The advisory defines a "cyber-event" to mean "an attempt to compromise or gain unauthorized electronic access to electronic systems, services, resources, or information." Even unsuccessful cyber-events that target such information or systems could require the filing of a SAR. Although RIAs are not currently subject to these requirements they will be once the proposed AML program and SAR filing rule for RIAs discussed above becomes final.[25]

VI. Electronic Communications

A. The SEC and other regulators (including the U.K. FCA) have focused on the controls that advisers have in place with respect to written and electronic communications.

B. In December 2018, the Office of Compliance Inspections and Examinations issued a risk alert entitled "Observations from Investment Adviser Examinations Relating to Electronic Messaging."[26]

1. OCIE noticed an increasing use of various types of electronic messaging by adviser personnel for business purposes. In response, OCIE conducted a limited-scope examination initiative of registered advisers designed to obtain an understanding of the various forms of electronic messaging used by advisers and their personnel, the risks of such use and the challenges in complying with certain provisions of the Advisers Act.

   (a) For purposes of the examination, "electronic messaging" or "electronic communication" included written business communications conveyed electronically using, for example, text/SMS messaging, instant messaging, personal email, and personal or private messaging.

   (b) OCIE included communications when conducted on the adviser's systems or third-party applications ("apps") or platforms or sent using the adviser's computers, mobile devices issued by advisory firms, or personally owned computers or mobile devices used by the adviser's personnel for the adviser's business.

2. Relevant Regulation

   (a) Rule 204-2 ("Books and Records Rule") requires advisers to make and keep certain books and records relating to their investment advisory business, including typical accounting and other business records as required by the SEC.

   (b) Rule 204-2(a)(11) requires advisers to make and keep a copy of each notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser circulates or distributes, directly or indirectly, to 10 or more persons.

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[25] *See* FIN-2016-A005, Advisory to Financial Institutions on Cyber-Events and Cyber-Enabled Crime (Oct. 25, 2016), https://www.fincen.gov/sites/default/files/advisory/2016-10-25/Cyber%20Threats%20Advisory%20-%20FINAL%20508_2.pdf.

[26] For this section, *see generally* Office of Compliance Inspections and Examinations, *Observations from Investment Adviser Examinations Relating to Electronic Messaging,* National Exam Program Risk Alert, (2018), https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Electronic%20Messaging.pdf [hereinafter, "*Electronic Messaging Alert*"].

(c) The Commission has stated that "regardless of whether information is delivered in paper or electronic form, broker-dealers and investment advisers must reasonably supervise firm personnel with a view to preventing violations."[27]

(d) Rule 206(4)-7 ("Compliance Rule") requires advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and rules thereunder.

(i) The SEC stated that an adviser's policies and procedures should address, to the extent relevant to the adviser, "[t]he accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction," among other things.[28]

(ii) The Compliance Rule also requires an adviser to review, no less frequently than annually, the adequacy of the adviser's compliance policies and procedures and the effectiveness of their implementation.

3. OCIE Observations

(a) During examinations, OCIE identified the following examples of practices that may assist advisers in meeting their record retention obligations under the Books and Records Rule and their implementation and design of policies and procedures under the Compliance Rule.

(b) Policies and Procedures[29]

(i) Permitting only those forms of electronic communication for business purposes that the adviser determines can be used in compliance with the books and records requirements of the Advisers Act.

(ii) Specifically prohibiting business use of technology that can be readily misused by allowing an employee to communicate anonymously, allowing for automatic destruction of messages, or prohibiting third-party viewing or back-up.

(iii) In the event that an employee receives an electronic message using a form of communication prohibited by the firm, requiring in firm procedures that the employee move those messages to another electronic system that the adviser determines can be used in compliance with its books and records obligations, and including specific instructions to employees on how to do so.

(iv) Where advisers permit the use of personally owned mobile devices for business purposes, adopting and implementing policies and procedures addressing such use with respect to, for

[27] *Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information*, Advisers Act Rel. No. 1562 (May 9, 1996), https://www.sec.gov/rules/interp/33-7288.txt.

[28] *Compliance Programs of Investment Companies and Investment Advisers*, Advisers Act Release No. 2204 (Dec. 17, 2003) at note 19, http://www.sec.gov/rules/final/ia-2204.htm.

[29] *See Electronic Messaging Alert*, *supra* note 26, at 3-4.

example, social media, instant messaging, texting, personal email, personal websites and information security.

(v) If advisers permit their personnel to use social media, personal email accounts or personal websites for business purposes, adopting and implementing policies and procedures for monitoring, review and retention.

(vi) Including a statement in policies and procedures informing employees that violations may result in discipline or dismissal.

(c) Employee Training and Attestations[30]

(i) Requiring personnel to complete training on the adviser's policies and procedures on the use of electronic messaging and electronic apps and the disciplinary consequences of violating these procedures.

(ii) Obtaining attestations from personnel at the start of employment with the adviser and regularly thereafter that employees (a) have completed all of the required training on electronic messaging, (b) have complied with all such requirements and (c) commit to do so in the future.

(iii) Providing regular reminders to employees of what is permitted and prohibited under the adviser's policies and procedures with respect to electronic messaging.

(iv) Soliciting feedback from personnel as to what forms of messaging are requested by clients and service providers, in order for the adviser to assess their risks and how those forms of communication may be incorporated into the adviser's policies.

(d) Supervisory Review[31]

(i) Contracting with software vendors to (a) monitor social media posts, emails or websites used for business purposes; (b) archive such business communications to ensure compliance with record retention rules; and (c) ensure that they have the capability to identify any changes to content and compare postings to a lexicon of key words and phrases.

(ii) Regularly reviewing popular social media sites to identify if employees are using the media in a way not permitted by the adviser's policies. Such policies could include prohibitions on using personal social media for business purposes or using it outside of the vendor services the adviser uses for monitoring and record retention.

(iii) Running regular internet searches or setting up automated alerts to notify the adviser when an employee's name or the adviser's name appears on a website to identify potentially unauthorized advisory business being conducted online.

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[30] *See Id*. at 4.

[31] *See Id*. at 4-5.

(iv) Establishing a reporting program or other confidential means by which employees can report concerns about a colleague's electronic messaging, website or use of social media for business communications.

(e) Control Over Devices[32]

(i) Requiring employees to obtain prior approval from the adviser's information technology or compliance staff before they are able to access firm email servers or other business applications from personally owned devices.

(ii) Loading certain security apps or other software on company-issued or personally-owned devices prior to allowing them to be used for business communications.

(iii) Allowing employees to access the adviser's email servers or other business applications only by virtual private networks or other security apps to segregate remote activity in order to help protect the adviser's servers from hackers or malware.

VII. Alternative Data

A. Alternative data is a term used for big, unstructured data sets such as news feeds, social media, website scraping, online communities, communications metadata, satellite imagery and geospatial information. For private funds, the appeal of investing in alternative data is largely the potential for an information advantage over the market regarding investment management decisions.[33]

B. Risks of the Use of Alternative Data in Trading Strategies

1. Companies which gather alternative data sell it to buyers including hedge funds.[34] The market in data focused on location-targeted advertising alone was worth an estimated $21 billion in 2018.[35] However, alternative data presents risks, such as:

(a) What appears to be public data could be material non-public information.[36]

(b) The data may have been obtained in violation of a duty to keep it confidential, producing a need for enhanced due diligence on the part of buyer.

(c) Consumer protection concerns relating to personally identifiable information ("PII"), including:

(i) How PII is obtained;

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[32] *Id*. at 5.

[33] *Id*.

[34] *See* Jennifer Valentino-DeVries, Natasha Singer, Michael H. Keller and Aaron Krolik, "Your Apps Know Where You Were Last Night, and They're Not Keeping It Secret,*" New York Times* (Dec. 10, 2018), https://www.nytimes.com/interactive/2018/12/10/business/location-data-privacy-apps.html.

[35] *Id*.

[36] *See generally SEC v. Bonan Huang, et al*., Civil Action No. 2:15-cv-00269 (E.D. Pa.), https://www.sec.gov/litigation/complaints/2015/comp23216.pdf

(ii) How PII data is anonymized, and whether data that has been anonymized can still be used to identity individuals if cross-referenced with other data sets; and

(iii) The risk of PII data being used inappropriately by rogue users.

VIII. Anti-Money Laundering ("AML") Updates for Private Fund Advisers

A. Relevant U.S. Statutes, Regulations and Guidance

B. The Money Laundering Control Act ("MLCA"), 18 U.S.C. §§ 1956 and 1957.

C. The Bank Secrecy Act ("BSA") of 1970, 31 U.S.C. §§ 5311 – 5330, as amended, including by the USA PATRIOT Act of 2001, and the BSA's implementing regulations, 31 C.F.R. Chapter X.

1. The BSA currently requires "financial institutions" to have effective AML compliance programs. "Financial institutions" currently include banks, broker-dealers, any entity required to register under the Commodity Exchange Act ("CEA") (including futures commission merchants ("FCMs"), introducing brokers in commodities ("IB-Cs"), commodity trading advisors ("CTAs") and commodity pool operators ("CPOs")), mutual funds, operators of credit card systems, money services businesses, insurance companies, casinos, loan or finance companies, and dealers of precious metals, stones and jewels.

2. This AML compliance program rule does not yet apply to private funds and investment advisers, although advisers have adopted and implemented AML programs consistent with U.S. regulatory requirements applicable to regulated financial institutions because of the criminal AML statutes, as a matter of sound business practice and because their investors and counterparties, such as banks and broker-dealers, expect or require them to do so.

D. Proposed AML Program Rule for RIAs.

1. In 2015, FinCEN issued for public comment a proposed rule requiring investment advisers registered with the SEC ("RIAs") to establish AML programs and report suspicious activity to FinCEN pursuant to the BSA (the "Proposed Rule").[37] The Proposed Rule will not apply to investment advisers that fall within an exemption from SEC registration, such as firms that rely on the exemption for venture capital fund advisers under Advisers Act Section 203(l), the exemption for private fund advisers managing less than $150-million in regulatory assets under management from a place of business in the United States under Section 203(m) or the exemption for foreign private advisers under Section 203(b)(3), family offices relying on Rule 202(a)(11)(G)-1 or CTAs whose business is not predominantly securities-related advice. However, FinCEN cautions that "future rulemakings" may include other types of investment advisers found to present AML risks. The public comment period has closed and the Proposed Rule will be subject to additional review and revision before it is finalized by FinCEN. The effective date is proposed as six months after the rule is published in the *Federal Register*. The Proposed Rule delegates to the SEC examination authority over RIAs for compliance with FinCEN's rules, which require:

[37] *See* Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers, 80 Fed. Reg. 52680 (Sept. 1, 2015), https://www.govinfo.gov/content/pkg/FR-2015-09-01/pdf/2015-21318.pdf.

(a) *AML Program Requirements*. Under the Proposed Rule, an AML program must be approved in writing by the RIA's board of directors or its equivalent and include the following "four pillars":

(i) Establish and implement policies, procedures and internal controls to ensure ongoing compliance;

(ii) Designation of a qualified person (or persons) responsible for implementing and monitoring the operation and internal controls of the program (the "AML officer");

(iii) Ongoing training for appropriate personnel; and

(iv) Periodic independent testing of the AML program for compliance. The Proposed Rule will allow RIAs to delegate contractually the implementation and operation of aspects of its AML program (except for the role of the AML officer).

Importantly, the RIA, not the third-party administrator or other delegee, remains responsible for the effectiveness of the program as well as for ensuring access to documents and information by regulators like FinCEN and the SEC.

(b) *Filing of Suspicious Activity Reports ("SARs").* Under the Proposed Rule, an RIA will be required to electronically file a SAR with FinCEN using FinCEN's BSA E-Filing system "no later than 30 calendar days after the date of the initial detection by the reporting investment adviser that may constitute a basis for filing a SAR." The purpose of a SAR is to report suspicious transactions that could suggest criminal activity, particularly money laundering and terrorist financing, but also other criminal activity such as fraud, to regulators and to law enforcement.

(c) *Record-Keeping and Travel Rules.* The Proposed Rule will also subject RIAs to the BSA's Record-Keeping and Travel Rules, which impose several requirements on financial institutions with regard to funds transfers and certain other transactions.

(d) *Filing of Currency Transaction Reports ("CTRs").* The Proposed Rule will require RIAs to file CTRs for transactions involving more than $10,000 in currency. This change is unlikely to have a substantial impact on RIAs, as RIAs are already required to report such transactions on a different form, known as a Form 8300, and most RIAs do not deal in cash (and may have policies prohibiting cash transactions).

(e) *Section 314 of USA PATRIOT Act.* Under the Proposed Rule, RIAs will be subject to mandatory information sharing pursuant to government requests for information under Section 314(a), which authorizes law enforcement agencies to request, through FinCEN, that financial institutions search their records to determine whether they have maintained an account or conducted a transaction with a person that law enforcement has certified is suspected of engaging in terrorist activity or money laundering. The Proposed Rule will also expand *voluntary* information-sharing under Section 314(b) of the USA PATRIOT Act to include RIAs. Section 314(b) allows financial institutions in the United States to share information for the purpose of identifying and reporting money laundering or terrorist activity, with specific protection from civil liability.

(f) *Implementation of a Customer Identification Program ("CIP").* At this time the Proposed Rule does not require RIAs to establish a CIP pursuant to Section 326 of the USA PATRIOT Act. The Proposed

Rule states that FinCEN will address CIP requirements for RIAs via a joint rulemaking effort with the SEC.

E. Customer Due Diligence Rule

1. On May 11, 2016, FinCEN issued a regulation that clarifies and enhances customer due diligence ("CDD") requirements for covered financial institutions (which does not yet include private fund managers or RIAs, but does include banks, brokers or dealers in securities, mutual funds, FCMs and IB-Cs) and adds a new requirement for covered financial institutions to identify, and verify the identity of, the beneficial owners of certain of their legal entity customers, subject to certain exemptions, that open a new account with the covered financial institution ("CDD Rule"). The new rule requires covered financial institutions to determine the *beneficial owners* of their legal entity customers. In addition, the CDD Rule requires covered financial institutions to understand the nature and purpose of each customer relationship, conduct ongoing monitoring for reporting suspicious transactions, and, in a risk-based way, maintain and update customer information. The CDD Rule became effective on July 11, 2016, and covered financial institutions have had to comply with the CDD Rule since May 11, 2018. Although private fund managers and RIAs are currently not subject to the CDD Rule, private fund managers and RIAs may be indirectly impacted through various requests for information from counterparties that are subject to these rules.

F. Efforts to Combat Money Laundering in Property Sector

1. FinCEN has issued several Geographic Targeting Orders ("GTOs") over the past few years, and most recently on Nov. 15, 2018, requiring U.S. title insurance companies to identify the individuals behind shell companies involved in all-cash purchases of residential real estate. According to FinCEN, these GTOs have provided valuable data on the purchase of residential real estate by persons implicated, or allegedly involved, in various illicit enterprises including foreign corruption, organized crime, fraud, narcotics trafficking and other violations.[38] The purchase amount threshold is $300,000 for each metropolitan area, covering certain counties within the following major locations: Boston, Chicago, Dallas-Fort Worth, Honolulu, Las Vegas, Los Angeles, Miami, New York City, San Antonio, San Diego, San Francisco and Seattle. FinCEN is also requiring that covered purchases using virtual currencies to be reported to FinCEN.[39]

IX. Cash Solicitation Rule

A. In October 2018, the Office of Compliance Inspections and Examinations issued a Risk Alert focusing on common deficiencies relating to the Cash Solicitation Rule (Rule 206(4)-3).[40]

B. While the scope of that rule is narrow and will not directly apply to many private fund managers, the Risk Alert highlights analogous concerns for a broader base of managers.

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[38] *See* Frequently Asked Questions, Subject: Geographic Targeting Orders Involving Certain Real Estate Transactions (Nov. 15, 2018), https://www.fincen.gov/sites/default/files/shared/Real%20Estate%20GTO%20FAQs_111518_FINAL%20508.pdf.

[39] A copy of the GTO is *available at*: https://www.fincen.gov/sites/default/files/shared/Real%20Estate%20GTO%20GENERIC_111518_FINAL.pdf.

[40] For this section, *see generally* Office of Compliance Inspections and Examinations, *Investment Adviser Compliance Issues Related to the Cash Solicitation Rule,* National Exam Program Risk Alert, (2018), https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Cash%20Solicitation.pdf.

C. In recent months, OCIE personnel have publicly noted that advisers are increasingly being cited for violations of the Cash Solicitation Rule. The Rule prohibits registered advisers from directly or indirectly paying a "cash fee" to any person who solicits a client for the adviser unless certain conditions are met, such as:

1. The solicitation agreement must be in writing and detail the business arrangement between the solicitor and the adviser;

2. The solicitor must provide prospective clients with the adviser's Form ADV Part 2A brochure and a separate written disclosure document disclosing the solicitor's compensation arrangement; and

3. The adviser must receive a "signed and dated acknowledgment of receipt" from the client of the adviser's brochure and the solicitor's written disclosure document.

D. In addition, Rule 275.206(4)-3(a)(2)(iii)(C) requires the investment adviser to make "a bona fide effort to ascertain whether the solicitor has complied with the agreement" sufficient to allow the adviser to have "a reasonable basis for believing that the solicitor has so complied."

1. Compliance personnel at private fund managers that employ or contract with placement agents or solicitors should consider, if necessary, broadening the scope of their annual compliance review to address compliance with the topics identified in the Risk Alert.

E. Application to Private Fund Managers

1. Historically, the Cash Solicitation Rule has not been directly relevant to private fund managers, because the rule only applies to solicitors of *client mandates* and does not apply to the solicitation of *investors* for a private fund.[41] However, all private fund managers should still consider the intent of the rule in reviewing their marketing and investor relations programs.

2. While the Risk Alert may not directly be relevant to managers who manage solely private funds and do not advise traditional managed accounts, there still are several points worth considering for private fund managers:

   (a) Managers that employ placement agents solely to identify fund investors should consider whether the disclosure principles embedded in the Cash Solicitation Rule apply to their situation and, if so, whether those principles are addressed in their current procedures.

   (b) Managers should consider whether fund investors may be offered co-investment or other limited opportunities and, if they are, whether those investors now could be considered to be "clients." If that is the case, then the manager should consider whether any related placement agent arrangements are covered by the Cash Solicitation Rule.

   (c) Similarly, pursuant to the 2017 amendments to Form ADV, some so-called "funds of one" are now reported as "managed accounts" instead of "private funds" on Form ADV. Any manager that has

[41] *See* Office of Chief Counsel Division of Investment Management, *Mayer Brown LLP – Interpretive Letter*, Securities and Exchange Commission (July 28, 2008), https://www.sec.gov/divisions/investment/noaction/2008/mayerbrown072808-206.htm.

engaged a placement agent for potential funds of one should consider whether that solicitation arrangement is or should be compliant with the Cash Solicitation Rule.

(d) Disclosures and other requirements related to the solicitation of sovereign wealth funds and other public entity investors are not lessened by compliance with, or the non-applicability of, the Cash Solicitation Rule; compliance with the requirements specific to those investors and clients should continue to be separately and independently addressed.

(e) Advisers registered with the SEC but whose business primarily focuses on commodity trading activity should consider whether their commodity trading solicitation agreements (if any) satisfy, or should satisfy, the Cash Solicitation Rule (and, if there is a fund involved, whether those solicitors need to be registered as broker-dealers).

X. Issues for Managers of Cryptocurrencies and Digital Assets

A. With several regulatory developments in the cryptocurrency and digital asset space in 2018, managers that are considering acquiring these kinds of assets for client accounts should pay careful attention to the shifting regulatory status of the industry. Fund sponsors investing in cryptocurrencies and other blockchain-related assets face unique issues.

B. Recent cases highlight key issues in the crypto and digital assets regulatory space, including the CFTC's increasing focus on enforcement in the area and courts' evolving understanding of the distinction between securities and commodities in the digital asset context.

1. Gelfman Ponzi Matter – CFTC Anti-Fraud Rules Applied to Bitcoin

(a) In October 2018, the CFTC capped recent enforcement efforts with a $2.5-million fine in restitution and civil monetary penalties against Gelfman Blueprint Inc. ("GBI") and its CEO Nicholas Gelfman of Brooklyn, New York, in the first anti-fraud enforcement action involving Bitcoin filed by the CFTC.[42] From approximately 2014 through early 2016, Gelfman and GBI operated a Bitcoin Ponzi scheme in which they fraudulently solicited $600,000 from at least 80 customers. Customers were told that their funds were invested in a pooled commodity vehicle that employed a high-frequency algorithmic trading strategy. However, both the strategy and purported performance reports were false, and client payouts consisted of misappropriated funds from other clients.

2. My Big Coin Matter – Cryptocurrency Found To Be a Commodity

(a) On Sept. 26, 2018, the U.S. District Court for the District of Massachusetts ruled that a cryptocurrency, "My Big Coin," is a commodity rather than a security, removing a jurisdictional bar and permitting the CFTC to proceed with its fraud case against defendant "My Big Coin Pay Inc."[43]

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[42] *See* Press Release, U.S. Commodity Futures Trading Commission, Federal Court Orders Trading Firm and CEO to Pay More than $2.5 Million for Fraudulent Bitcoin Ponzi Scheme, Rel. No. 7831-18 (Oct. 18, 2018), https://www.cftc.gov/PressRoom/PressReleases/7831-18.

[43] *See* Press Release, Federal Court Finds that Virtual Currencies Are Commodities, Rel. No. 7820-18 (Oct. 3, 2018), https://www.cftc.gov/PressRoom/PressReleases/7820-18.

3. ICOs Can Be Subject to Securities Law

(a) In July 2017, the SEC released an investigative report declaring that DAO tokens were considered securities, but did not pursue an enforcement action. 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. The SEC noted in its report that DAO Tokens fulfilled the *Howey* test: [44]

(i) DAO token holders invested assets to purchase the tokens;

(ii) DAO token holders expected to profit from the increase in value of the tokens;

(iii) The DAO was a common enterprise in which the token holders invested; and

(iv) 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.

(b) In June 2018, SEC Chairman Jay Clayton stated that the SEC has no intention of changing the definition of a security to achieve any particular accommodation to the cryptocurrency markets.[45] The SEC continued to bring enforcement actions throughout 2018 related to the offer, sale and distribution of digital tokens through ICOs based on violations of the securities laws.

(i) *AriseBank*. In January 2018, the SEC filed a complaint in U.S. District Court in Dallas against the founders of AriseBank for raising capital through an ICO while making false statements material to the offering.[46]

(ii) *Centra Tech Inc.* In April 2018, the SEC filed a complaint in the U.S. District Court for the Southern District of New York against the founders of Centra Tech Inc. for engaging in an illegal unregistered offering of securities through an ICO.[47]

(iii) *TokenLot LLC*. In September 2018, the SEC announced a settlement with TokenLot LLC and its founders for operating as an unregistered broker-dealer in connection with the sale of digital tokens through ICOs.[48]

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[44] *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").

[45] *See* Kate Rooney, *SEC chief says agency won't change securities laws to cater to cryptocurrencies*, CNBC (June 6, 2018), https://www.cnbc.com/2018/06/06/sec-chairman-clayton-says-agency-wont-change-definition-of-a-security.html.

[46] *See Securities and Exchange Commission v. AriseBank*, No. 3:18-cv-186-M (N.D. Tex. filed Feb. 2, 2018), https://www.sec.gov/litigation/complaints/2018/compa24088.pdf.

[47] *See Securities and Exchange Commission v. Sharma*, No. 1:18-cv-02909 (S.D. N.Y. filed April 2, 2018), https://www.sec.gov/litigation/complaints/2018/comp-pr2018-53.pdf.

[48] *See* Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Section 8a of the Securities Act of 1933, Sections 15(b) and 21c of the Securities Exchange Act of 1934, and Section 9(b) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, No. 3-318739 (2018), https://www.sec.gov/litigation/admin/2018/33-10543.pdf.

(iv) *Crypto Asset Management LP*. In September 2018, the SEC announced a settlement with Crypto Asset Management LP and its founder for violations of the Advisers Act, including relating to the marketing of funds investing in digital tokens. In addition, the SEC found that Crypto Asset Management LP violated the Investment Company Act for not registering certain funds as investment companies (notably, the SEC found that the digital assets held by those funds constituted "investment securities" for purposes of the Investment Company Act).[49]

(c) On Sep. 11, 2018, the U.S. District Court for the Eastern District of New York issued an order in *United States v. Zaslavskiy*[50] finding that prosecutors' indictment had adequately pled that digital tokens promoted through an initial coin offering were in violation of securities anti-fraud laws. Judge Raymond Dearie's decision applied the *Howey* test and found that the substance of the economic transaction involved in the *Zaslavskiy* case was sufficient to support a fraud claim under the Securities Act, regardless of any language suggesting that these instruments were not securities contained in offering materials.

C. Efforts to Combat Money Laundering in Cryptocurrency Sector – Cryptocurrency Guidance.

1. FinCEN Director Kenneth A. Blanco recently discussed the agency's efforts in the area of cryptocurrency at a conference, wherein he cited a recent surge in crypto-related SARs filed by money services businesses in the cryptocurrency space (which are regulated financial institutions under the BSA) and other BSA-regulated financial institutions. According to FinCEN's data, the average number of monthly SAR complaints has now risen to over 1,500. Director Blanco stated that[51] private fund managers and RIAs engaging in cryptocurrency-related activity may be impacted by the increased regulatory focus in this area, either directly or indirectly from counterparties that are subject to these rules.

XI. Issues for Managers Considering Cannabis-Related Investments

A. The legalization of marijuana in various U.S. states has given rise to a variety of investment opportunities in a rapidly growing industry; however there are significant issues accompanying these investments. Managers considering or involved in such investments should consider the following points for inclusion in their annual reviews.

B. Illegality of Marijuana Under Federal Law

1. Notwithstanding its legalization in various states for recreational and/or medicinal purposes, cannabis remains a Schedule I controlled substance under the Controlled Substances Act ("CSA"), a federal criminal statute. The CSA prohibits the manufacture, importation, possession, use and distribution of marijuana and imposes severe penalties for violations of these prohibitions, including fines and

[49] *See* Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Section 8a of the Securities Act of 1933, Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940, and Section 9(f) of the Investment Company Act of 1940, Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order, No. 3-18740 (2018), https://www.sec.gov/litigation/admin/2018/33-10544.pdf.

[50] *See* Order on Motion to Dismiss for Lack of Jurisdiction, No. 1:17-cr-00647-RJD-RER (2018), https://www.americanbar.org/content/dam/aba/events/criminal_justice/2018/SessionIV_Zaslavskiy-EDNY_Order.pdf.

[51] *See* Prepared Remarks of FinCEN Director Kenneth A. Blanco, delivered at the 2018 Chicago-Kent Block (Legal) Tech Conference (Aug. 9, 2018), https://www.fincen.gov/news/speeches/prepared-remarks-fincen-director-kenneth-blanco-delivered-2018-chicago-kent-block.

imprisonment. Therefore, even in those states that have legalized marijuana, and regardless of the fact that they may be properly licensed under state law, marijuana-related businesses are acting in violation of federal law.

2. Legal liability under the CSA and related federal laws does not require an entity or individual to have actually possessed, distributed or produced a controlled substance. Managers who invest in marijuana-related businesses face the prospect of criminal liability under federal law, including under (i) aiding and abetting, (ii) conspiracy and (iii) money laundering theories.

3. While the DOJ has not, to date, brought prosecutions of persons engaged in marijuana activities lawful at the state level, before deciding to invest in a marijuana-related business, managers must assess whether they are willing to accept the risks of engaging in activity that clearly or likely violates federal criminal law in light of the likelihood that the DOJ will, as a practical matter, not prosecute such activity.

C. Other Risks Associated with Marijuana

1. Fund agreements often restrict a manager from engaging in conduct that does not comply with applicable law, including federal law. Accordingly, managers who are willing to tolerate the risk of criminal liability in making certain cannabis investments might nonetheless be precluded from doing so under the language of their governing documents.

2. There is conflicting case law on whether contracts, legal under state law, relating to the marijuana industry might nonetheless be void and unenforceable as against public policy because marijuana remains illegal under federal law.[52] Managers should consider mandatory arbitration provisions and select a favorable forum to mitigate the risk its contracts with cannabis businesses will be unenforceable.

3. Because marijuana is a Schedule I controlled substance, banks and other financial institutions subject to reporting under the Bank Secrecy Act ("BSA") are required to file Suspicious Activity Reports ("SARs") with the federal government on their clients in the cannabis industry. FinCEN, the arm of the U.S. Treasury that regulates SAR filings, has issued guidance that instructs financial institutions to file different levels of SARs depending on whether the marijuana-related business is merely engaged in lawful activity under state law or is engaged in other activities. Managers should consider whether investing in a marijuana-related business would result in the filing of a SAR pertaining to their investment, and whether it could disrupt their existing relationships with their banks or prime brokers.

D. Conducting Due Diligence on Marijuana Investments

1. In order to mitigate the risks of legal liability, including criminal liability, associated with investing in a marijuana-related business, managers are well-advised to conduct robust due diligence to ensure that

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[52] *See*, *e.g.*, *Ginsburg v. ICC Holdings LLC*, No. 3:16-cv-2311-d (N.D. Tex. Nov. 13, 2017) ("… [w]here it is alleged that an agreement contravenes a federal statute…the court looks to federal law to determine whether the contract is illegal or violates public policy, and if so, whether the contract is unenforceable as a result."); *cf. The Green Earth Wellness Center, LLC v. Atain Specialty Ins. Co.*, No. 13-cv-03452-MSK-NYW, 2016 WL 632357 (D. Col. Feb. 17, 2016) ("… in light of … a continued erosion of any clear and consistent federal public policy in this area, this Court declines to follow" precedent stating that the federal Controlled Substances Act prevailed over state law, and thus contracts relating to the marijuana industry were void for reasons of public policy.).

the business is in compliance with applicable state law and regulation. At a minimum, those steps should include:

(a) Verifying that a cannabis business's local and state licenses are both valid and active, and that the licenses are appropriate for the operations of the business;

(b) Conducting background checks on management and other key personnel;

(c) Analysis of the company's business, including whether the company sells or markets its products to minors;

(d) Ensuring adequate internal and external compliance programs are in place, and revising those policies as necessary; and

(e) Confirming the business is properly reporting cash transactions in excess of $10,000.

E. Efforts to Combat Money Laundering in Marijuana Sector – "Marijuana-SAR" Filing Requirement.

On Feb. 14, 2014, FinCEN issued guidance to BSA-regulated financial institutions seeking to provide services to marijuana-related businesses.[53] Because marijuana is a Schedule I controlled substance, BSA-regulated financial institutions are required to file different levels of SARs depending on whether the client engaged in marijuana-related business is merely engaged in lawful activity under state law or is engaged in other activities. Managers should consider whether investing in a marijuana-related business would result in the filing of a SAR pertaining to their investment, and whether it could disrupt their existing relationships with their banks or prime brokers. In order to mitigate the risks of legal liability, including criminal liability, associated with investing in a marijuana-related business, managers are well-advised to conduct robust due diligence to ensure that the business is in compliance with applicable state law and regulation.

XII. ERISA Considerations of Managing Plan Assets

A. The Employee Retirement Income Security Act of 1974, as amended ("ERISA"), imposes certain duties and obligations on persons deemed to be "fiduciaries" of an employee benefit plan. Additional responsibilities and restrictions are imposed under the Internal Revenue Code of 1986 ("Code"). ERISA provides that a person is a fiduciary with respect to a plan to the extent he or she exercises any authority or control respecting management or disposition of the plan's assets or renders investment advice for a fee with respect to its money or property. In certain circumstances, if a plan invests in an entity, such as a hedge fund, the assets of the entity may be also be considered plan assets — commonly referred to as a "plan asset fund — and the manager of the entity would be a plan fiduciary when he or she exercises any authority or control respecting management or disposition of the entity's assets.

1. While it is generally easier for an investment to avoid being a plan asset fund, it is increasingly becoming more common for investment entities to operate as a "plan asset funds" in compliance with ERISA.

[53] *See* FIN-2014-G001, BSA Expectations Regarding Marijuana-Related Business (Feb. 14, 2014), https://www.fincen.gov/sites/default/files/shared/FIN-2014-G001.pdf.

2. This outline summarizes the most important of these rules and restrictions applicable to investment managers of hedge funds in circumstances in which investment in the fund by employee benefit plans causes the hedge fund to be a "plan asset fund."

B. General Application of the Fiduciary Provisions

1. Coverage

(a) *ERISA*. The fiduciary responsibility and prohibited transaction provisions of Title I of ERISA, which impose responsibilities on plan fiduciaries and which regulate plan dealings with providers of services and other parties in interest, apply generally to "employee benefit plans," such as "tax-qualified retirement plans."[54]

(i) ERISA does not cover (1) an individual retirement account ("IRA"), annuity or bond created by an individual employee, to which his employer does not contribute;[55] (2) a plan which covers only the sole owner of a business (incorporated or unincorporated) and/or his spouse (often called a "one-man" plan);[56] or (3) a plan which covers only partners and their spouses (often called a "partner-only" plan).[57]

(ii) Although IRAs, one-man plans and partner-only plans are not covered by ERISA's fiduciary responsibility rules, they are subject to restrictions imposed by the Internal Revenue Code, as discussed below.

(iii) ERISA also excludes from its fiduciary responsibility rules those plans maintained by governmental bodies, certain plans maintained by churches and certain plans maintained by private employers primarily for the purposes of providing deferred compensation for a select group of management or highly compensated employees. However, plans maintained by tax-exempt organizations *other* than governmental bodies and churches are subject to ERISA's fiduciary responsibility provisions, and governmental plans may be subject to ERISA-like fiduciary responsibility rules imposed under state law.

(b) *Internal Revenue Code*. The provisions of the Internal Revenue Code regulating transactions involving employee benefit plans apply to IRAs, annuities or bonds, and "tax-qualified plans" (including one-man plans and partner-only plans).

NOTE: It is important to keep in mind that, since IRAs, one-man plans and partner-only plans are subject to the Internal Revenue Code, the prohibited transaction rules imposed by the Internal Revenue Code apply to these accounts and plans even though they are exempt from the ERISA fiduciary responsibility rules. The fiduciary obligations imposed solely by ERISA, which do *not* apply, are summarized in part D of Section I. The prohibited transaction rules, which are imposed both by

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[54] ERISA § 401(a); 3(3).

[55] Labor Reg. § 2510.3-2(d).

[56] Labor Reg. § 2510.3-3(b).

[57] Labor Regs. § 2510.3-3(b) and § 2510.3-3(c).

ERISA and by the Internal Revenue Code, and which *do* apply to IRAs, one-man plans and partner-only plans, are summarized in part E of Section I.

1. Definition of Fiduciary

   (a) ERISA and the Internal Revenue Code regulate the activities of "fiduciaries." A person is a fiduciary with respect to a plan to the extent the fiduciary:

      (i) Exercises any discretionary authority or control with respect to the management of a fund or the management or disposition of the fund's assets;

      (ii) Renders investment advice to the fund for a fee or compensation, direct or indirect, with respect to any moneys or property of the fund or has any authority or responsibility to do so; or

      (iii) Has any discretionary authority or discretionary responsibility in administering the fund.[58]

   (b) This statutory test is a purely functional test.

2. Definition of Party in Interest

   (a) ERISA and the Internal Revenue Code also restrict transactions involving a plan and a "party in interest." The Internal Revenue Code does not use the term "party in interest" but refers instead to a "disqualified person." The definition of a "disqualified person," though not identical to that of "party in interest," is sufficiently similar so that, for simplicity, the term "party in interest" will be deemed to include a "disqualified person" for purposes of this outline. A "party in interest" is defined to include:

      (i) Any fiduciary (including by definition a trustee);

      (ii) Any person providing services to a plan;

      (iii) An employer whose employees are covered by the plan;

      (iv) A union or other employee organization whose members are covered by the plan;

      (v) An owner of a 50 percent or more interest in an entity described in (iii) or (iv);

      (vi) A relative of an individual described in (i), (ii), (iii) or (v). "Relative" includes a spouse, ancestor, lineal descendant or spouse of a lineal descendant;[59]

      (vii) An entity 50 percent or more of which is controlled, directly or indirectly, by individuals or entities described in (i), (ii), (iii), (iv) or (v);

      (viii) An employee, officer, director or a person directly or indirectly controlling 10 percent or more of an individual or entity described in (ii), (iii), (iv), (v) or (vii); or

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[58] ERISA § 3(21)(A); Internal Revenue Code § 4975(e)(3).

[59] ERISA § 3(15); Internal Revenue Code § 4975(e)(6).

(ix) A person who is a 10 percent or more partner or joint venturer in an individual or entity described in (ii), (iii), (iv), (v) or (vii).[60]

3. General Duties of a Fiduciary

(a) Under ERISA, a fiduciary's general obligations with respect to a plan consist of:

(i) Duty to act solely in the interest of participants and beneficiaries of the investing ERISA-covered employee benefit plans for the exclusive purpose of providing benefits under and defraying reasonable administrative costs of such plans.[61]

(ii) Duty to act with the care, skill, prudence and diligence under the prevailing circumstances that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and like aims.[62]

(iii) Duty to diversify plan investments so as to minimize the risk of large losses (with certain very limited exceptions).[63]

(iv) Duty to act in accordance with the documents governing the investing plans to the extent that such documents are consistent with ERISA.[64]

(v) Except as authorized by regulation, duty to not hold the indicia of ownership (or title) of any assets outside the jurisdiction of the district courts of the United States.[65] A DOL regulation allows certain persons to maintain assets outside the United States under limited circumstances.[66] Under this regulation, a fiduciary may purchase securities issued by a foreign corporation or governmental entity, or whose principal trading market is outside of the United States, if:

(1) The fiduciary is a corporation or partnership organized under United States or state law that has its principal place of business in the United States, and

(2) The fiduciary is a registered investment adviser (or a bank or insurance company) with $50-million under management and either (i) over $750,000 in shareholders' or partners' equity; or (ii) all of its liabilities are assumed or guaranteed by a bank, insurance company, another investment adviser with over $750,000 in shareholders' or partners' equity, or a registered broker or dealer with a net worth of over $750,000.

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[60] ERISA § 3(14); Internal Revenue Code § 4975(e)(2).

[61] ERISA § 404(a)(1)(A); Internal Revenue Code § 401(a).

[62] ERISA § 404(a)(1)(B). This is sometimes referred to as the prudent expert standard. It is a higher standard than the common law fiduciary standard of a general partner to a partnership.

[63] ERISA § 404(a)(1)(C).

[64] ERISA § 404(a)(1)(D).

[65] ERISA § 404(b).

[66] Labor Reg. § 2550.404b-l.

(vi) Must not cause a plan to invest in employer securities or employer real property in excess of certain specified limitations.[67]

(b) In general, under applicable DOL regulations, to satisfy the requirement that a fiduciary act with the care, skill, prudence and diligence of a prudent person with respect to an investment if, with regard to a particular investment or investment course of action, the fiduciary gives appropriate consideration of the facts and circumstances which, given the scope of the fiduciary's investment duties, the fiduciary knows or should know are relevant to a particular investment or investment course of action.

(i) A fiduciary should consider the role that the particular investment or investment course of action plays in the fund's overall investment portfolio.

(ii) The fiduciary should determine whether the particular investment or investment course of action is reasonably designed, as part of the fund's investment portfolio, to further the purpose of the fund given the risk of loss and opportunity for gain (or other return) associated with the investment.

(iii) Among the factors that a fiduciary should consider are the composition of the fund's investment portfolio and its diversity or lack thereof, the liquidity, rate of return and cash flow needs of the fund and the projected return from the fund's investments relative to other types of investments.

4. Prohibited Transactions

(a) Under ERISA, a fiduciary may not engage in a prohibited transaction with a plan nor cause the fund to engage in a prohibited transaction with a party in interest. Except as otherwise indicated below, these rules are imposed both by ERISA and by the Internal Revenue Code.

(b) Prohibited transactions involving fiduciary self-dealing:

(i) Dealing with the assets of the plan in the fiduciary's own interest or for his own account (e.g., effecting a securities transaction through a broker-dealer that is an affiliate of the plan asset fund manager or purchasing a security with fund assets for the purpose of maintaining the price of the security for the benefit of such a broker-dealer or its other customers).[68]

(ii) Acting on behalf of a party whose interests are adverse to the interests of the plan in any transactions involving the plan (e.g., the manager of a plan asset fund crosses the fund's securities trades with another hedge fund managed by the same manager).[69] (ERISA only).

(iii) Receiving any consideration for its own account from any party dealing with the plan in connection with a transaction involving the plan's assets (e.g., the manager of a plan asset fund

[67] ERISA § 406(a)(2).

[68] ERISA § 406(b)(1); Internal Revenue Code § 4975(c)(1)(E).

[69] ERISA § 406(b)(2).

receives a fee or other thing of value from an unaffiliated broker in return for the manager selecting that broker to execute trades for the fund).[70]

(c) These prohibited transaction rules are intended to prevent a fiduciary from engaging in any acts of self-dealing or in transactions where the fiduciary has, or may have, a conflict of interest.

5. Prohibited transactions between a party in interest (including any fiduciary) and a plan involving:

   (a) A sale, exchange or lease of property.[71]

   (b) Loans and other extensions of credit, including margin loans and short sales. (However, see the exemption for certain margin loans and short sales discussed below in Section IV of this outline.)[72]

   (c) Furnishing of goods, services or facilities.[73]

   (d) Transfers to, or use by a party in interest of, any fund assets.[74]

   (e) Subject to certain exceptions, acquisition by a party in interest, on behalf of the fund, of any employer security or employer real property (ERISA only).[75]

6. Consequences of Violating the Fiduciary and Prohibited Transaction Provisions of ERISA

   (a) ERISA

      (i) A fiduciary with respect to a plan that breaches any of the standards of fiduciary conduct imposed by ERISA is personally liable to make the plan "whole" for any losses incurred by the plan resulting from the breach and to restore to the plan any profits of the fiduciary arising from the fiduciary's use of plan assets. Making a plan whole for its losses requires that the breaching fiduciary both restore any investment losses and provide to the plan an amount equal to the income the plan would have earned had there been no fiduciary breach. That amount is typically determined based on the rate of return on the other assets of the plan and by determining how the assets committed as a result of the breach would otherwise have been invested. The

[70] ERISA § 406(b)(3); Internal Revenue Code § 4975(c)(1)(F). A violation of this section may give rise to criminal penalties. 18 U.S.C. § 1954.

[71] ERISA § 406(a)(1)(A); Internal Revenue Code § 4975(c)(1)(A).

[72] ERISA § 406(a)(1)(B); Internal Revenue Code § 4975(c)(1)(B).

[73] ERISA § 406(a)(1)(C); Internal Revenue Code § 4975(c)(1)(C).

[74] ERISA § 406(a)(1)(D); Internal Revenue Code § 4975(c)(1)(D). This prohibition would bar the investment manager of a plan asset fund from receiving any soft dollars from the broker-dealers through which the investment manager executes the fund's trades. However, in Technical Release 86-1, the DOL recognized that Section 28(e) of the Securities Exchange Act of 1934 was passed after ERISA and thus preempts ERISA's ban on the receipt of soft dollars. This preemption only applies to soft dollars that fall completely within the scope of Section 28(e). Thus, a manager's receipt of non-28(e) soft dollars (such as rent subsidies, free trips, apartment rentals, etc.) would be prohibited.

[75] ERISA § 406(a)(1)(E).

fiduciary may also be removed by a court for violation of fiduciary responsibilities and may be subject to any other relief that the court deems appropriate.[76]

(ii) ERISA requires the DOL to impose a civil penalty against a fiduciary who commits a fiduciary breach (including a prohibited transaction) equal to 20 percent of the amount recovered by the DOL pursuant to a settlement agreement with the DOL or pursuant to a court order in a judicial proceeding instituted by the DOL.[77] A similar penalty must be assessed against any non-fiduciary who knowingly participates in such a breach.[78] The DOL has the authority to waive or reduce the penalty if the DOL determines that the fiduciary or non-fiduciary acted in good faith or if imposing the penalty would cause a severe financial hardship.

(b) Internal Revenue Code

(i) The Internal Revenue Code imposes a tax on a disqualified person who participates in a prohibited transaction. The initial tax is 15 percent of the greater of the fair market value of the consideration given or the fair market value of the consideration received in the transaction.[79] However, if the prohibited transaction involves the receipt of excess compensation for the performance of services, the initial tax is 15 percent of the excess compensation. The tax is payable for every year beginning with the year in which the transaction occurs and ending with the year in which occurs the earlier of:

(1) The mailing date of a notice of deficiency (90-day letter) to the taxpayer;

(2) The date on which the initial excise tax is assessed; or

(3) The "correction date," i.e., the date the transaction is undone to the extent possible, and in any case, the date on which the plan is placed in a financial position not worse than it would have been if the party in interest were acting under the highest fiduciary standards.[80]

a. If the correction date does not occur prior to 90 days after the mailing of a notice of deficiency, there is an additional tax of 100 percent of the consideration given or received or the consideration in excess of reasonable compensation, whichever is applicable,[81] and the amount on which the tax is based may be the highest fair market value during the taxable period.[82] Section 4975(d)(23) of the Internal Revenue Code together with Section 4975(f)(11) of the Internal Revenue Code provide an exemption from the prohibited transaction excise tax if a disqualified person enters into a

[76] ERISA § 409(a).

[77] ERISA § 502(1).

[78] ERISA § 502(1).

[79] Internal Revenue Code § 4975(a) and (f)(4).

[80] Internal Revenue Code § 4975(a), (f)(2) and (f)(5).

[81] Internal Revenue Code § 4975(b).

[82] Internal Revenue Code § 4975(f)(4)(B).

prohibited transaction with the plan as long as the fiduciary did not know (or should not reasonably have known) that the transaction was a prohibited transaction and if the prohibited transaction is corrected during a correction period.[83]

(ii) Liability for the Tax

(1) The tax is imposed on any party in interest who participates in the transaction (other than a fiduciary acting only as such). Generally, the tax is imposed without regard to whether or not the party in interest was aware that the fiduciary was participating in a prohibited transaction.[84]

(2) If more than one person is liable for the tax, the tax is the joint and several liability of all such persons.[85] However, if a plan fiduciary participates in a prohibited transaction solely in his capacity as a fiduciary, the fiduciary is not liable for the tax.[86]

(c) Liability for Breach of Co-Fiduciary

(i) In addition to any liability that a fiduciary may have for his own breaches of fiduciary duty, the fiduciary is liable for the breach of another fiduciary of the same plan if it:

(1) Knowingly participates in or undertakes to conceal a breach of fiduciary duty, which the fiduciary knows to be a breach;

(2) Enables such fiduciary to commit the breach by not discharging his own fiduciary duties properly; or

(3) Is aware that the breach has occurred, unless the fiduciary takes reasonable steps to remedy the breach.[87]

(ii) If a plan fiduciary has knowledge of another plan fiduciary's breach of fiduciary responsibility, it has an affirmative duty to make reasonable efforts to remedy the breach. Failure to do so will expose the fiduciary to potential liability for the acts of the offending fiduciary.

C. Determining If a Hedge Fund Holds Plan Assets

1. ERISA and a DOL regulation, commonly called the "Plan Asset Regulation,"[88] describe when the underlying assets of an entity in which "benefit plan investors," as defined in Section 3(42) of ERISA and

[83] Internal Revenue Code § 4975(f)(5) and (f)(11).

[84] Internal Revenue Code § 4975(a) and (b).

[85] Internal Revenue Code § 4975(f)(1).

[86] Internal Revenue Code § 4975(a) and (b).

[87] ERISA § 405(a).

[88] Labor Reg. § 2510.3-101.

any regulations promulgated thereunder ("Benefit Plan Investors"), invest are treated as "plan assets" for purposes of ERISA.

2. *Benefit Plan Investors*. Under ERISA, the term "Benefit Plan Investors" includes an "employee benefit plan" that is subject to the provisions of Title I of ERISA, a "plan" that is subject to the prohibited transaction provisions of Section 4975 of the Internal Revenue Code, and entities the assets of which are treated as "plan assets" by reason of investment therein by Benefit Plan Investors. Benefit Plan Investors include:

   (a) U.S. private company pension plans;

   (b) U.S. private company 401(k)/profit sharing plans;

   (c) U.S. private company health and welfare plans (medical plans, life insurance plans, vacation plans, etc.);

   (d) Keogh plans;

   (e) Church plans that have elected to be covered by Title I of ERISA;

   (f) Certain life insurance company general and separate accounts;

   (g) Individual retirement accounts (traditional, Roth, SEP-IRAs, SIMPLE IRAs, etc.);

   (h) Group trusts qualified under IRS Revenue Ruling 81-100; and

   (i) Entities that are treated under ERISA as holding plan assets (e.g., a fund of funds).

3. In general, when a Benefit Plan Investor invests in another entity, the Benefit Plan Investor's assets will include the investment, but do not, solely by reason of such investment, include any of the underlying assets of the entity if:

   (a) The investment consists of debt and not equity;

   (b) The investment is an "equity interest" that is a "publicly offered security";

   (c) The investment is a security issued by an investment fund registered under the Investment Company Act of 1940;

   (d) The investment is an equity interest in an "operating company"; or

   (e) The investment is an equity interest but the total investment in the entity by Benefit Plan Investors satisfies the so-called "25% Test."

4. *25% Test*. If Benefit Plan Investors own 25 percent or more of any class of the equity interests in the entity, each Benefit Plan Investor's assets will include not only its equity interest in the entity, but also an undivided interest in each of the underlying assets of the entity. The entity is deemed to be holding the plan assets of each Benefit Plan Investor.

(a) Any entity providing services to the entity will be deemed to be providing services to each of the investors that is subject to ERISA and/or the prohibited transaction provisions of the Internal Revenue Code, causing the service provider to be a party in interest to each such investing plan. Similarly, the investment manager of the entity will be deemed to be providing investment management services to each of the investors that is subject to ERISA and/or the prohibited transaction provisions of the Internal Revenue Code. Accordingly, the investment manager of a plan asset fund will be a fiduciary to each such investing plan and subject to ERISA's fiduciary responsibility provisions discussed in Section I of this outline.

(b) The 25% Test must be made by disregarding the value of any equity interests held by a person (other than a Benefit Plan Investor) who has discretionary authority or control with respect to the assets of the entity or any person who provides investment advice for a fee (direct or indirect) with respect to such assets, or any affiliate of such a person.

"Affiliate" of a person includes any person, directly or indirectly, through one or more intermediaries, controlling or controlled by, or under common control with, the person. For purposes of this definition, "control" with respect to a person other than an individual means the power to exercise a controlling influence over the management or policies of such person.

(c) The 25% Test must be made immediately after the most recent acquisition of any equity interest in the entity. Neither Section 3(42) of ERISA nor the Plan Asset Regulation addresses the treatment of a redemption of an equity interest or an intra-family transfer; the term "acquisition" is undefined. In an advisory opinion letter (Advisory Opinion 89-05A), dated April 5, 1989, the DOL indicated that, in its view, the redemption of a partner's equity investment in a partnership would constitute an acquisition, triggering a test of the level of Benefit Plan Investor participation in the entity because the redemption would result in an increase in the interests of the remaining partners. The DOL also stated that, in its view, intra-family transfers of equity interests in a partnership, whether by devise or inheritance, also would require the 25% Test to be re-run.

D. Consequences of an ERISA-Covered Plan Investing in a Plan Asset Fund

1. Trustees may be relieved of their duty to manage plan assets.

(a) ERISA provides that the trustees of a plan are vested with the exclusive authority and discretion to manage the assets of the plan.[89] The trustees must fulfil this responsibility in accordance with the fiduciary responsibility provisions of ERISA discussed in part D of Section I of this outline.

(i) Regardless of their financial education or sophistication, the trustees of the plan will be held to an extremely high standard of behavior. Congress recognized that this was somewhat unfair and relieved the trustees of their responsibility for day-to-day management of the plan's assets as long as the authority to manage and control the assets of the plan has been delegated to an investment manager.[90]

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[89] ERISA § 403(a)(1).

[90] ERISA § 403(a)(2).

(ii) ERISA provides that if an investment manager has been appointed, the trustees will not be liable for the acts or omissions of the investment manager, nor will they be obligated to invest or otherwise manage the assets entrusted to the investment manager.[91] This relief is only available if the entity that is managing plan assets meets the definition of an investment manager set forth in Section 3(38) of ERISA.

ERISA defines an investment manager to include a bank, an insurance company and, most significantly, a registered investment adviser.[92] Hiring an unregistered adviser provides no relief for the plan trustees. In fact, the opposite is true. The trustees will retain full liability for the acts or omissions of the unregistered adviser as if they were the acts or omissions of the trustees themselves. It is for this reason that the investment manager of a plan asset fund must be registered as an investment adviser unless the manager is either a bank or an insurance company. Without that, the trustees of each Benefit Plan Investor that is an ERISA-covered plan will be responsible for the individual decisions of the plan asset fund manager as if they made those decisions themselves.

2. Special Reporting Requirements

(a) In general, each Benefit Plan Investor that is covered by ERISA or the prohibited transaction provisions of the Internal Revenue Code is required to file an annual report (Form 5500) with the DOL and the IRS. One item required by the annual report is a list of all the assets of the plan, including the fair market value of each asset. Therefore, each plan is required to include information regarding each asset held by a plan asset fund. However, as an alternative, each such plan may include on its annual report solely the value of its interest in the hedge fund, provided that the hedge fund files certain information with the DOL regarding the hedge fund's investments and expenses for the year. Many plans prefer to rely upon this alternative, and the fund should furnish timely valuation information to each such plan investor.

(b) A plan must report certain direct and indirect compensation paid by the plan in connection with its investments. A plan is expected to request this information from the various investment managers and investment vehicles in which the plan invests. This information is filed on Schedule C to the plan's Form 5500. In connection with a plan asset fund, all of the compensation that the plan is required to report would be indirect compensation unless the plan paid a placement agent directly in connection with its investment in the hedge fund. Indirect compensation includes the management and incentive fees paid by the hedge fund, brokerage amounts in excess of pure execution fees, entertainment received by the hedge fund manager from its service providers, and any other fees paid to the hedge fund manager by third parties in connection with the investment of the hedge fund's assets (for example, if an entity in which the hedge fund invests then pays consulting fees to the hedge fund manager or an affiliate because of the hedge fund's investment in that entity). Plans request this compensation information in many different formats, and we suggest that the investment manager of a plan asset fund develop its own model response rather than attempting to complete the various forms it receives from the ERISA-covered investors.

[91] ERISA § 404(d)(1).

[92] ERISA § 3(38).

3. Bonding Requirement

(a) To protect employee benefit plans against loss as a result of fiduciary misconduct, ERISA requires that certain plan fiduciaries be bonded in an amount equal to the lesser of 10 percent of the funds handled by such fiduciaries or $500,000.[93] The Pension Protection Act of 2006 raised this number to $1 million if a plan holds securities of its plan sponsor. However, it is unclear whether every fiduciary handling a plan's assets needs to maintain the $1-million (rather than $500,000) coverage, or only those who invest in employer securities. A letter was filed with the DOL on this issue that took the position that if a fiduciary does not invest in employer securities, it should be allowed to purchase the lower bond, regardless of whether other investment managers for the plan have purchased the plan sponsor's securities. If the DOL's response is that every manager of a plan holding employer securities will have to purchase a $1-million bond, then the investment manager of a plan asset fund would purchase the bigger bond as it is highly unlikely that the investment manager would keep tabs on the plan's other holdings.

(b) Regardless of the answer to the question regarding the amount of the ERISA Section 412 bond, the investment manager of a plan asset fund must obtain such a bond, which names the client plan as the insured. In the alternative, the investment manager may provide by contract that each ERISA-covered investing plan will cover the investment manager of the fund on an agent's rider to the plan's fidelity bond. This complies with the provisions of Section 412 of ERISA, but larger plans often push back on this requirement and may require the manager to agree to obtain the bond in a side letter.

E. Class Exemption from the Prohibited Transaction Rules of ERISA for Qualified Professional Asset Managers

1. In 1984, in recognition of the fact that the definition of the term "party in interest" was so broad that it caused many beneficial and appropriately priced transactions to become prohibited, the DOL granted extensive relief to professional asset managers in their dealings with "remote" parties in interest with respect to their plan clients. PTCE 84-14 ("QPAM Exemption")[94] provides that a plan that is managed by a qualified professional asset manager ("QPAM") may enter into a transaction described in Section 406(a) of ERISA (such as a loan, lease, provision of services, etc. between a plan and a party in interest) that would otherwise be prohibited if, at the time of the transaction, the QPAM Exemption is satisfied.

(a) *Definition of "QPAM."* A QPAM includes a bank, S&L, insurance company or, most importantly, a registered investment adviser with $85-million under management as of the last day of its most recent fiscal year and shareholder's or partner's equity (determined under U.S. Generally Accepted Accounting Principles) of at least $1 million.

(i) The $1-million determination is made based on the investment adviser's most recent balance sheet prepared within the last two years preceding the transaction for which QPAM relief is required. However, for convenience, this determination is typically based on the adviser's balance sheet as of the last day of its most recent fiscal year.

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[93] ERISA § 412.

[94] 49 Fed. Reg. 9494 (March 13, 1984).

(ii) If an investment adviser fails the net worth test, it may still be a QPAM if the investment adviser and its affiliates together have shareholder's or partner's equity in excess of $1 million and certain affiliate(s) unconditionally guarantee to pay all of the investment adviser's liabilities, including any liabilities that may arise if the investment adviser violates any of its fiduciary obligations to the plan or violates any of the prohibited transaction rules.

(b) *General QPAM Exemption Requirements*. For the QPAM Exemption to apply to a transaction between a Benefit Plan Investor and a party in interest:

(i) The transaction must not be covered by a prohibited transaction class exemption involving securities lending arrangements, acquisitions of interests in mortgage pools, or mortgage financing arrangements (which transactions must meet the requirements set forth in the applicable class exemptions).

(ii) The terms of the transaction must be negotiated on behalf of the Benefit Plan Investor by the QPAM, the QPAM must make the decision on behalf of the Benefit Plan Investor to enter into the transaction, and the transaction must not be part of an agreement, arrangement or understanding designed to benefit a party in interest.

(iii) The party in interest involved in a transaction must not be the QPAM or a related party to the QPAM.

(iv) The Benefit Plan Investor's assets managed by the QPAM at the time of the transaction, when added to the assets of other employee benefit plans maintained by the same employer or an affiliate that also are managed by the QPAM, must not exceed 20 percent of the total client assets managed by the QPAM.

(v) At the time the transaction is entered into and at the time of any subsequent renewal or modification thereof that requires the consent of the QPAM, the terms of the transaction must be at least as favorable to the Benefit Plan Investor as the terms generally available in arm's-length transactions between unrelated parties.

(vi) At the time of the transaction, the party in interest, or an affiliate thereof, must not have the authority to appoint or terminate the QPAM or negotiate the terms of the management agreement. With respect to a pooled investment fund, such as a hedge fund, managed by a QPAM, this requirement is deemed satisfied if no plan, when aggregated with all other plans sponsored by the same employer (or affiliated group of employers) that have invested in the fund represents 10 percent of the assets of the fund. In an advisory opinion issued by the DOL in 2007 (DOL Advisory Opinion 2007-02A), the DOL clarified that indirect investment by plans in an investment fund through other funds (e.g., fund of funds) can be excluded. An investment manager of a hedge fund is not required to consider the ownership interests of any plan investors in an investment fund that invests in the fund managed by the manager. However, the DOL also warned that the QPAM Exemption would not provide relief if the investment by one investment fund in a second investment fund pursuant to an agreement or understanding that the manager of the second investment fund would engage in transactions that benefit the manager of the first investment fund or its affiliates (and the investment, itself, would constitute a conflict of interest that is prohibited by ERISA). The DOL Advisory Opinion included the following example:

Assume that Plan X is a 50 percent investor in the First Fund and also a 4 percent investor in the Second Fund. The First Fund purchases a 30 percent interest in the Second Fund. The underlying assets of both Funds contain plans assets.

(vii) Based on the assumption that the managers of the two funds were unrelated, it was the DOL's view that "the 10% exception . . . does not require the consideration by a QPAM of the ownership interests of any plan investors in an investment fund which is investing in a second fund managed by such QPAM." However, the DOL also warned that the QPAM Exemption would not provide relief if the investment by one investment fund in a second investment fund pursuant to an agreement or understanding that the manager of the second investment fund would engage in transactions that benefit the manager of the first investment fund or its affiliates (and the investment, itself, would constitute a conflict of interest that is prohibited by ERISA).

(c) *QPAM Exemption Provides Broad Relief.* The QPAM Exemption provides extensive relief for an investment manager of a plan asset fund, particularly if its investment strategy involves the acquisition of securities on margin, short-sale transactions or entering into swaps. In all of these cases, the transactions give rise to extensions of credit between the plan and the broker-dealer executing the transaction (and are prohibited under Section 406(a)(1)(B) of ERISA).[95] The QPAM Exemption allows the QPAM to freely enter into transactions involving the extension of margin credit and to pay interest on any margin debt created in short selling without the need to keep a list of all broker-dealers providing services to the plan.[96] In addition, in connection with a short-sale program managed by a QPAM, the plan may borrow the stock (typically from a broker-dealer) to cover the short sale without the need to examine whether the lender is a party in interest. As discussed above, the only limitations in both cases are that the party extending credit cannot be the QPAM or an affiliate of the QPAM, nor can the party possess the power to hire or fire the QPAM.

(d) Investment Managers and Broker-Dealers. The QPAM Exemption allows an investment manager of a plan asset fund to enter into principal trades with broker-dealers that provide execution services to one or more of the fund's Benefit Plan Investors. Because the broker-dealer is a service provider to each such plan, the trade would violate the prohibition of Section 406(a)(1)(A) of ERISA that bars a sale or exchange of property between a plan and a party in interest. The QPAM Exemption permits the transaction to occur, again assuming that the broker-dealer is neither the QPAM nor an affiliate of the QPAM, nor does it possess the power to hire or fire the QPAM. As another example of the usefulness of the QPAM Exemption, it has become common for a hedge fund of funds to borrow from a bank on a short-term basis to fund investments and redemptions. Just as the QPAM Exemption permits extensions of credit in connection with trading on margin and short sales, it also

[95] By executing the securities transactions of a plan asset fund, the broker-dealer becomes a party in interest (as a service provider) to each Benefit Plan Investor in the hedge fund. Because the broker-dealer is a service provider, the extension of credit violates Section 406(a)(1)(B) of ERISA.

[96] While providing exemptive relief from the prohibition against extensions of credit, the purchase of securities on margin and the existence of margin debt in short-sale transactions may cause income derived from these investments to be deemed to be "debt financed income" subject to the unrelated business income tax under Sections 512 and 514 of the Internal Revenue Code. Accordingly, an investment adviser should seek assurance from the investing plan that no governing plan documents specifically prohibit investments that could subject the plan to the unrelated business income tax.

permits extensions of credit in such situations, even if the bank is otherwise a party in interest to a Benefit Plan Investor in the plan asset fund of funds.

(e) *Where the QPAM Exemption Is Inapplicable*. As noted above, the QPAM Exemption is not applicable to transactions covered by a prohibited transaction class exemption involving securities lending arrangements, acquisitions of interests in mortgage pools or mortgage financing arrangements (which transactions must meet the requirements set forth in the applicable class exemptions). The most important of these transactions is securities lending. If the borrower of the securities is a party in interest with respect to any Benefit Plan Investor in a plan asset fund, the loan of securities will violate Section 406(a)(1)(b) of ERISA. Although the QPAM Exemption does not provide relief for such transactions, a separate class exemption, Prohibited Transaction Exemption 2006-16[97] for securities lending, and the statutory exemption for dealings with "remote" parties in interest set forth in Section 408(b)(17) of ERISA (discussed in Section V of this outline), provide sufficient relief to allow the investment manager of a plan asset fund to engage in securities lending on behalf of the fund. Although not mentioned in the QPAM Exemption, in the preamble to Prohibited Transaction Exemption 2006-16, the DOL raised a question as to whether repurchase agreements were not structurally the same as securities loans.[98] Although not providing a definitive answer, the DOL's discussion of this issue has led a number of investment managers of plan asset funds and their counterparties to conclude that the QPAM Exemption may not permit repurchase agreements between the fund and the counterparty. Instead, the parties to the transaction will often rely on the statutory exemption for dealings with "remote" parties in interest set forth in Section 408(b)(17) of ERISA (discussed in Section V of this outline).

F. General Exemption for Transactions with Service Providers

1. Section 408(b)(17) of ERISA[99] provides a statutory exemption that permits a fiduciary with respect to a plan to cause the plan to enter into an otherwise prohibited (i) sale, exchange or lease of property; (ii) loans including a margin loan; or (iii) transfer to, or use by a party in interest of, any plan assets, with a party in interest. Section 408(b)(17) of ERISA sets forth two conditions to the very broad relief provided thereunder. First, the party in interest dealing with the plan cannot be a fiduciary with respect to the investment of the plan assets involved in the transaction. Second, the plan must receive no less, nor pay no more, than adequate consideration with respect to the transaction.

2. *"Adequate Consideration."* In the case of a security traded on a national exchange, Section 408(b)(17) of ERISA defines adequate consideration as the price on the exchange taking into account factors such as size of the transaction and marketability of the security. In the case of a security that is not traded on a national exchange, Section 408(b)(17) of ERISA defines adequate consideration as a price not less favorable than the offering price for the security as established by the current bid and ask quotes of a party independent of the issuer and the party in interest to the transaction, again taking into account factors such as size of the transaction and marketability of the security. In the case of an asset other than a security for which there is a generally recognized market, Section 408(b)(17) of ERISA defines adequate

[97] 71 Fed. Reg. 63786 (Oct. 21, 2006).

[98] 71 Fed. Reg. 63786, 63792 (Oct. 21, 2006).

[99] ERISA § 408(b)(17) and Internal Revenue Code § 4975(d)(20).

consideration as the fair market value of the asset as determined in good faith by a fiduciary or fiduciaries in accordance with DOL regulations.

3. *Investment Managers and Parties in Interests.* In the context of a plan asset fund, Section 408(b)(17) of ERISA would permit an investment manager of the fund to enter into transactions with a "party in interest" to a Benefit Plan Investor in the hedge fund if the counterparty were not acting in a fiduciary capacity with respect to the particular transaction. In a typical counterparty transaction relying on the relief provided in Section 408(b)(17) of ERISA, there will be a representation in the documents evidencing the transaction that the counterparty is not a fiduciary to the plan asset fund and its Benefit Plan Investors because the counterparty is not providing the investment manager with advice with respect to the transaction that is being relied upon by the investment manager in consummating the transaction. In theory, the relief provided by Section 408(b)(17) of ERISA should replace the need for the investment manager of a plan asset fund to be a QPAM (but not a registered investment adviser) because it provides very broad relief for the transactions exempted under the QPAM Exemption. However, because this section of ERISA is so new and the DOL has issued no regulations thereunder, most counterparties continue to insist on QPAM representations before they will enter into transactions with a plan asset fund.

G. Special Prohibited Transaction Concerns That Arise in Managing a Plan Asset Fund

1. Payment of Performance-Based Compensation (Incentive Allocation/Fees)

(a) As a fiduciary, the investment manager of a plan asset fund is generally not permitted to deal with the assets in his own interest, or act on behalf of a party whose interests are adverse to those of the fund. The investment manager may not cause the fund to pay a performance-based fee (i.e., an incentive allocation or fee) in circumstances in which the investment manager can impact the amount of its fees by its own actions. However, according to applicable DOL advisory opinions,[100] an investment manager may receive performance-based compensation (i.e., receive an incentive fee or allocation) in the following factual situation:

(i) The investment manager is registered under the Investment Advisers Act of 1940;

(ii) The decision to retain the investment manager and to pay the incentive fee is made by each fiduciary of each Benefit Plan Investor, and such fiduciary must be independent of the investment manager;

(iii) Each Benefit Plan Investor has total assets of at least $50 million;

(iv) No more than 10 percent of each Benefit Plan Investor's total assets are placed in the fund (i.e., under the control of the investment manager);

(v) The investment manager generally invests the fund's assets in securities for which market quotations are readily available, and if market quotations are not readily available (e.g., illiquid

[100] *See* Adv. Op. 86-20A (BDN Advisers Inc.), Adv. Op. 86-21A (Batterymarch Financial Management) and Adv. Op. 89-31A (Alliance Capital Management LP).

securities that are not regularly traded), the securities are valued by a qualified party who is independent of the investment manager and who is selected by the Benefit Plan Investors;

(vi) The investment manager's services may be terminated on reasonably short notice under the circumstances;

(vii) The incentive fee arrangement complies with the terms and conditions of Securities and Exchange Commission Rule 205-3 governing performance-based compensation;

(viii) The total fees paid to the investment manager do not exceed reasonable compensation for services performed by the investment manager;

(ix) Securities purchased or sold by the investment manager on behalf of the fund are not securities for which the investment manager (or an affiliate) is a market-maker;

(x) The incentive fee is determined based on annual performance, taking into account both realized and unrealized gains and losses, and where the investment manager's services are terminated on a date other than an anniversary date, net profit is determined for the period from the commencement of the preceding full year through the termination date; and

(xi) Each Benefit Plan Investor's plan fiduciary represents that it fully understands the formula for calculating the incentive fee and the risks associated with such an arrangement.

(b) While the relevance of each of the above facts is open to discussion, two are clearly fundamental.

(i) First, the ability of the investment manager to control the amount of its compensation by assigning its own values to the hedge fund's assets could give rise to an act of self-dealing prohibited by Section 406(b)(1) of ERISA. Of course, this would also be true even if the manager is compensated purely on the basis of assets under management. However, the DOL has chosen to focus on manager valuation of the assets only in connection with the payment of performance-based compensation. In order to avoid prohibited transaction issues, the investment manager of a plan asset fund must not set its compensation by setting the value of the fund's securities. That does not necessarily require the fund to hire an independent valuator to determine the value of all of the assets, or even of the non-liquid securities. However, the manager must set forth in advance and in a fully disclosed manner to the Benefit Plan Investors how pricing will be determined from (and by) external sources. The subscription agreement will then serve as the consent of the Benefit Plan Investors to the stated valuation methodology.

(ii) Second, the incentive fee must be determined based on performance that takes into account both realized and unrealized gains and losses. In the view of the DOL, taking an incentive allocation on realized gains without taking into account unrealized gains and losses clouds the investment judgment of the investment manager, such that the fiduciary no longer acts in the sole interest of the Benefit Plan Investors and gives rise to an act of self-dealing. In the DOL's view, paying on realized gains only provides the investment manager with an incentive to (1) sell the winners and hold onto the losers; and (2) sell the winners early, in each case in order to generate current fees at the expense of the needs of the ERISA investors.

(iii) It should be noted that the factual statement set forth in the advisory opinions that the performance fee is to be measured over a one-year period merely reflects the state of Securities Exchange Commission Rule 205-3 at the time the DOL issued its advisory opinions. This one-year requirement has no independent existence under ERISA, nor is it linked to any of the prohibited transaction provisions of the statute. Similarly, neither the requirement that a plan investing in an entity that will pay performance-based compensation have assets of at least $50-million, nor the requirement that the plan have no more than 10 percent of its assets managed by a manager receiving performance-based compensation, have any independent existence under ERISA, nor are they linked to any of the prohibited transaction provisions of the statute. They are merely facts regurgitated by the DOL from the submissions received from the parties requesting the advisory opinions. However, it is clear that the independent plan fiduciary making the decision to invest in the hedge fund must have the sophistication necessary to make a meaningful determination that the investment is in the best interests of the applicable plan.

2. Employer Securities

(a) ERISA restricts the ability of a Benefit Plan Investor to hold securities issued by the sponsoring employer (or any affiliate of the sponsoring employer) of any Benefit Plan Investor ("employer securities").[101] To comply with this restriction, an investment manager of a plan asset fund may seek to restrict the acquisition of employer securities. For example, if the XYZ Pension Plan is an investor in a plan asset fund, the investment manager of the fund should consider restricting the purchase of XYZ stock or debt. In the absence of a self-imposed prohibition, a plan asset fund could acquire "qualifying employer securities"[102] if the value of the qualifying employer securities (when combined with "qualifying employer real property") held by the Benefit Plan Investor does not exceed 10 percent of the value of the Benefit Plan Investor's assets. Each Benefit Plan Investor is considered to have a proportionate interest in each asset of the hedge fund. If the XYZ Pension Plan's assets equal $100 million, the plan invests 8 percent of its assets directly in XYZ stock and acquires 5 percent of the hedge fund, a violation of ERISA would occur if the hedge fund acquires more than $40-million of XYZ stock because the XYZ Pension Plan will be deemed to have invested 10 percent of its assets in the XYZ stock (i.e., 8 percent directly and 2 percent indirectly through its investment in the hedge fund).

(b) Unless a plan asset fund is willing to monitor its compliance with the ERISA employer security holding limitations every time it purchases employer securities, either (1) the hedge fund should not invest in employer securities or (2) the hedge fund's subscription agreement should provide for an acknowledgement by the fiduciary of the Benefit Plan Investor that the investment manager is not taking on responsibility for monitoring compliance with the plan's ERISA restrictions imposed on the acquisition and holding of employer securities, and acknowledging that this is the responsibility of

[101] ERISA §§ 406(a)(1)(E), 406(a)(2), 407(a).

[102] A "qualifying employer security" includes both stock and marketable obligations of the Benefit Plan Investor's sponsoring employer, provided that no more than 25 percent of the outstanding stock or marketable obligations at the time of acquisition is held by the Benefit Plan Investor, at least 50 percent of the outstanding stock or marketable obligations is held by persons independent of the sponsoring employer, and, in the case of marketable obligations, immediately following the acquisition, no more than 25 percent of the Benefit Plan Investor's assets are invested in marketable obligations of the sponsoring employer.

the subscribing fiduciary. The investment manager may also wish to include an indemnity with respect to this acknowledgement from the fiduciary acting on behalf of the Benefit Plan Investor.

3. Investments in Other Entities

(a) If a fund of funds is a plan asset fund, the investment manager will need to determine whether the underlying hedge funds in which it invests will permit investments from a plan asset fund.

(b) If Benefit Plan Investors own 25 percent or more of any class of equity interests in an underlying fund that accepts investments from such a plan asset fund of funds, then such underlying hedge fund would be a plan asset fund subject to all of the rules discussed in this outline. Further, in such a situation, the investment manager of the fund of funds steps into the shoes of the plan trustees with respect to its responsibility to invest the assets of the hedge fund of funds. If the manager of the underlying hedge fund is not a registered investment adviser, the manager of the investing plan asset fund of funds would be liable for each of the investment decisions of the manager of the underlying plan asset fund.

(c) The investment manager of a plan asset fund of funds can limit its investment responsibilities for the investment of the assets in an underlying plan asset fund if:

(i) The investment manager of the plan asset fund of funds should be appointed by the ERISA plans investing in the hedge fund of funds as a "named fiduciary" (within the meaning of Section 402 of ERISA) of each of such ERISA plans, for the limited purpose of investing in underlying plan asset funds; and

(ii) The investment manager of any underlying plan asset fund must also be a registered investment adviser, or the delegation will be ineffective. (See the discussion in part A of Section III of this outline.)

H. Increasing ERISA Capacity While Trying To Avoid Plan Asset Fund Status: "The Hard Wired Feeder Concept"

1. ERISA-covered pension plans have been a growing source of assets flowing into hedge funds. While many corporations have frozen their traditional defined benefit pension plans (i.e., no new benefits are accruing under the plan), those plans still have billions of investible assets, and investment time horizons of 20 to 40 years. A common approach to providing expanded ERISA capacity while at the same time avoiding subjecting the hedge fund and its manager to the fiduciary responsibility provisions of ERISA involves restructuring an existing master-feeder structure, or establishing a new master-feeder structure in place of existing arrangements.

(a) *Hard Wiring*. Each feeder into the master fund is "hard wired" into the master fund. All of the investible assets of each of the feeder funds are required to be invested in the master fund, which, in turn, makes all of the investments.

(b) *Feeders Are Conduits*. None of the feeders make their own investments. The feeder funds may maintain a minimal amount of cash to pay expenses, but in many cases the feeder funds do not even do that. Rather, a feeder fund will receive distributions from the master fund every time it has an expense to pay (which typically is not that often given the minimal role played by the feeder funds).

The offering memorandum for the feeder funds will often refer to them as mere conduits into the master fund and will specifically state that the feeder funds are not making their own independent investments.

(c) *Classes of Equity Interests*. The "hard wired" master-feeder structure assumes that there is only one class of equity interests at the master fund (although sometimes there is a second class that holds the investments by the manager or its affiliates). After restructuring or establishing a "hard wired" master-feeder structure, an offshore feeder fund will often have one or more classes of equity interests exceeding the 25 percent limitation on investment by Benefit Plan Investors. However, the master fund, where the capital from all of the feeder funds is aggregated, will be under the 25 percent threshold. Even though the offshore feeder fund is a Benefit Plan Investor, only a portion of its investment in the master fund is counted as Benefit Plan Investor capital. At the onshore feeder fund, little if any investment will have come from Benefit Plan Investors. No part of the onshore feeder fund's investment in the master fund is counted as Benefit Plan Investor capital. When properly structured, the non-Benefit Plan Investor capital from the offshore and onshore feeder funds will exceed 75 percent of the capital in the only class of shares of the master fund, and neither the master fund nor its investment manager are subject to ERISA.

(d) *Manager of the Offshore Feeder Fund*. While the offshore feeder fund is a plan asset fund, the "manager" of the offshore feeder fund generally is viewed as not acting as an ERISA fiduciary when it invests the assets from the offshore feeder fund into the master fund. Because the "manager" of the offshore feeder fund undertakes only ministerial actions in connection with the management of the offshore feeder fund, it is a commonly held position that the "manager" of the offshore feeder fund is not acting as an ERISA fiduciary of the investing Benefit Plan Investors. Although this position has been endorsed by many practitioners, it is important to stress that there is no formal government authority affirming the position.

(e) *Steps To Hard Wire a Master-Feeder Structure*. The principal downside to the "hard wired" master-feeder structure is that it eliminates the flexibility to invest at the feeder fund level. This structure will not be appropriate for all investment strategies given the tax and regulatory issues connected with certain investments (e.g., ECI and FIRPTA). Among the items that need to be considered and actions that need to be taken to convert an already existing master-feeder structure into a "hard wired" master-feeder structure are the following:

(i) Review the hedge fund's current investment program to determine if all of the investments can be made at the master fund level.

(ii) Review the hedge fund's existing and prior investments to determine if all are or were at the master fund level, or if some are or were at the feeder fund level.

(iii) If there are or were feeder fund level investments, determine if all those investments could have been made at the master fund level (or can be transferred to the master fund in the case of existing feeder fund investments).

(iv) Determine if the hard wiring of the feeder funds constitutes a material change in the investment program.

(v) If hard wiring gives rise to a material change in the investment program, determine if investor consent, or redemption rights, will be necessary.

(vi) Review the master fund to determine how many classes of shares exist at the master fund, and if there are multiple classes at the master fund level, determine if they can be merged.

(vii) Contact the ERISA investors to inform them of the proposed hard wiring and discuss any issues they may have with such a structure.

(viii) Review the offering memorandum for each of the feeder funds and determine the revisions necessary to reflect the hard wiring and the position that the "manager" of the offshore feeder fund is not acting as an ERISA fiduciary to the ERISA investors by investing the assets of the offshore feeder fund into the master fund.

(ix) Revise the investment management agreements for the feeder funds to reflect the hard wiring, stripping the agreements of all language that suggests discretionary investing at the feeder fund level.

(x) Revise the limited partnership agreement of the onshore feeder fund to reflect the hard wiring, stripping the agreements of all language that suggests discretionary investing at the onshore feeder fund level.

(xi) Send a letter to the ERISA investors in the offshore feeder fund stating that the investment manager is not acting as an ERISA fiduciary in investing the assets of the offshore feeder fund into the master fund and obtain consent to the statement that the fiduciaries of the ERISA investors will never assert a position to the contrary.

(xii) Amend subscription agreements to include the statement that the investment manager is not acting as an ERISA fiduciary in investing the assets of the offshore feeder fund into the master fund and obtain consent to the statement that the fiduciaries of the ERISA investors will never assert a position to the contrary.

(xiii) Address the need for the offshore feeder fund to obtain an ERISA fidelity bond covering each of the ERISA investors or provide for the ERISA investors to cover the "manager" of the feeder fund on an agent's rider to the ERISA investor's own fidelity bond.

(f) *ERISA Investor Issues*. The conversion of an existing master-feeder structure into a hard wired master-feeder structure has become somewhat common as a means to allow the offshore feeder fund to exceed the 25 percent limit as long as the master fund is kept under 25 percent plan assets. However, there are two issues that do arise from ERISA investors. First, certain funds of funds that are Benefit Plan Investors have promised their ERISA investors that the fund of funds would not invest in a plan asset fund. Many of those funds of funds have accepted that investing in a "hard wired" master-feeder structure in which the master fund is not a plan asset fund complies with the fund of funds' promise to its ERISA investors, though not all. In those situations where a fund of funds that is a Benefit Plan Investor is not willing to invest in a "hard wired" offshore feeder fund that is over 25 percent plan assets, we recommend that an ERISA-only offshore feeder fund be set up to accommodate the existing ERISA investors that are willing to make the switch as well as for new ERISA investors. Those ERISA investors that state that they may not invest in a plan asset fund would remain in the original offshore feeder fund, which continues to be below the 25% Test threshold and is not a plan asset fund. A second issue that arises from ERISA investors involves the fidelity bond mandated by ERISA for anyone who "handles" pension money. Whether the "manager" of the offshore feeder fund needs to obtain the fidelity bond and who pays for the bond are the subject of negotiation. ERISA would permit the ERISA investor to cover the "manager" of the offshore feeder fund as an agent on the ERISA investor's own fidelity bond, but plans and funds of funds that are themselves, Benefit Plan Investors, are sometimes resistant to doing this. If the "manager" of the offshore feeder fund agrees to obtain the fidelity bond, ERISA would permit the offshore feeder fund to pay the premium, but here, too, resistance is sometimes encountered from ERISA plans and other Benefit Plan Investors.

Secondary Transactions: Tender Offers, Side Pocket Clearing and Residual Assets

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Secondary Transactions: Tender Offers, Side Pocket Clearing and Residual Assets

I. **Introduction**

A. Secondary transactions are seen as a means to achieve accelerated liquidity for investors prior to the disposition by a fund of its assets in the ordinary course of business, particularly for private equity funds, but also for hedge funds whose illiquid investments or "side pockets" do not afford withdrawal rights.

B. Secondary transactions involve one of two types of transactions: (1) sales by one or more investors of their partnership interest in a fund to one or more buyers or (2) the sale by a fund of all of its assets to one or more buyers in one or a series of transactions.

C. Secondary sales are associated with "zombie" funds. Zombie funds have been seen as the drivers of a broad network of other funds that are secondary buyers. Given the maturation of the secondary market, prices for secondary transactions and the number of potential secondary buyers have increased.

D. Secondary transactions raise an array of legal issues, including:

1. Compliance with partnership agreements;

2. Compliance with Delaware (or other jurisdictional) obligations, including compliance with fiduciary duties;

3. Tax issues;

4. Securities laws compliance – the transaction and the transferee must meet regulatory constraints; and

5. Tender offer rules – an offer to purchase interests owned by limited partners from multiple sellers may be deemed to be a tender offer; and, although the SEC has adopted extensive rules on how tender offers must be conducted, the SEC has never defined a tender offer.

II. **Limited Partner-Led Secondary Transactions**

A. To achieve liquidity, investors may negotiate and structure sales of their own interests in funds, whether a sale of a single fund interest or sales of multiple fund interests.

B. An LP would normally coordinate with the general partner of the fund whose interest is being transferred to address partnership agreement compliance, including:

1. Disclosure of confidential information – If the selling LP likely wishes to share confidential information with its prospective buyer, the GP's consent to such disclosure is required. This typically results in the drafting and negotiation of non-disclosure agreements.

2. The partnership agreement may provide for rights of first refusal. LPs have requested purchase rights in their side letters. GPs often resist such provisions.

C. The GP is not a party to LP-led transactions but must nevertheless consider the structure of the transaction and the identity of the buyer in light of the following:

1. For purposes of the Securities Act, the buyer should be an accredited investor.

2. For Investment Company Act purposes, the buyer may also need to be a qualified purchaser if the fund relies on Section 3(c)(7) of the Investment Company Act; or if the fund relies on Section 3(c)(1) of the Investment Company Act, then the transfer must not create a "slot" issue.

3. For purposes of the Investment Advisers Act, the buyer may need to be a "qualified client" if the manager is a registered investment adviser.

4. For tax, the GP must track whether the transaction increases the risk of the fund becoming a "publicly traded partnership" ("PTP") that is taxable as a corporation.

5. For purposes of ERISA, the GP must track whether the buyer is a "benefit plan investor" and therefore whether the transaction results in ownership by all "benefit plan investors" in the fund of more than 25 percent of a single class of interests, thus creating a plan asset fund under ERISA.

6. For purposes of money laundering regulations, the buyer must provide appropriate "anti-money laundering" representations.

While the seller and the buyer customarily enter into a purchase agreement, the above regulatory considerations will be addressed in a separate transfer agreement provided by the GP to the selling LP and its purchaser in which representations are made to the fund and the GP that covers the above issues. The GP's consent to the transaction is based on such representations.

D. Tender Offer Issues: Even if the GP is not involved in the LP-led transaction, where an LP-led transaction involves multiple offers to purchase by a buyer from several sellers, then tender offer rules might apply. Conversely, if there is only a single buyer negotiating with a single seller, the tender offer rules would not apply.

E. Tax Issues

1. "Publicly Traded Partnerships" – Transfers by investors in funds treated as partnerships for U.S. tax purposes raise PTP considerations. A PTP is a partnership (i) whose interests are traded in an established securities market (e.g., an MLP) or (ii) for which there exists a secondary market (or the substantial equivalent thereof) for the trading of interests. A PTP is taxed as a corporation unless it meets a 90-percent qualifying/passive income test set forth in Section 7704(c).[1]

(a) Unless a partnership meets the income exception noted above, it will take great care to ensure that there is no "secondary market (or the substantial equivalent thereof)" for the trading of its interests. The most common exceptions to creating a secondary market (or the substantial equivalent thereof) are the following:

(i) 100 partner safe harbor;

(ii) "Block transfers" (i.e., a transfer by a partner of greater than 2 percent of partnership capital or profits);

(iii) Transfers involving a carryover basis, family transfers, transfers at death and other "private transfers" described in Treasury Regulations Section 1.7704-1(e); and

[1] "Section" references are to the applicable sections of the Internal Revenue Code of 1986, as amended.

(iv) Facts and circumstances analysis to ensure that there is no secondary market or the substantial equivalent thereof. Unlike many affiliate or family transfers, a pure secondary transfer between unrelated parties will often be rejected by the fund if the fund cannot rely on any of the preceding exceptions. There may be more latitude for allowing transfers to an existing partner under a "redemption and repurchase" safe harbor than to a non-partner.

2. Possible Withholding of the Purchase Price – Withholding is required under Section 1446(f) by a buyer (or, secondarily, the fund) of 10 percent of the amount realized by the seller of an interest in an entity treated as a partnership for U.S. tax purposes unless an applicable certification can be made, including that the seller is a U.S. person or that the fund has little "effectively connected income" or assets generating such income. Also consider potential withholding of 15 percent of the amount realized under Section 1445 if the seller or the fund cannot make the applicable FIRPTA representation.

3. Other tax considerations raised by transfers of interests in funds include:

(a) Potential future recognition by purchasers of the fund's unrealized gains, even when the purchase is made at fair market value.

(b) Transfers often force a fund that is taxed as a partnership where either (i) the fund has a >$250K net unrealized loss in its positions or (ii) the transferor suffers a >$250K taxable loss on the transfer, to operate as if it had a Section 754 election in effect, which can be time-consuming and expensive for a hedge fund holding hundreds of positions, even if the buyer and seller cover the costs. Some private equity funds may operate under an "electing investment partnership" exception.

(c) Different tax status of the transferor and transferee.

(i) Is the transferee going into the "correct" fund — e.g., offshore vs. onshore fund or blocker vs. unblocked product.

(ii) Different tax compliance may be required by the fund for a non-U.S. partner than a U.S. partner.

(d) Obtain W-8/W-9 from new investors. If foreign, ensure FATCA-compliant.

(e) Income allocation between transferor and transferee.

(f) Look for disguised sale of partnership interests.

F. LP-led secondaries may involve sales by a single investor of an entire portfolio of fund interests (typically by strategy), and these transactions present greater challenges.

1. Sellers must coordinate with multiple GPs to obtain clearance of the transfer, to enter into confidentiality agreements and to enter into transfer agreements while separately negotiating a purchase agreement with a buyer.

2. These sales do not all close on the same date given the difficulties in working with several GPs.

3. These transactions are very expensive. GP costs are borne by the seller and/or buyer.

4. If multiple buyers are involved, each may have different structuring, regulatory or tax needs driving its own transaction.

5. Existing investors in the fund may have rights to purchase other LP interests. Consider compliance with rights of first refusal resulting from the transaction.

6. A buyer may seek new side letter rights or assume the side letter of selling investors.

G. Even though an LP-led transaction involves the GP solely for its consent, we see more accommodations being requested from GPs in LP-led transactions, including:

1. Representations regarding underlying investments, both for tax reasons and for business diligence. As noted above, withholding obligations may arise given the nature of the fund's investments, and, therefore, the GP may be requested to provide a certification as to its fund's investments.

2. Requests to shift from "blocked" structures to "unblocked" structures — consider tax implications to the fund entity and the transferee resulting from the shift, including possible income recognition.

3. Requests for new side letters (or assignments of existing side letters).

4. Requests for GPs to find buyers. These requests raise fiduciary duties, as there may be an obligation to assist all LPs seeking liquidity even though the GP is being approached by a single LP.

III. **General Partner-Led Secondary Transactions**

A. Where multiple LPs request liquidity from a single fund, the GP of that fund is more likely to become involved in and structure the secondary transaction. These transactions are referred to as "GP-led secondary transactions." A GP-led secondary transaction may take the form of (i) the sale of multiple investor interests in a fund or (ii) the sale of all the assets of a fund in a single transaction. In private equity funds, the pressure from investors for GPs to lead secondary transactions has arisen after the term of the fund has been extended, thereby potentially delaying dispositions of investments.

B. GP-led secondaries usually involve an investment banker/broker who is retained to locate a buyer and to structure the transaction. Bankers can facilitate the sales process.

C. After the bankers assist in identifying a buyer, the GP will typically notify investors of the key terms of the potential transaction.

1. Arrangements with investment bankers must be disclosed, including fees payable to the agent.

2. The benefits afforded to the GP affiliate in the transaction must be carefully disclosed.

3. Investors should also understand the fees and expenses that will be charged to them as part of the transaction (such as bankers' fees) and that such fees will reduce the proceeds they will receive.

4. The GP seeks to ensure that the buyer does not have better access to material information than the fund's potential selling investors — the GP acts as a fiduciary and use efforts to protect its investors' interests. Both sellers and buyers are making an investment decision to sell (and implicitly whether to hold) and to buy.

(a) Although the specific tender rules that apply to unregistered funds are not particularly onerous, the SEC has broad authority to prohibit fraudulent, deceptive or manipulative practices and they have sometimes used that authority to bring enforcement actions against tender offers that the SEC deemed to be abusive even if they did not violate any specific rules.

(b) In a 2000 guidance, the SEC suggested including certain disclosures in tender offers for limited partnership units, including risk factors, a discussion of any conflicts of interest and a discussion of the market price for the units and how the offer price was determined, financial information about the partnership and a discussion of tax consequences of the offer.

(c) The SEC also expects the GP to state whether the GP takes a position on whether holders should participate in the tender offer (and the GP is permitted to state that it takes no position).

D. In addition to the disclosure referred to above, tender offer issues need to be generally addressed in GP-led transactions.

1. The GP considers whether a transaction in which the GP identifies a potential purchaser for the interests of its fund is in fact a tender offer.

(a) The most widely used definition is an eight-factor test from *Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979), with the most important factors being the number of offerees and the percentage of securities sought to be purchased.

(b) The number of LPs who actually accept an offer is not determinative of whether the transaction constitutes a tender offer.

2. So long as the fund is not an SEC-reporting company, complying with the U.S. tender offer requirements is less burdensome than most people expect.

3. The most significant requirement for non-reporting entities is that the offer remain open for a minimum of 20 U.S. business days. The offer may need to be extended if there are any changes to the terms of the offer. Realistically, changes to the terms of the transaction will change.

4. Following the expiration of the tender offer, the purchase price must be paid "promptly." There is no clear definition of "promptly." For traded securities, settlement is generally required in two to three business days. For non-traded fund interests, settlement will require more time.

5. There are also restrictions on making any purchases outside of the tender offer after it has been announced or announcing the tender offer without the ability and the expectation that it will be completed.

6. Tender offers may be subject to additional local law requirements in other jurisdictions where investors may be located.

E. GP-led secondaries involving the sale of partnership interests involve the purchase of limited partnership interests from up to all the limited partners of a fund by a single buyer identified to selling limited partners.

1. Not all limited partners will agree to buyer's price or terms. As a result, the buyer may only purchase a portion of the interests in a fund. Typically, a buyer requires a minimum amount of sellers to be compelled to close the transaction.

2. A buyer may agree in advance to consent to an amendment to the fund's partnership agreement or other terms (such as a new waterfall, management fees, term and possibly additional capital commitments).

(a) The GP should evaluate whether existing LPs may veto such amendments.

(b) The buyer will be required to assume unfunded capital commitments of the sellers, but the buyer is unlikely to provide new commitments. Occasionally, the buyer's purchase of interests in an existing fund is "stapled" to an investment in a successor fund.

3. Usually, the GP does not sell its partnership interest in secondary transactions. Rather, the GP seeks to "reset" the waterfall so as to be able to receive a carried interest on a lower cost basis (i.e., the cost that the new investors paid for the LP interests, as opposed to the fund's actual cost of investments) per the amendments referred to above.

F. Tax issues relating to transfers of interests in funds by investors in GP-led transactions raise the same tax issues discussed above for LP-led transactions. Carry should be allocated from profits earned by the fund that are allocable to the underlying LP interest even if calculated on a waterfall that has been "reset" at the time of the secondary transaction.

G. GP-led secondary transactions may involve the sale of fund assets instead of fund interests.

1. If assets of the fund are being sold, a new vehicle managed by the GP or its affiliate would typically be set up to acquire such assets. The buyer would become an investor in the new vehicle; the new vehicle would purchase assets from the fund; and the proceeds from the sale would be distributed to the existing investors (to the extent such investors have elected to cash out of the fund).

2. The transfer of the assets to an entity controlled by, and which will make payments to, a GP affiliate requires a conflict approval. Even if LPAC approval is technically the only requirement for a sale of fund assets to a new vehicle that will be managed by the GP or its affiliates, typically LPAC members will want all LPs to have a chance to approve the transaction and may want such LPs to be fully informed and consulted on (and not formally consent to) with respect to the transaction. The buyer may also condition its offer on obtaining a minimum level of consent from investors (separately from the minimum number of LPs electing to participate in the transaction).

3. Transferring assets may require third-party approvals under portfolio company documents, such as lender consents, stockholder and portfolio company consents. Consider whether there are rights of first refusal.

4. Pricing of the secondaries transaction will be subject to scrutiny, and therefore GPs typically seek to (a) demonstrate that an auction for the sale was held, and/or (b) obtain a valuation from an independent valuation agent. Certain offers are not necessarily credible. Comparisons of offers may not be as simple as the relative pricing. For instance, a buyer may need to finance the purchase price or may need its own approvals to proceed with the purchase.

5. In light of pricing issues, a GP may offer LPs a "rollover" option, where the LPs, individually, have the right to receive cash or to invest their proceeds from the transaction in the new vehicle.

(a) The offer of interests in the new vehicle would need to comply with the same securities laws restrictions as an offering of interests in an entirely new fund and, depending on the structure of the transaction, offering interests in a new vehicle in exchange for the interests in the existing vehicle could be an exchange offer, which could then be subject to the tender offer rules.

(b) The buyer may expect a minimum amount of "rollover" investors in order to plan for its own financing of the transaction. Therefore, it is important to provide organizational documents of the new vehicle to "rollover" investors promptly.

(c) A “cashless” transaction may require additional tax compliance, including tracking the basis of assets contributed, or deemed contributed, to the new vehicle.

H. Proceeds from the sale of assets will be distributed by the fund to its partners, including a carried interest to the GP.

1. At this time, the GP may owe a clawback, which is unlikely to be waived.

2. The fund may have indemnification obligations to its buyer and may not be permitted to distribute the sales proceeds immediately. Accordingly, the desired liquidity for investors may be delayed. The GP must also consider escrows, potential claims against the partnership, purchase price adjustments/earn-outs, etc.

IV. Conclusion

A. Secondary transactions have become a regular and larger part of the investment management business in creating exit strategies.

B. The growth of this market has increased the pool and types of purchasers: (i) existing LPs in funds; (ii) GPs; and (iii) secondary funds.

C. Participants in the investment management industry should be familiar with structures and processes utilized to effect these transactions.

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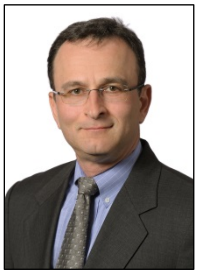

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Boris is co-head of the firm's Structured Finance & Derivatives Group. With almost 25 years of experience across diverse asset classes, Boris focuses on asset-backed securitizations, warehouse facilities, secured financings and commercial paper conduits. His practice encompasses a variety of asset classes, including life settlements, equipment leases, structured settlements, lottery receivables, timeshare loans, litigation funding and cell towers, in addition to other esoteric asset classes such as intellectual property, various insurance-related cash flows and other cash flow producing assets. He also represents investors, lenders, hedge funds, private equity funds and finance companies in acquisitions and dispositions of portfolios of assets and financings secured by those portfolios.

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Insurance Dedicated Funds and Related Strategies

I. Insurance Dedicated Funds

A. Background

1. What Is an Insurance Dedicated Fund ("IDF")?

   (a) An IDF is a fund established by a manager, the investors of which are generally segregated asset accounts ("separate accounts") of insurance companies that maintain variable life insurance and/or annuity contracts. The insurance company issues the contracts, or policies, to policy owners.

2. What Is a Separate Account?

   (a) A separate account is an account of an insurance company that is segregated from the general asset accounts of the insurance company pursuant to U.S. federal and/or state law. It is a separate pool subject to separate accounting.

3. Growth

   (a) IDFs have grown significantly over the last 13 years. One market intermediary noted that it handled just four IDFs in 2004, a number which grew to 108 IDFs in 2017.

4. From a U.S. federal tax perspective, gains are generally not taxed until the end of the contract and are possibly excluded from gross income if paid out as death benefits.

B. Structure

1. For managers experienced with advising private funds, the IDF will be a new fund that may have overlapping strategies with your existing funds. It must be a separate legal entity from the life insurance company's segregated asset account.

2. *Structural Overview*. In an ordinary private fund structure, the basic setup includes asset managers who advise legal entities (i.e., the funds) that sell interests to persons or entities (i.e., the investors) who invest their capital in the funds that are advised by the managers. When setting up an IDF, there are a few more parts to the structure.

   (a) The IDF structure begins with the life insurance or annuity contract policy owners, however, these are not the investors in the IDF. They are not limited partners in the IDF and do not have any rights as such. The policy owners interact with the insurance brokers and take out a policy that will have its returns linked to the IDF. As discussed below, the policy owners are prohibited from directing the investment program of the IDF.

   (b) Licensed insurance brokers interact with the policy owners and assist with obtaining the appropriate insurance policy from one or more life insurance companies.

   (c) The life insurance companies become investors by purchasing interests in the IDF through their separate accounts. The life insurance companies negotiate the terms and conditions of the IDF (as opposed to the policy owners). There are service providers in the market who, for a fee, sit as intermediaries between the life insurance companies and the IDFs ("IDF Intermediaries"). IDF

Intermediaries may also form their own Delaware limited partnership structure and different managers may each advise a separate series of the Delaware entity.

(d) The premiums from the insurance policies are contributed to life insurance company separate accounts and are invested by the insurance companies in the IDF (sometimes through the multi-series legal entities sponsored by the IDF Intermediaries).

(e) An IDF may be a fund designed by the manager to follow one or more of the manager's investment strategies (without being a "clone" fund of any of the manager's other funds) and invest the premiums contributed to the IDF from the life insurance company separate accounts.

C. IDF Setup and Operation

1. Below are some of the implementation considerations for a manager wishing to build an IDF.

(a) The manager should learn the key tax rules surrounding IDFs, which are outlined below.

(b) Like any other fund formation process, the manager will need to create legal entities.

(c) The manager will need to prepare offering documents with counsel (e.g., PPM, limited partnership agreement/operating agreement, subscription agreement and side letters, which most insurance companies will insist on).

(d) The negotiations with the life insurance companies resemble the negotiations a manager might have with any significant investors in the manager's other funds; however, the life insurance companies pay particular attention to the details of the tax risks with these products and expect indemnities and other protections in their side letters.

2. Many of the ongoing responsibilities of an investment manager mirror the manager's existing obligations for its other funds.

(a) Monitoring underlying funds;

(b) Managing the portfolio; and

(c) Providing periodic performance reports and tax information to investors. In addition, the manager of an IDF must monitor for compliance with the diversification rules of Section 817(h) of the U.S. Internal Revenue Code of 1986, as amended ("Code"), and the investor control doctrine.

D. Diversification Rules

1. There are general diversification requirements that apply to separate accounts that are funded by private placement life insurance policies and annuity contracts are set forth in Treasury Regulations Section 1.817-5 ("Diversification Rules").

2. Tax consequences if not adequately diversified:

(a) Under the Treasury Regulations, a variable contract which is based on one or more separate accounts shall <u>not</u> be treated as a life insurance or annuity contract for any calendar quarter period for which the investments of any such account are not adequately diversified in accordance with the Diversification Rules. If the variable contract is not respected as a life insurance or annuity contract, then the tax benefits associated with such a contract are lost.

3. The Diversification Rules place certain limitations on the proportion of the assets of a separate account that may be represented by any single investment, generally:

   (a) No more than 55 percent of the value of the total assets of the account is represented by any one investment;

   (b) No more than 70 percent of the value of the total assets of the account is represented by any two investments;

   (c) No more than 80 percent of the value of the total assets of the account is represented by any three investments; and

   (d) No more than 90 percent of the value of the total assets of the account is represented by any four investments ("Diversification Test").

4. Compliance with the Diversification Test is tested at the end of each calendar quarter (or within 30 days thereafter). Insurance company investors generally require an investment manager to make quarterly certifications with respect to an IDF.

5. There are exceptions for the start-up period and the liquidation period, as follows: a separate account will be considered adequately diversified (i) for its first year and (ii) for the one-year period beginning on the date it adopts a plan of liquidation (subject to special rules for "real property accounts").

6. Look-Through Rule

   (a) The Treasury Regulations provide a "look-through rule" for partnerships that allows a separate account to look through an IDF to its underlying investments for purposes of satisfying the Diversification Rules. In general, to be eligible for look through treatment, all the interests in the IDF must be held by separate accounts (subject to limited exceptions for insurance company general accounts, the manager of the IDF in certain circumstances and others).

7. Market Fluctuations

   (a) A separate account that satisfies the Diversification Test at the end of any calendar quarter (or within 30 days thereafter) shall not be considered non-diversified in a subsequent quarter because of a discrepancy between the value of its assets and the Diversification Test if the discrepancy results solely from changes in market prices (and not from the acquisition or sale of an asset or assets).

E. The Investor Control Doctrine

1. The investor control doctrine limits the control that a policy owner may have over the underlying investment assets of an IDF.

   (a) Determinations of impermissible investor control are based on facts and circumstances rather than a bright line test and are guided by Internal Revenue Service revenue rulings and other official interpretations.

2. Tax Consequences of Impermissible Investor Control

   (a) If a policy owner has investment control over the assets underlying its policy or contract, then the policy owner, and not the insurance company, is deemed to be the owner of the assets. If the policy owner is deemed to be the owner of the assets, then the policy owner loses the tax benefits of the insurance or annuity contract and is currently taxable on the income attributable to the assets.

3. There shall be no arrangement, plan, contract or agreement between the policy owner and the investment manager or the insurance company regarding the availability of a particular fund, the investment strategy of any fund or the assets to be held by a particular fund. The policy owner may not communicate (directly or indirectly) with the investment manager regarding the selection, quality or rate of return of any specific investment or group of investments.

    (a) All investment decisions for the IDF must be made by the investment manager. The policy owner may not select or recommend particular investments or investment strategies. The policy owner shall not be able to insist on the use of a specific investment manager or remove the investment manager.

    (b) The ability to choose among broad, general investment strategies does not constitute sufficient control over investment decisions so as to cause ownership of the underlying assets to be attributable to the policy owner.

4. The IDF cannot be a "clone" of a fund that is otherwise available to non-insurance investors. Generally speaking, interests in an IDF shall be available solely through the purchase of a variable life insurance policy or annuity contract (subject to narrow exceptions for certain other permitted holders) and the investment portfolio of the IDF must be differentiated from the investment portfolio of the investment manager's other funds.

F. Corporate Terms and General Considerations

1. In many ways, the PPM for a manager's IDF will follow the same format as the PPM for its other funds. However, there are a few key terms that are unique to IDFs and to which a manager must pay special attention.

    (a) First, the IDF's withdrawal rights generally need to include two special withdrawal rights.

        (i) Periodically, the life insurance company must be able to make withdrawals to pay fees, including fees to its insurance brokers.

        (ii) If the policy holder dies, the IDF must be able to distribute cash to the life insurance company to meet the death benefit obligation of the life insurance company. The timing of these payments varies depending on the jurisdiction of the life insurance company.

    (b) Second, the manager's compensation may be structured differently.

        (i) The "look-through rule" in the Treasury Regulations described above provides that a manager may hold an interest in an IDF, but only if the return on such interest is computed in the same manner as the return on an interest held by a separate account. A performance allocation or carried interest at the IDF level would cause a different return on the manager's interest. Asset-based and/or performance-based fees to a manager do not run afoul of this rule.

        (ii) If the IDF invests in the manager's other funds, then those other funds may charge their regular compensation, including performance allocations or carried interest, which is relevant if the manager wishes to invest a percentage of the IDF into the manager's other funds.

(c) Third, allocation of investment opportunities must be handled carefully to conform to obligations under the Investment Advisers Act, the manager's allocation policies and the differentiation requirement described above.

(d) Fourth, onboarding with either the IDF Intermediaries or directly with the life insurance companies will require some level of negotiation. In particular, the indemnification obligations of the manager must be defined and resolved. The key to this negotiation is understanding who bears the risk of a breach of the diversification rules and the investor control doctrine and what the tax and other costs of doing so could entail.

(e) Finally, the manager of an IDF should review how the manager's marketing team approaches the sale of interests in the IDF. The marketing agents should make certain not to violate the investor control doctrine discussed above, provide insurance-related advice in breach of local insurance laws or over-sell the tax benefits of the IDF in violation of the advertising provisions of the Investment Advisers Act.

G. Group Variable Annuity Products

1. Some non-U.S. insurance company investors are seeking the tax advantages associated with IDFs through the use of a group variable annuity ("GVA") product. Under this structure, a non-U.S. investor purchases a GVA from a non-U.S. insurance company. The non-U.S. insurance company places the premium contributions in a separate account, which makes investments at the direction of an investment manager. The separate account is subject to the Diversification Rules and the investor control doctrine discussed above. Underlying funds in which the separate account invests may withhold U.S. federal income tax on income that is "effectively connected" with a U.S. trade or business in accordance with applicable law, and the non-U.S. insurance company files to recapture such tax in the form of a refund.

II. Various Product Types[1]

A. Life Settlements

1. Current Trends in Life Settlements

(a) Background

(i) The industry began in the 1980s with the onset of the AIDS epidemic in the United States. Many AIDS patients owned life insurance policies that they no longer needed, and viatical settlements were created.

(1) A viatical settlement is the sale of a life insurance policy by a terminally ill person (generally, someone with a life expectancy of less than two years).

(ii) With the development of protease inhibitors, AIDS patients were better able to control their illness and their life expectancies increased substantially.

(iii) In the 1990s, the viatical settlements industry was reborn as the life settlements industry and focused on purchasing life insurance policies from seniors who were not suffering from terminal illnesses.

[1] This is not an exhaustive list of insurance-related investments.

(iv) The demand for life settlements was driven initially by German investment funds who believed that life settlement investments provided attractive benefits under the German tax code.

(v) With the growth of the life settlement industry, states adopted new laws and regulations, with most of the legislative and regulatory activity taking place between 2005 and 2009.

(b) Risks of investing in life settlements include longevity, insufficient reserves for premiums, inconsistent cash flows during ramp-up, insurable interest (validity of policy), fraud in the application and cost of insurance.

(c) Benefits of investing in life settlements include the ability to build a performing portfolio, the challenge risk has significantly declined, noise has subsided and the asset class is generally uncorrelated.

(d) Regulation of Life Settlements

(i) State Regulation Today

(1) 45 states, Washington, DC and Puerto Rico regulate life settlements.

(2) Three states of the 45 regulate viatical transactions only.

(3) Five states do not have any life settlement-related regulation.

(ii) The Contestability Period

(1) With a number of limited exceptions, carriers may not challenge a policy based on fraud in the application after the end of the two-year contestability period.

(2) Generally, carriers may challenge a policy after the end of the contestability period based on a lack of insurable interest at the time of issuance.

(3) The following states, however, have ruled that a policy may not be challenged after the end of the contestability period for any reason: Florida, New York, Michigan, Wisconsin and Utah.

(4) Most recently, the Florida Supreme Court ruled that, based on a plain reading of the incontestability statute, a carrier may not challenge a policy for any reason after the end of the two year contestability period. Policies issued after the effective date of Florida's 2010 anti-STOLI statute were not addressed.

(5) This followed a Wisconsin decision holding that Wisconsin's anti-wagering laws do not apply to life insurance and that an insurable interest challenge may not be brought after the end of the contestability period.

a. The decision was upheld on appeal to the 7th Circuit, and the carrier is seeking additional time to file an appeal to the U.S. Supreme Court.

(6) In *PHL Variable Ins. Co. v. Price Dawe*, the Delaware Supreme Court ruled that a carrier may challenge a policy based on an alleged lack of insurable interest after the end of the contestability period.

a. The court noted that the intent of the insured at the time the policy was issued is not relevant.

b. The court did look to who paid the premiums in order to determine the true party in interest. At the same time, the court noted that premium finance is legal.

(7) Delaware courts have held that if a carrier seeks to rescind a policy, it must return the premiums paid, but it may have a claim for damages.

(e) Secondary Market Transactions

(i) The policy owner retains a life settlement broker to sell his/her policy.

(ii) The life settlement broker prepares the documentation and submits it to life settlement providers.

(iii) The life settlement broker negotiates with the life settlement providers and, after receiving approval from the policy owner, accepts the winning bid.

(iv) The life settlement provider arranges for funding through an institutional funder.

(v) The transaction is consummated through an escrow agent.

(vi) The price paid in a secondary market transaction exceeds the cash surrender value of the policy.

(f) Tertiary Market Transactions

(i) In a tertiary market transaction, life insurance policies that were previously purchased by an investor through a life settlement provider are sold by such investor to another investor and in subsequent transactions.

(ii) As discussed below, tertiary market transactions are not subject to the regulatory scheme applicable to the secondary market transactions. Accordingly, neither a life settlement broker nor a life settlement provider is involved in a tertiary market transaction and the form of purchase agreement is not filed with, nor approved by, the applicable state insurance regulator.

(g) Key Players in Life Settlement Transactions

(i) Policy Owner/Viator

(1) The person or entity to whom the life insurance company originally issued the life insurance policy.

(ii) Insured

(1) The person or persons named as an insured in the life insurance policy.

(iii) Consumer Representative (Agent and Life Settlement Broker)

(1) The person retained by the policy owner to solicit offers for the life insurance policy. A life settlement broker owes a fiduciary duty to the policy owner. A life settlement broker must be licensed, where applicable.

(iv) Life Settlement Provider

(1) The person that initially purchases a policy from the original policy owner is called a life settlement provider. The life settlement provider often acts on behalf of an investor and owes a fiduciary duty to the investor.

(v) Institutional Funder

(vi) Insurer

(vii) Life Expectancy Provider

(1) An independent third party that evaluates the insured's medical records and produces a report, called a life expectancy report, setting forth an estimate of the insured's life expectancy.

(viii) Escrow Agent

(1) Secondary market transactions are closed through escrow with a third-party escrow agent.

(ix) Policy Servicer

(h) Life Settlement Transaction Cycle

(i) The policy owner retains a life settlement broker to sell his policy.

(ii) The life settlement broker prepares the documentation and submits it to life settlement providers.

(iii) The life settlement broker negotiates with the life settlement providers and, after receiving approval from the policy owner, accepts the winning bid.

(iv) The life settlement provider arranges for funding through an institutional funder.

(v) The transaction is consummated through an escrow agent.

B. Structured Settlements

1. Guaranteed Structured Settlements

(a) These arise primarily out of personal injury settlements and represent pure insurance company credit risk. Historically, guaranteed structured settlements have very low delinquency rates and are generally uncorrelated.

2. Life Contingent Structured Settlements

(a) These represent insurance company credit risk and mortality risk, and are generally uncorrelated.

3. Legal Framework

(a) IRC § 5891: Structured settlement factoring transactions.

(i) The tax code imposes an excise tax on the purchase of structured settlements unless the transaction satisfies the requirements of § 5891, which requires a court to approve the sale.

(b) State transfer statutes: State laws governing transferability.

C. Personal Annuities

1. Guaranteed Annuities

(a) These represent pure insurance company credit risk. Historically, guaranteed annuities have very low delinquency rates and are generally uncorrelated.

2. Life Contingent Annuities

(a) These represent insurance company credit risk and mortality risk and are generally uncorrelated.

3. Legal Framework

(a) Personal annuities are issued by licensed carriers and the subsequent sale of such annuities is largely unregulated. Some states have raised the question of insurable interest.

D. Commissions

1. Originating commissions are paid in connection with the origination of a policy.

(a) Renewal commissions provide recurring cash flows which are paid periodically, typically annually, but are subject to persistency risk.

2. Legal Framework

(a) Both the agent and the assignee must be licensed.

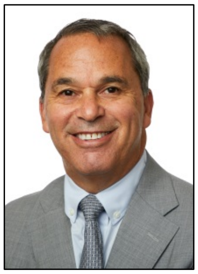
III. Certain Structuring Considerations for Insurance-Related Investments

A. Life settlement funds investing in life insurance policies with U.S. risks may be structured to address tax considerations relevant to foreign investors, taxable U.S. investors and tax-exempt U.S. investors.

B. Absent an applicable tax treaty, the involvement of a U.S. insurance carrier and U.S. insured may result in U.S.-source income that would be subject to withholding taxes for foreign investors.

C. Under an applicable U.S. income tax treaty, the insurance payouts may constitute business profits or other income not attributable to a U.S. permanent establishment. Such income would be exempt from withholding taxes. One jurisdiction with a favorable treaty in which such fund entities may be formed is Ireland. The fund entity is treated as a corporation for U.S. federal income tax purposes and, depending on satisfaction of certain treaty provisions and considerations of the Passive Foreign Investment Company (“PFIC”) and Controlled Foreign Corporation (“CFC”) rules under U.S. tax law, may be used as the investment vehicle for foreign investors and tax-exempt U.S. investors.

Current Employment Issues



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Mark is co-head of the Employment & Employee Benefits Group. His areas of concentration include ERISA, employment discrimination, labor relations and related litigation. Mark is a frequent public speaker and author. He has served as an instructor at Columbia University Teacher's College and as a lecturer in the Cornell University ILR School's Labor Relations Studies Program.

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Mark is listed in *The Best Lawyers in America* and *New York Super Lawyers* and was recognized by both *Human Resource Executive* and *Lawdragon* as one of the 100 most powerful employment attorneys in America. Mark received the Cornell University School of Industrial and Labor Relations' prestigious Judge William B. Groat Alumni Award, the Emerald Isle Immigration Center's Robert Briscoe Award, membership in the Academy of Employee Benefit Authors, and the Lawyers Alliance for New York's Cornerstone Award (for outstanding pro bono service to New York nonprofit organizations), in addition to being the first recipient of LANY's Pro Bono Leadership Award. He also is active in several not-for-profit organizations and serves on the Board of Directors of New York University School of Law's Center for Labor & Employment Law, the Advisory Council of Cornell University ILR School, the Board of Trustees of Bard College, the Advisory Board of The Scheinman Institute of Conflict Resolution at Cornell University and is a trustee emeritus of the Montefiore Health System Inc. Mark earned his B.S. in Industrial and Labor Relations from Cornell University and his J.D. and LL.M in Labor Law from New York University School of Law.

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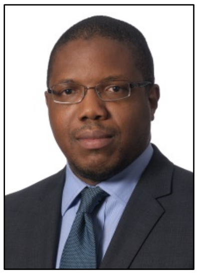
Max focuses his practice on representing employers in all areas of employment law. He litigates disputes involving employment agreements, restrictive covenants, employment discrimination and harassment, contract claims, common law tort claims, executive compensation and ERISA claims in federal and state court, in arbitrations and before administrative agencies. Max also advises employers on day-to-day employment issues including hiring and terminating employees, drafts and advises on separation and other employment-related agreements, and conducts and leads trainings and investigations for clients. He also represents clients in connection with government investigations.

Max has been listed in *New York Super Lawyers* as a “Rising Star” for employment litigation: defense. He is also a member of Bloomberg Law’s Labor & Employment Technology and Innovation Board. He received his J.D. from Columbia Law School and his A.B., *magna cum laude*, from Brown University.



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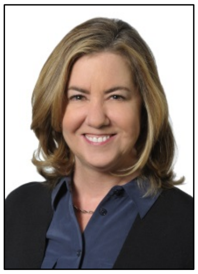
Omoz focuses his practice on the representation of sponsors and investors in the formation and structuring of private equity funds, hedge funds and hybrid funds. He also advises investment managers on strategic transactions involving alternative asset management businesses. Omoz has extensive experience representing sponsors and investors on funds employing credit, distressed investment, buyout, real estate, special opportunities, structured products, activist, multi-strategy and quantitative strategies. Omoz has advised clients on spin-out transactions, acquisitions of minority stakes in hedge fund and private equity firms, joint ventures between investment management firms and strategic transactions involving a change of management of private investment funds. He also represents hedge fund managers and investors in the negotiation of seed-capital transactions, and advises sponsors of private equity firms and hedge fund firms in the structuring of complex carry-sharing arrangements among principals and employees. Omoz's recent representations include institutional sponsors and boutique firms in the formation of private equity funds, hedge funds and hybrid funds; lead investors on their investments in private equity funds; hedge fund managers and investors in seed-capital arrangements; investment managers in joint venture arrangements; and investment managers and investors in the formation of special purpose acquisition and co-investment vehicles.

Omoz is listed in *The Legal 500 US* and he regularly speaks to investment managers about current developments relating to private investment funds. He spoke on "Permanent Capital Investment Vehicles" at SRZ's 27th Annual Private Investment Funds Seminar and discussed "Liquidity and Winding Up Issues" at SRZ's 6th Annual Private Equity Fund Conference. Omoz contributed to the *Fund Formation and Incentives Report* (Private Equity International in association with SRZ) and authored the article "Investor Remedies: The Importance of Key-Person Provisions," published in *Law360*. Omoz was also featured in the article "Ringing the Changes," published in leading private equity magazine *Private Funds Management*. Omoz received his J.D. from University of Michigan Law School and his B.A., with highest honors, from Michigan State University.



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Holly focuses her practice on the representation of employers in all aspects of employment law and employee relations. She also serves as co-head of the Cybersecurity Group. Holly litigates disputes involving restrictive covenants, ERISA claims, executive compensation, employment agreements, statutory employment discrimination claims, and common law tort and contract claims in federal and state courts, before administrative and government agencies and in arbitral forums. She advises employers on employment law compliance, best practices, human resources matters, hiring and termination, and litigation avoidance; drafts and negotiates employment agreements, separation agreements, data security and privacy policies and other employment-related agreements; and provides training and conducts investigations. Holly has extensive experience in designing anti-sexual harassment training programs, policies and procedures and considerable expertise about employer obligations and best practices with respect to sexual harassment and discrimination in the workplace.

Holly is listed in *The Best Lawyers in America* and *New York Super Lawyers*. A recognized thought leader, Holly has authored or co-authored numerous articles of interest to employers. Recently, she co-authored the articles “How Employers Are Responding to New York’s New Anti-Sexual Harassment Laws” and “Overcoming the Presumption that Courts Must Decide Class Arbitrability,” both published in the *New York Law Journal*. A much sought-after speaker, she recently discussed “Conducting the Internal Investigation — Considerations, Processes and Procedures & Privilege Issues and Ethical Traps in Conducting the Investigation” at PLI Internal Investigations 2018 and spoke at NYU’s 21st Annual Employment Law Workshop for Federal Judges. Holly earned a J.D. from the University of Virginia School of Law and a B.A. from Emory University.

Current Employment Issues

I. Overview of Litigation and Other Trends in Employment Law

A. Litigation Trends

1. U.S. Equal Employment Opportunity Commission ("EEOC")

(a) Suits Filed

(i) In 2017, the EEOC filed 201 enforcement suits, the most since 2011 and almost double the amount filed in 2016. In contrast, the number of individual charges filed with the EEOC decreased from 91,503 in 2016 to 84,254 in 2017. The number of individual charges filed in 2017 was the lowest since 2007.

(ii) Based on preliminary data, the EEOC filed 50 percent more suits challenging sexual harassment in 2018 than it did in 2017. Furthermore, the number of charges filed with the EEOC alleging sexual harassment increased by more than 12 percent between 2017 and 2018.

(iii) In 2017, the EEOC recovered $47.5 million for victims of sexual harassment through litigation and administrative enforcement. That number increased to approximately $70 million in 2018.

(b) Recent Regulations

(i) The EEOC recently issued regulations relating to disability discrimination. The regulations clarify federal agencies' affirmative action obligations for individuals with disabilities and provide guidance to employers that use incentives to encourage employees to participate in wellness programs that ask for disability-related information or involve medical examinations.

(ii) The EEOC also recently issued a regulation that addresses the extent to which an employer may incentivize an employee's spouse to provide information relating to the spouse's manifestation of diseases during a health risk assessment in connection with wellness programs. The regulation clarifies that the employer may provide limited inducements so long as the confidentiality requirements of the Genetic Information Nondiscrimination Act are observed.

(c) Political Trends

(i) EEOC Appointments

(1) The issue of EEOC appointments has been the center of recent controversy. President Trump nominated three people to become EEOC commissioners and one person to serve as the EEOC general counsel. Traditionally, the Senate confirms EEOC commissioners as a block. However, Senator Mike Lee of Utah has put a hold on the nominations, which has prevented the Senate from moving forward with the nominees.

(2) Senator Lee's objection to proceeding with the nominees relates to Chai Feldblum, who is one of President Trump's nominees and has served as a commissioner since President Obama nominated her in 2010. Senator Lee opposes Feldblum because of her views on marriage and LGBTQ rights. Feldblum helped draft and propose the Employment Non-

Discrimination Act, which has not been passed but would provide federal protections against sexual orientation and gender identity discrimination.

(3) Feldblum's current term expires on Dec. 31, 2018. After Feldblum's term expires, the EEOC will lack a quorum until the Senate confirms at least one commissioner. In December 2018, Daniel Gade, one of President Trump's commissioner nominees, withdrew from consideration because of the "toxic political climate." President Trump originally nominated Gade in August 2017.

(ii) EEOC/DOJ Split over Title VII of the Civil Rights Act

(1) Under the Obama Administration, the Department of Justice and the EEOC interpreted Title VII as prohibitive of discrimination on the basis of sexual orientation and gender identity. The Trump Department of Justice, however, has reversed course. In October 2017, the DOJ told agency heads and U.S. Attorneys that "Title VII's prohibition on sex discrimination encompasses discrimination between men and women but does not encompass discrimination based on gender identity per se, including transgender status." The DOJ also withdrew a 2014 memorandum that reflected the Obama DOJ's approach.

(2) Despite the DOJ's change in course, the EEOC continues to interpret Title VII as it did under the Obama Administration and continues to bring discrimination cases based on sexual orientation and gender identity. Because of the delay in EEOC appointments, the EEOC is currently run by a Democratic majority, which explains why the EEOC's approach to Title VII differs from that of the Trump DOJ.

(iii) Recent Circuit Court Precedents Regarding Title VII

(1) The Seventh Circuit recently overruled its own precedent and held that Title VII recognizes sexual orientation as a form of sex discrimination. *See Hively v. Ivy Tech Cmty. Coll.*, 853 F.3d 339 (7th Cir. 2017). The case involved an openly gay adjunct professor who, after her employer rejected her applications for full-time positions and declined to renew her contract, alleged sexual orientation discrimination. The Seventh Circuit held that the question was whether the employer disadvantaged the professor because she was a woman. Had the professor been a man married to or living with a woman, would the employer have treated her differently? With this as the central question in the case, the Seventh Circuit held that the professor had made out a prima facie claim of sex discrimination under Title VII.

(2) The Second Circuit also recently overruled its own precedent to hold that Title VII's prohibition on sex discrimination includes sexual orientation discrimination. *See Zarda v. Altitude Express*, 883 F.3d 100 (2d Cir. 2018). The Second Circuit relied on similar reasoning to that of the Seventh Circuit in *Hively*.

(3) The Sixth Circuit recently held that Title VII's sex discrimination provision included transgender discrimination. *EEOC v. R.G. & G.R. Harris Funeral Homes, Inc.*, 884 F.3d 560 (6th Cir. 2018). The case involved a transitioning employee at a funeral home who was fired after telling her employer about her transition. The EEOC brought the case and the Sixth Circuit held that transgender discrimination fell under Title VII's sex discrimination provision, in part, because discrimination based on a change in sex inherently involves discrimination based on sex.

2. Trends in Discrimination Case Jury Awards

   (a) Between 2011 and 2017, the mean value of jury awards in discrimination cases increased, but the median value remained relatively constant (dropping slightly between 2016 and 2017).

      (i) The mean value in 2016 was $424,273 and the median was $165,677. In 2017, the mean value was $692,648 and the median was $157,202.

      (ii) The increase in mean value, but relatively constant median value, can be explained by a small number of more recent cases with large awards.

         (1) For example, the total range of awards for discrimination cases in 2015 was between $1 and $7,137,391. In 2016, the range was between $1 and $2,946,563. In 2017, the total range of awards was between $1 and $15,544,413.

         (2) Between 2011 and 2017, disability discrimination and sex discrimination cases have seen the most high-value jury awards. For disability discrimination cases, 4 percent of awards were equal to or in excess of $2,000,000 and the highest jury award was $7,137,391. For sex discrimination cases, 2 percent of awards equaled or exceeded $2,000,000, and the highest jury was $15,544,413. One percent or fewer of other discrimination cases resulted in awards that equaled or exceeded $2,000,000, and the highest jury award was $3,800,000.

   (b) The takeaway is that jury awards have remained relatively stable. There has, however, been an uptick in large awards in a small number of recent cases, primarily those involving sex or disability discrimination.

B. Litigation Strategy Trends

1. As a result of many recent high-profile sexual harassment cases and the #MeToo movement, the plaintiff-side playbook has shifted from threats about money to threats of public exposure. Plaintiff's lawyers are more willing to file complaints in court, even when enforceable arbitration agreements exist.

2. Anecdotally, the public exposure threat has resulted in more employers settling cases prefiling for larger amounts. Employer insurers have been pushing back on funding large settlements, arguing that coverage extends only to risk of monetary loss – not reputational harm.

3. The parties often agree to utilize alternative dispute resolution procedures (e.g., mediation, arbitration, etc.).

C. Employment Contract Trends

1. Many of the high-profile #MeToo cases have involved the employer terminating the accused employee and paying significant severance.

2. Employers are increasingly including sexual misconduct/harassment as part of the definition of "cause" in employment contracts.

D. Legislative Trends Regarding Hiring Processes

1. Credit Checks

(a) Over the past eight to 10 years, various states and jurisdictions have begun to ban, or limit, the ways in which employers can access or consider credit history of job applicants. To date, California, Colorado, Connecticut, Delaware, Hawaii, Maryland, Nevada, Oregon, Vermont, Washington and Washington, DC have passed laws limiting an employer's use of credit information. In addition, Chicago, Philadelphia and New York City have passed their own laws addressing credit information in employment.

(b) New York City's law, the Stop Credit Discrimination in Employment Act, amended the New York City Human Rights Law to prohibit employers from requesting or using consumer credit reports, with some narrow exceptions. For example, employers can still use credit information when hiring a chief financial officer or if the candidate will have regular access to trade secrets, as defined in the statute.

2. Salary Inquiries

(a) To date, 11 states have banned employers from inquiring into compensation history when considering job candidates. Several localities have done the same.

(b) In January 2017, New York State banned compensation inquiries by state employers. New Jersey has a similar ban, which was passed in February 2018.

(c) New York City instituted a compensation history inquiry ban in October 2017 that applies to all employers in New York City. New York City employers may verify and rely on compensation history only if it is provided voluntarily and without prompting. Albany County followed in December 2017 with a similar ban of its own, as did Westchester County in July 2018.

(d) Effective Jan. 1, 2019, Connecticut prohibits employers from asking about an applicant's previous pay, unless the applicant volunteers the information.

(e) Michigan and Wisconsin are the only states that have taken the opposite approach – they prohibit salary inquiry bans.

3. Criminal Background Checks

(a) More than 30 states have passed laws that prohibit employers from asking job applicants about criminal history. "Ban-the-box" laws, as they are called, apply to public employers in some states and to all employers in other states. "Ban-the-box" has been gaining momentum in recent years as more states and localities ban job application questions that ask about criminal history.

(b) In 2015, New York City amended its Human Rights Law with the Fair Chance Act. The Fair Chance Act prohibits criminal history questions on job applications or in job interviews. It also prohibits criminal record checks before an employee receives a conditional job offer. Employers may still run a criminal history check after extending a conditional job offer. If the employer rescinds a job offer as a result of information learned about criminal history, the employer must produce a written report detailing "job relatedness" and provide the report to the applicant.

(c) More recently, the New York City Commission on Human Rights issued rules interpreting the Fair Chance Act. The Commission created a category of per se violations, which include references to criminal convictions or background checks in job postings; seeking information about arrests that did not result in a criminal conviction; and failing to comply with the law's procedural requirements for giving notice when an employer withdraws a conditional offer of employment because of information in an applicant's background report. The Commission's rules also clarified the procedure for withdrawing an offer of employment and addressed other related topics, such as search terms that employers cannot use with an applicant's name prior to extending a condition offer (e.g., "jail," "mugshot" and "warrant").

II. Market Practices Relating to Restrictive Covenants

A. Non-Competition Provisions

1. Non-Competes in New York

(a) New York courts will generally enforce a non-compete to the extent necessary to prevent a former employee from engaging in unfair competition by disclosing or using trade secrets or confidential information, or if the employee's services are unique or extraordinary. See *Reed, Roberts Assoc., Inc. v. Strauman*, 40 NY.2d 303 (N.Y. 1976); *Ivy Mar Co. v. C.R. Seasons Ltd.*, 907 F. Supp. 547 (E.D.N.Y 1995). When drafting a non-compete, employers need to identify one of these protectable interests and tie the covenant's restrictions to the interest.

(i) The scope of what constitutes a protectable interest is broad.

(1) Trade secrets can constitute a protectable interest. A New York court will look at several factors to determine whether a trade secret is protectable: (a) the extent to which employees who do not have a need to know the information have knowledge of the information; (b) the measures the employer takes to safeguard the information; (c) the value of the information to the employer and its competitors; (d) the amount of money or effort that the employer spent to develop the information and (e) the ease or difficulty with which the information could be acquired or duplicated by others. *See Ivy Mar Co*, 907 F. Supp. 547.

(2) Trade secrets can include client or customer relationships. *See Solomon Agency Corp. v. Choi*, 2016 WL 3257006 (E.D.N.Y. May 16, 2016). Furthermore, a New York court found that client goodwill is a protectable interest even when there was no current relationship between the employer and client. *See Globaldata Mgmt. Corp. v. Pfizer Inc.*, 814 N.Y.S.2d 561 (N.Y. Sup. Ct. 2005).

(3) Courts will also uphold non-competes against an employee whose services are unique or extraordinary. However, this protectable interest is not as common as the trade secret protectable interest.

(ii) Because of the burden a non-compete imposes on a former employee's ability to make a living, New York courts will only enforce a non-compete that is reasonable. A non-compete is reasonable only if it (1) is no greater than is required to protect a legitimate interest of the employer, (2) does not impose undue hardship on the former employee and (3) does not conflict with public policy. *See BDO Seidman v. Hirshberg*, 93 N.Y.2d 382 (N.Y. 1999).

(iii) Employers should tailor non-competes as closely as possible to the company's protectable interests and avoid extending non-competes to restrict interests that are not protectable. The more tailored the covenant is, the more likely a court will uphold it.

(1) Traditionally, geographic scope played more of a role in a court's evaluation of a non-compete's reasonableness. It used to be that courts would give greater weight to non-competes that were limited in geography because the non-compete was better tailored to the employer's interest.

(2) In many industries, including the financial services industry, the importance of geographic scope has waned in recent years. Former employees have the ability to conduct their business anywhere in the world and still threaten a former employer's protectable interests.

(b) Courts sitting in equity can broadly consider all relevant factors, including whether either party has unclean hands, such as if either party has engaged in bad acts or self-help. One example could include an employee's misuse or improper possession of employer confidential information or property.

(c) Employment can constitute consideration for non-compete agreements at the outset of employment. Continued employment can also be consideration if termination was the alternative or the employee continued to work for the employer for a "substantial time" after signing the non-compete. *See Zellner v. Stephen D. Conrad, M.D., P.C.*, 183 A.D.2d 250 (N.Y.S. App. Div. 1992).

(d) If an employee challenges a non-compete, the employer needs to be ready to explain the trade secret or confidential information at issue and describe the adverse impact that disclosure of that information would have on the employer's business. Mere generalized knowledge of information is not enough to support the need for a non-compete. The employer needs to show specifically how the employee's knowledge of the trade secret could harm the company, and the scope and time of the non-compete needs to be connected to the potential harm as well. *See Int'l Bus. Mach. Corp. v. Visentin*, 2011 WL 672025 (S.D.N.Y. Feb. 16, 2011).

(e) New York courts have been inconsistent on whether a non-compete is enforceable when the employer terminates without cause. In 1979, the New York Court of Appeals refused to enforce a forfeiture for competition clause because the employee had been terminated without cause. *Post v. Merrill Lynch, Pierce, Fenner & Smith*, 48 N.Y.2d 84 (N.Y. 1979). Since *Post*, New York courts have been hesitant to enforce restrictive covenants when the employer fired the employee without cause. *See Buchanan Capital Mkts., LLC v. DeLucca*, 144 A.D.3d 508 (N.Y. App. Div. 2016) (citing Post). However, in 2012, the Second Circuit noted that Post only applied to forfeiture for competition clauses and not to other restrictive covenants. *See Hyde v. KLS Prof'l Advisors Grp., LLC*, 500 F. App'x 24 (2d Cir. 2012). The Fourth Department has held similarly. *See Brown & Brown, Inc. v. Johnson*, 25 N.Y.3d 360 (N.Y. 2015).

(f) In general, New York courts will recognize the right of contracting parties to select which states' laws will apply to their contract and, therefore, their non-compete. However, New York courts will only do so if a "substantial relationship" exists between the controversy and the state whose laws the parties want applied. *See* Restatement (Second) of Conflicts of Law § 187.

(i) The types of substantial contacts that a court will look for are generally the:

(1) Place of contracting;

(2) Negotiation and performance of the contract;

(3) Domicile of the parties; and

(4) Location of the subject matter of the contract. *See* Restatement (Second) of Conflicts of Law § 188(2).

(ii) Even if a substantial relationship exists between the controversy and the state in the parties' choice of law provision, a New York court will not apply the choice of law provision if the law of the chosen state would undermine a fundamental public policy of another state that has a materially greater interest in the controversy. *See* Restatement (Second) of Conflicts of Law § 187. For example, in *Brown & Brown, Inc. v. Johnson*, the New York Court of Appeals held that a Florida choice of law provision in a non-compete was unenforceable. 25 N.Y.3d 360 (N.Y. 2015). The court applied New York law instead. Florida law prohibits courts from considering the burden that a non-compete would have on an employee while New York law requires such consideration. The court therefore held that applying Florida law would offend fundamental public policies of New York.

(g) Employers should undertake appropriate due diligence with respect to prospective hires to determine what, if any, restrictive covenants a prospective hire is bound by.

2. Recent Developments in Other States' Non-Compete Laws

(a) Massachusetts

(i) In August 2018, Massachusetts enacted a law that regulates, and limits, non-compete agreements. The new law applies to any agreement entered into on, or after, Oct. 1, 2018. Previously, Massachusetts common law provided that non-competes could be no broader than necessary to protect a legitimate business interest and that non-competes must be reasonable in duration, scope and geography. The new law codified this principle. *See* Mass. Gen. Laws ch.149, § 24L (2018).

(ii) Under the new law, non-competes cannot exceed 12 months, except in certain limited circumstances such as when the employee breaches a fiduciary duty to the employer or takes the employer's property. The new law also established that a geographic scope limited to the area in which the employee provided services or had an influence is presumptively reasonable. Furthermore, if the scope of prohibited activities under the non-compete is limited to the specific types of services that the employee provided to the employer during the last two years of employment, then the scope is presumptively reasonable.

(iii) Employers cannot enforce a non-compete against any employee who is non-exempt under federal overtime law, employees who were terminated without cause or laid off, student interns and employees aged 18 or younger.

(iv) Non-competes must be supported by adequate consideration, which the parties must specify in the agreement. If an employer and employee enter into a non-compete during employment (rather than at the beginning of employment), then the consideration must be more than continued employment, such as "garden leave." Garden leave refers to the practice of continuing pay after termination. Under the new law, any garden leave provision must provide for prorated payments during the restricted period of at least 50 percent of the employee's highest annualized base salary for the two years prior to termination.

(v) The new law has a mandatory governing law and forum selection provision. Non-competes must apply Massachusetts law if the employee has been a resident of, or employed in, Massachusetts for at least 30 days before the termination of employment. Governing law provisions to the contrary are unenforceable under the new law. Employers must also bring any enforcement action of a non-compete in the county where the employee lives. Alternatively, if both parties agree, the employer can bring the action in Suffolk County. This prevents a Massachusetts employer from attempting to circumvent the new restrictions by contracting to have another state's laws apply.

(vi) There are several exceptions to the new law's restrictions. A few of them are forfeiture agreements, non-disclosure agreements, non-solicit agreements and non-competes in connection with an employee's cessation or separation of employment. However, this last exception only applies if the employee is given seven business days to rescind acceptance after originally agreeing to the non-compete.

(b) California

(i) California has long restricted the use of non-competes. Except for a few narrow exceptions, such as in the context of the sale of a business, California prohibits enforcement of non-compete provisions for public policy reasons. *See* Cal. Bus. & Prof. Code § 16600.

(ii) A California Court of Appeals recently invalidated a non-solicit citing to the same statute that bars non-competes. The case involved nurse recruiters who had signed an agreement at the start of their employment. The non-solicit purported to bar the nurse recruiters from soliciting employees of the former employer for a period of one year. The court held that the provision was too burdensome and contrary to California's public policy that disfavors restrictive covenants. *See Amn Healthcare, Inc. v. Aya Healthcare Servs., Inc.*, 28 Cal. App. 5th 923 (Cal. Ct. App. 2018).

(iii) Some employers have attempted to minimize the impact of California's broad ban on non-competes by using choice of law provisions to select a more favorable jurisdiction. However, these other jurisdictions sometimes find that California's fundamental public policy of prohibiting non-competes overrides the contract's choice of law provision. Under California law, employers cannot require that an employee who primarily resides and works in California agree to a foreign venue or choice of law provision as a condition of employment. The exception is when the employee is represented by legal counsel. *See* Cal. Lab. Code § 925.

(1) Nonetheless, a Delaware court recently found that California's public policy was not so fundamental as to override the parties' choice of law provision because the employee was represented by counsel and knowingly bargained away protections. The case involved a Delaware corporation doing business in California, NuVasive, and an employee who was a California resident. The employee resigned from his post and began working for a competitor. NuVasive sought to enforce a non-compete agreement, which included a Delaware choice of law provision. *See NuVasive, Inc. v. Miles*, No. CV 2017-0720-SG, 2018 WL 4677607 (Del. Ch. Sept. 28, 2018).

(2) *NuVasive* marks a potential change in how courts will view choice of law provisions in the context of non-competes with California residents. To maximize the chances of repeating the outcome of NuVasive, employers should make sure that any California employee is represented by counsel when the parties negotiate the non-compete.

B. Non-Solicitation Provisions

1. Non-solicits can operate in two ways. First, a non-solicit provision can prevent a former employee from recruiting and hiring from the employer's ranks. Second, employers can use non-solicits to prevent a former employee from soliciting customers, investors or clients. In both cases, employers can extend the non-solicit to current and former employees, customers, investors and clients.

(a) For former employees, customers, investors and clients, the employer typically crafts the non-solicit so that it applies to anyone who was an employee, customers, investor or client within several months of the employee's termination.

(b) Covering former employees protects against employees quitting in anticipation of being rehired by the departing employee.

2. There is typically less litigation over non-solicits as compared to non-competes.

(a) Solicitation can be difficult to prove in terms of who initiated the communication.

(b) When litigating a non-solicit, the employer will need to prove damages unless the employer is seeking an injunction. Employers should also tailor non-solicits so that they are as narrow as possible in scope and time to adequately protect the employer's interest. Non-solicits may extend for a longer period of time than a non-compete.

C. Forfeiture-for-Competition

1. Forfeiture-for-competition provisions present employees with a choice: compete and forfeit a prospective benefit or refrain from competing and retain the benefit.

2. In contrast to their close scrutiny of non-competes, New York courts are more inclined to uphold forfeiture-for-competition provisions because forfeiture-for-competition provisions do not interfere with an employee's ability to make a living in the same way as non-competes.

3. New York courts will not uphold a forfeiture for competition clause against an employee who was involuntarily terminated without cause. *Post v. Merrill Lynch, Pierce, Fenner & Smith*, 48 N.Y.2d 84 (N.Y. 1979); *see also Lucente v. IBM*, 310 F.3d 243 (2d Cir. 2002). The courts have held that in such circumstances there is no choice because the employee would be forced to search for another job and therefore forfeit their benefits. In such a case, the court will analyze the provision as a regular non-compete and will only enforce the provision if it is reasonable in scope and duration.

D. Clawbacks

1. Clawbacks allow an employer to reclaim compensation already paid to an employee if the employee violates a restrictive covenant. In New York, employers cannot claw back wages. Any compensation that an employer paid to its employee for services rendered is insulated from clawback provisions. *See* New York Labor Law
§ 195-4.5(e)-(g).

2. An exception is when the employee violated a duty of loyalty. Under New York law, if an employee was disloyal, the employer can recover any compensation that was paid during the period of disloyalty. *See Phansalkar v. Anderson Weinroth & Co.*, 344 F.3d 184 (2d Cir. 2003).

3. Incentive compensation is not considered wages. *See Truelove v. Northeast Capital & Advisory, Inc.*, 95 N.Y.2d 220 (N.Y. 2000). Therefore, an employer can require forfeiture of previously awarded but unvested compensation, provided that it was discretionary when awarded.

E. Confidentiality Provisions

1. Employers use confidentiality provisions to protect the company's trade secrets and proprietary and confidential information. New York courts will generally enforce a confidentiality provision for as long as the information that is subject to the provision remains valuable and secret.

2. There are a few limitations to confidentiality provisions.

   (a) Both the National Labor Relations Act and New York's labor law prohibit employers from barring employee discussions of wages and other compensation among co-workers. Employers can, however, impose reasonable time, place and manner restrictions on such discussions.

   (b) Confidentiality agreements should not restrict use and disclosure of information that becomes public through means other than a breach of the provision.

   (c) Confidentiality provisions should include carve-outs for information that an employee must disclose by law and for whistleblowing, as required under the federal Defend Trade Secrets Act (DTSA).

F. Protections Under Federal and State Trade Secret Laws

1. The federal Lanham Act includes protections for false or misleading advertisements under section 1125 of the statute. An example of when an employer might turn to section 1125 is when a former employee represents the employer's track record as his or her own in promotional materials. To prove the violation under section 1125, the employer must show that the information in the promotional materials is (a) a false and misleading statement of fact, (b) likely to confuse and/or deceive potential investors, (c) material in its effect on investing decisions, (d) connected with interstate commerce and (e) damaging or likely to damage the employer.

2. The DTSA provides employers with a cause of action for when an employee misappropriates trade secrets. Under the DTSA, employers can bring suit against former employees who steal trade secrets or disclose them in violation of their duties to their employer. In some cases, employers can even bring suit against third parties who use the trade secrets.

3. New York law also provides a cause of action for misappropriation of trade secrets. To bring suit, an employer must prove two elements: (a) that the information at issue is, in fact, a trade secret and (b) that the defendants used the trade secret in breach of an agreement, confidential relationship or duty, or as a result of discovery by improper means. *See E.J. Brooks Co. v. Cambridge Sec. Seal*, 31 N.Y.3d 441 (N.Y. 2018) (citing *Integrated Cash Management Services, Inc. v. Digital Transactions, Inc.*, 920 F. 2d 171 (2d Cir. 1990).

G. Non-Disparagement Clauses

1. Non-disparagement clauses prevent employees and/or employers from making disparaging comments to third parties. Non-disparagement provisions should include carve-outs to avoid conflicts with whistleblower protection laws and to avoid preventing the employee from cooperating with government investigations.

2. One issue that may arise with non-disparagement provisions is with enforcement.

(a) An employer will likely have difficulty proving and calculating damages. In addition, since damages will likely relate to the employer's damaged reputation, the employer might have to involve its clients or investors, or prospects, to show how the employee's remarks damaged the employer.

(b) The purpose of subjecting an employee to a non-disparagement provision is to preserve the reputation of the employer. Unless the parties have agreed to confidential arbitration, the employer will need to file a lawsuit in order to enforce the provision. Suing the employee would require including the employee's disparaging remarks in a public filing, which may undermine the original purpose of the provision.

III. Compliance with New Legislation Aimed at Preventing Sexual Harassment

A. New York State and New York City Requirements for Sexual Harassment Prevention Policies

1. New York State and New York City recently enacted laws requiring employers to have sexual harassment prevention policies that meet minimum standards set forth in the statutes.

(a) New York State

(i) Effective Oct. 9, 2018, policies must explain what sexual harassment is and provide examples; include a standard complaint form; include information about state and federal sexual harassment laws and remedies; include information about employee rights; include a clear statement that sexual harassment is considered a form of employee misconduct; and prohibit retaliation.

(ii) Policies must also include a complaint form and inform all employees of their rights of redress and all available forums.

(iii) The New York State Department of Labor, in consultation with the New York State Division of Human Rights, developed a model sexual harassment prevention guidance document and a model sexual harassment prevention policy.

(1) Employers can adopt the model policy or create their own that meets or exceeds the minimum requirements.

(2) Most employers have not adopted the model policy. The model policy only covers sexual harassment. Many employers' discrimination policies are broader and cover other types of discrimination in addition to sexual harassment, so many employers have revised their existing policies to ensure compliance with the new sexual harassment prevention requirements. In that regard, the model policy serves a compliance tool that employers use when updating their own policies.

(b) New York City

(i) The Stop Sexual Harassment in NYC Act amended the New York City Human Rights Law to provide expanded protections. The law goes into effect in April 2019.

(1) The statute of limitations for filing a gender-based harassment claim with the New York City Commission on Human Rights increases from one year to three years.

(2) The new law also extended protections to all employees no matter the size of the employer. This includes interns and independent contractors.

(ii) Effective Sept. 6, 2019, New York City employers need to post a notice in the workplace. The notice needs to be posted in English and Spanish. It describes the New York City Commission on Human Rights complaint process, gives examples of discrimination, encourages witnesses of harassment to file a report and explains that retaliation in response to reporting sexual harassment is prohibited.

(iii) New York City employers also need to distribute a fact sheet that covers similar material to the posting. Employers can either distribute the fact sheet to all employees and any new employees upon hiring, or employers can integrate the information into their employee handbooks (or free-standing harassment prevention policies) instead.

B. New York State and New York City Requirements for Sexual Harassment Training

1. New York State and New York City have enacted laws requiring employers to provide annual training to prevent sexual harassment in the workplace. While not all of the new provisions have gone into effect yet, there is no reason why employers should wait to update their trainings.

(a) New York State

(i) Effective Jan. 1, 2019, trainings must be interactive; explain what sexual harassment is and include examples; include a standard complaint form; include information about state and federal sexual harassment laws and remedies; include information about employee rights; include a clear statement that sexual harassment is considered a form of employee misconduct; and prohibit retaliation.

(ii) The New York State Department of Labor, in consultation with the New York State Division of Human Rights, developed a model sexual harassment prevention training program in addition to the model guidance document and model policy mentioned above.

(1) The model training program includes a script, PowerPoint and videos that are available on YouTube.

(2) Employers must either adopt the training program or develop their own training program that meets or exceeds the state's minimum standards.

a. Some issues with the model training program are that the model only covers sexual harassment and the examples are not tailored to the financial services industry.

b. The ideal training program is live and interactive and covers all forms of discrimination, not just sexual harassment. Also, for employers in financial services, the sexual harassment training should address situations and examples that are relevant to the industry.

(iii) Employers must train all employees on sexual harassment.

(1) This includes exempt, non-exempt, seasonal, part-time and temporary workers.

(2) Even though contractors are now protected under the new law, employers do not need to train them; however, training contractors on sexual harassment is encouraged.

(b) New York City

(i) Effective April 1, 2019, trainings must be interactive; occur at least annually (and, for new employees, within 90 days of employment); explain that sexual harassment is a form of discrimination; describe and provide examples of sexual harassment; address the internal complaint process available to employees; explain that retaliation against complaints is prohibited; provide examples of retaliation; provide information about bystander intervention; and address the specific responsibilities of supervisors and managers in preventing sexual harassment and retaliation.

(ii) Employers must keep a record of each training conducted for at least three years. The records must include signed employee acknowledgements, which can be electronic.

2. These new requirements under state and city law are the minimum. Employers can adapt or create their own trainings so long as the trainings meet or exceed the minimum requirements. EEOC has stated that one size does not fit all when it comes to trainings: "Training is most effective when tailored to the specific workforce and workplace, and to different cohorts of employees," such as departments and offices.

3. The best line of defense against behaviors that lead to sexual harassment claims is a commitment across all levels of the organization, starting at the top, to prevent harassment and develop an inclusive workplace.

C. Changes in New York State Law Regarding Non-Disclosure Agreements

1. New York State now prohibits employers from requiring an employee/complainant to sign a nondisclosure agreement as part of a settlement agreement involving a sexual harassment claim, unless confidentiality is the "complainant's preference." If the complainant prefers confidentiality, then there are some procedural requirements that the employer must follow:

(a) The employer must give the complainant 21 days to consider the confidentiality condition. This timeframe cannot be waived.

(b) If after 21 days the complainant agrees to confidentiality, then the parties should memorialize the complainant's preference for confidentiality in writing.

(c) After the complainant agrees to and signs the confidentiality condition, the complainant has seven days to revoke the agreement.

2. If an employer is settling a claim that does not involve sexual harassment, the employer should include a representation to that effect in the agreement.

D. Changes in New York State Law Regarding Arbitration

1. New York State recently passed a law that prohibits "any clause or provision . . . [requiring] that the parties submit to mandatory arbitration to resolve any allegation or claim of an unlawful discriminatory practice of sexual harassment." The law purports to nullify any mandatory arbitration clause covering sexual harassment claims except "where inconsistent with federal law."

2. It is unlikely that New York's ban on mandatory arbitration clauses for sexual harassment claims will be upheld by the courts, absent a change in federal law governing arbitration.

(i) The Supreme Court has repeatedly held that the Federal Arbitration Act (FAA) expresses a "liberal policy favoring arbitration." *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333, 339 (2011).

(ii) The Court has held that whenever state law prohibits arbitration of a particular type of claim, then the state law is displaced by the FAA. *See Concepcion*, 563 U.S. at 341.

3. The FAA will likely be held to preempt New York's new law. Employers should keep this in mind when considering whether to continue using arbitration provisions.

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Don is co-head of the Bank Regulatory Group. He focuses his practice on the regulation of banks, thrifts and licensed financial services providers, and specifically the regulation, acquisition and sale of payments companies and money transmitters, and the laws and practices applicable to mobile, digital, virtual, electronic, paper- and card-based payment products and systems. Don has represented leading banks, payments companies, card associations, money transmitters and private equity firms in transactional and regulatory matters associated with payments, prepaid cards, digital currencies and money transmission, including the negotiation of payments products and processing agreements.

Don has been recognized by *IFLR1000*, *The Legal 500 US* and *New York Super Lawyers* as a leading attorney in banking, mergers and acquisitions and consumer law. Don is a frequent author and public speaker on topics of interest to the prepaid card industry. He spoke on "The Future of Virtual and Crypto Currencies, Tokenization and the ICO Phenomenon" at ACI's Legal, Regulatory and Compliance Forum on FinTech and Emerging Payment Systems Conference, "Prepaid Card Compliance 101: An In-depth Guide To Compliance Essentials for Financial Institutions, Issuing Banks, and Other Industry Players" at ACI's 18th National Forum on Prepaid Card Compliance, "State Money Transmitter Licensing Laws: Are They Killing Payments Industry Innovation?" at the Money20/20 Conference and on "Prepaid Access" at the Money Transmitter Regulators Association Annual Conference & Examiners' School. His recent publications include co-authoring the *SRZ Alerts* "FinCEN and Federal Banking Agencies Issue Statement on Pooling Resources for BSA Compliance," "OCC Begins Accepting Fintech Charter Applications," and "NYDFS Issues Guidance to Deter Fraud and Manipulation in Virtual Currency Markets." Don received his J.D., *cum laude*, from St. John's University School of Law, where he served as notes and comments editor of the *St. John's Law Review*. He earned his B.A. from the State University of New York at Stony Brook.

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Practices

Broker-Dealer Regulatory & Enforcement

Hedge Funds

Investment Management

Regulatory & Compliance

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Julian is co-chair of the Broker-Dealer Regulatory & Enforcement Group. He advises broker-dealers and alternative trading systems on compliance with SEC, self-regulatory organization and Federal Reserve Board rules. His practice involves all aspects of broker-dealer regulation, with a focus on cash equities trading practices, alternative trading systems, net capital, customer asset segregation, prime brokerage, correspondent clearing and margin and securities lending. Julian represents many of the leading electronic market makers and alternative trading systems and serves on the best-execution committees of several major broker-dealers. In addition to regularly advising broker-dealers on regulatory compliance and best practices, Julian represents clients in response to examination findings and enforcement proceedings. He also provides legal counsel to financial institutions in connection with acquisitions of or investments in broker-dealers, credit facilities collateralized by securities and transactions subject to Regulation M.

Julian is listed in *Chambers USA* and *The Legal 500 US* as a leading financial services regulatory lawyer. A recognized thought leader, he co-authored the *SRZ Alert* "SEC Adopts New Transparency Requirements for NMS Stock Alternative Trading Systems," which was republished in *Law360*. He also co-authored the *SRZ Alert* "Cross-Border Implementation of MiFID II Research Provisions – SEC No-Action Relief to Investment Advisers and Broker-Dealers and European Commission Guidance" and he was featured in "Execution Enforcement Actions Escalate," both published in *The Hedge Fund Journal*. Julian earned his J.D. from American University Washington College of Law and his B.A. from Dickinson College.

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Practices

Broker-Dealer Regulatory & Enforcement

Blockchain Technology & Digital Assets

Hedge Funds

Investment Management

Regulatory & Compliance

Securities Enforcement

White Collar Defense & Government Investigations

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Craig is co-chair of the Broker-Dealer Regulatory & Enforcement Group. His practice focuses on securities enforcement and regulatory matters for broker-dealers, private funds, financial institutions, companies and individuals. Drawing on his experience both as a former enforcement attorney with the SEC and as a Special Assistant U.S. Attorney, Craig advises clients on securities trading matters and, when necessary, represents them in regulatory investigations and enforcement actions by the SEC, DOJ, FINRA and other self-regulatory organizations and state regulators. He also represents clients in connection with regulatory and enforcement matters related to blockchain technology and digital assets. Craig leads training sessions for clients on complying with insider trading and market manipulation laws and assists hedge funds and private equity funds in connection with SEC examinations. Craig also has experience representing entities and individuals under investigation for, or charged with, securities fraud, mail/wire fraud, accounting fraud, money laundering, Foreign Corrupt Practices Act violations and tax offenses. In his previous roles in the U.S. Attorney's Office for the Eastern District of New York and the SEC, Craig prosecuted numerous complex and high-profile securities fraud, accounting fraud and insider trading cases.

Craig is recognized as a leading litigation lawyer in *Benchmark Litigation: The Definitive Guide to America's Leading Litigation Firms and Attorneys*, *The Legal 500 US* and *New York Super Lawyers*. He is a former law clerk to the Honorable Lawrence M. McKenna of the U.S. District Court for the Southern District of New York. Craig has written about enforcement actions against hedge funds and other industry-related topics. Most recently, he co-authored the *SRZ Alert* "SEC Charges Hedge Fund Manager with Short-and-Distort Scheme," which was republished in *The Hedge Fund Journal*. Craig earned his J.D., *cum laude*, from Benjamin N. Cardozo School of Law and his B.A. from University of Michigan.

Blockchain and Digital Assets

I. Definitions

A. Cryptocurrency – A digital or virtual currency that utilizes encryption and cryptography to control the generation of new units of currency as well as secure and verify transactions of that currency.

B. App or Use Token – A special kind of virtual currency token that resides on its own blockchain and represents an asset or utility.

C. Decentralized Ledger – A ledger of transactions or contracts maintained in a decentralized form across different locations and people, eliminating the need of a central authority to keep a check against manipulation; all the information on it is stored using cryptography and can be accessed using keys and cryptographic signatures.

D. Private/Public Hash – A private hash/key consists of alphanumerical characters that gives a user access and control over their funds to their corresponding cryptocurrency address; the private key is used to sign transactions that allow the user to spend their funds. A public hash/key also consists of alphanumeric characters generated by the private key to an account and this can be publicly shared so that miners can verify digitally signed transactions; a user's private key is private to the user and the public key is known to everyone.

E. Initial Coin Offerings ("ICOs") – An event in which a new cryptocurrency sells advance tokens from its overall Coinbase, in exchange for upfront capital; frequently used for developers of a new cryptocurrency to raise capital; similar to an IPO.

F. SAFT/SAFE – A Simple Agreement for Future Tokens ("SAFT") is a form of fundraising, intended for digital-currency startups and directed at accredited investors, which promises tokens when the project or company becomes operational; while a SAFT sounds very similar to a standard ICO, the difference is that under an ICO the tokens are issued immediately; under a SAFT it is a promise to deliver tokens.

A Simple Agreement for Future Equity ("SAFE") is an agreement between an investor and a company that provides rights to the investor for future equity in the company similar to a warrant, except without determining a specific price per share at the time of the initial investment. The SAFE investor receives the futures shares when a priced round of investment or liquidation event occurs. SAFEs are intended to provide a simpler mechanism for startups to seek initial funding than convertible notes.

G. Stable Coin – A cryptocurrency designed to minimize the effects of price volatility; to minimize volatility, the value of the stable coin can be pegged to a currency, or to exchange traded commodities; stable coins backed and collateralized by currencies or commodities directly are said to be centralized, whereas those leveraging other cryptocurrencies are referred to as decentralized.

H. Staking – Using the Proof of Stake algorithm that is the basis of many new cryptocurrencies, staking involves the purchase of cryptocoins and holding them in a wallet for a particular period of time (akin to a fixed deposit in the non-digital currency sphere). This enables the protocol to update without minting new coins.

I. Blockchain – The public, decentralized ledger in a cryptocurrency network that records all transactions of that cryptocurrency.

J. Smart Contract Protocol – A computerized transaction protocol that executes the terms of a contract; smart contracts can be automatically executed by a computing system, such as a suitable distributed ledger system.

II. Fund Products

A. Wallet Funds

1. The basic vehicle that is offered is essentially a wallet. A wallet fund invests in cryptocurrency and pays cash back to investors when they decide to redeem. These funds provide value to investors by buying and storing digital assets safely, but the fund does not make the strategic decision of when to trade in and out.

2. The terms for these vehicles typically include:

   (a) Frequent (if not daily) liquidity;

   (b) Modest management fees; and

   (c) No incentive fee.

B. Funds That Invest in Multiple Cryptocurrencies

1. More recent products strategically invest in multiple cryptocurrencies. These funds allow managers to diversify their portfolio and make strategic bets on particular currencies. Funds also may be able to short cryptocurrencies that the sponsor thinks are overvalued.

2. Fund terms:

   (a) An incentive fee may be charged; and

   (b) Liquidity will likely be no more frequently than quarterly.

C. Funds That Invest in Venture Capital Companies

Funds may also invest in blockchain technology. Funds that invest in blockchain-related venture companies cannot provide liquidity and cannot easily justify charging fees based on mark-to-market values. Instead, they will probably be written to hold assets for a period of years and then pay investors out as assets are offered through an IPO or sold.

D. ICOs

1. The risks of ICOs are greater because they are not yet tested in the market. The Bitcoin protocol has been used globally for an extended period of time. On the other hand, newer currencies and their underlying protocols are more speculative, and generally the ICO is issued before the cryptocurrency it represents has been launched. U.S. Securities and Exchange Commission Chairman Jay Clayton, in a public statement addressing cryptocurrencies and ICOs, noted the concern that there is less investor protection and more opportunities for fraud and manipulation.[1]

[1] *See* Public Statement, "Statement on Cryptocurrencies and Initial Coin Offerings" (Dec. 11, 2017) *available at* https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11.

2. If the underlying asset in an ICO is a token, it is important to think about what that token represents. A token that functions like stock of an ICO issuer will be a security, with its own layers of regulation. A token that can be converted into a precious metal may be a commodity. A SAFT is a contract to buy crypto assets in the future. Depending on what will be bought, a SAFT could be a derivative, a security or neither.

E. Audit Issues

Other issues to think about when raising or investing in digital asset funds are how to structure a fund so that it is not a cryptocurrency exchange, and how crypto assets should be stored, audited and traded. Registered investment advisers ("RIAs") will also need to have auditors who can provide statements on time. Given the complexity and volatility of crypto assets, many accounting firms have refrained from auditing crypto assets.

F. Offering Issues

1. Consider offering with public advertising under Rule 506(c).

2. If a fund will hold securities, it needs to comply with Sections 3(c)(1)-3(c)(7).

3. Publicly traded partnership issues if frequent liquidity and more than 99 investors.

G. New Developments

1. Institutional investors are beginning to invest in this space.

2. Some managers are now registered as RIAs.

3. Increased interest in stable coins.

4. Increased regulatory focus on exchanges.

5. First settlements on ICOs treated as securities.

6. SEC once again denied the Winklevoss twins' effort to launch cryptocurrency.

7. Plunge in Bitcoin prices.

8. Substantial slowdown of ICO token trading.

III. Regulatory and Compliance Issues

A. Are Digital Currencies Securities?

1. The issue is what is meant by "currency." The Commodity Futures Trading Commission ("CFTC") has asserted jurisdiction over "pure play" digital currencies, such as Bitcoin, but the SEC has asserted jurisdiction over "digital coins" or "digital tokens." In July 2017, the SEC released a Report of Investigation on an offering of digital tokens by an entity called "The DAO."[2] After examining The DAO's digital tokens under the *Howey* test, the SEC concluded that The DAO tokens were securities under the Securities Act of 1934 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"), as the tokens essentially looked like the issuance of stock. In a recent order, the SEC explained that a token can be a

[2] *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Release No. 81207 (July 25, 2017).

security based on the long-standing facts and circumstances test, which includes assessing whether investors' profits are to be derived from the managerial and entrepreneurial efforts of others.[3]

2. In determining whether digital currencies are securities, regulators seem to be applying a functional and resemblance approach. Where a digital asset looks more like an investment contract or another variety of security (e.g., if it is an investment in a common enterprise with an expectation of profits to be derived from the efforts of others) the SEC will expect the requirements of the Securities and Exchange Acts to be followed.

B. Registration Issues

If a fund manager is advising others on trading digital assets that are securities, they may have to register with the SEC as an investment adviser. If a manager is required to register it will have to comply with the custody rule, which requires client funds and securities to be maintained with qualified custodians in an account either under the client's name or under the name of an agent or trustee of the client. Also consider exempt reporting adviser registration.

C. SEC Jurisdiction

Vehicles such as ETFs holding digital currencies clearly fall within the jurisdiction of the SEC. The SEC has rejected applications for Bitcoin on the basis of the fact that there is too much room for manipulation in the underlying instruments (a factor the SEC must consider before approving an ETF) given the largely unregulated nature of Bitcoin exchanges. However, Bitcoin futures are now being issued on major exchanges such as the Chicago Mercantile Exchange ("CME") and the Chicago Board Options Exchange ("CBOE"). A more robust futures market may ease the SEC's concerns about potential market manipulation. Since the launch of futures contracts by the CME and CBOE, several more applications for Bitcoin ETFs have been filed with the SEC.

D. Custody

RIAs are subject to Rule 206(4)-2, the Custody Rule, which generally requires that "client funds and securities" be held at a "qualified custodian." An increasing number of businesses are beginning to offer custodial services for digital assets but compliance with this aspect of the Custody Rule remains challenging.

E. SEC Enforcement

Unregistered Offerings

1. In December 2017, the SEC ordered a company selling digital tokens to investors to halt its ICO and refund investor proceeds after the SEC found that the ICO constituted the offer and sale of unregistered securities.[4] During the course of the ICO, the company, which was selling digital tokens to raise capital for its blockchain-based food review service, emphasized that investors could expect that efforts by the company and others would lead to an increase in the value of the tokens, and that the company would create and support a secondary market for the tokens. According to the SEC's order, the digital tokens should have been classified as an investment contract requiring SEC registration because purchasers for the tokens had a reasonable expectation of making a profit on their investment. Notably, this was the SEC's first time shutting down an ICO without alleging fraud, demonstrating the widening breadth of scrutiny on ICOs.

[3] *See In the Matter of Munchee Inc.*, File No. 3-18304 (Dec. 11, 2017).

[4] *See In the Matter of Munchee Inc.*, File No. 3-18304 (Dec. 11, 2017).

2. In November 2018, the SEC settled charges against two companies for failing to register ICOs.[5] Both companies held their ICOs after the SEC released the DAO Report, cautioning that those who offer and sell digital securities must comply with the federal securities laws. The SEC found that each company's token was a security under the *Howey* test, and neither company registered their ICOs as securities offerings or qualified for registration exemptions. These were the SEC's first cases imposing civil penalties solely for ICO securities offering registration violations. The SEC enjoined the defendants from violating Sections 5(a) and 5(c) of the Securities Act, and ordered each defendant to compensate harmed investors and pay civil penalties.

Unregistered Exchanges and Brokerage Activity

1. In November 2018, the SEC settled charges against the founder of a digital "token" trading platform for operating an unregistered securities exchange.[6] The SEC found that the platform allowed users to trade tokens that the SEC considers to be securities, making it an unregistered securities exchange. This was the SEC's first enforcement action based on findings that such a platform operated as an unregistered national securities exchange. The SEC enjoined the defendant from violating Section 5 of the Exchange Act, and ordered the defendant to pay disgorgement and civil penalties.

2. In February 2018, the SEC charged a company and its founder with operating an unregistered online securities exchange and defrauding users of the exchange.[7] The SEC also charged the operator of the exchange with making false and misleading statements in connection with an unregistered offering of securities. In the charges, the SEC alleged that the defendants misappropriated customer Bitcoins and failed to disclose a cyberattack that resulted in the theft of a significant number of Bitcoins. The SEC also alleged that the defendants sold unregistered securities that purported to be investments in the exchange and misappropriated funds from that investment. The SEC sought to enjoin the defendants from violating Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder.

3. In September 2018, the SEC settled charges against a self-described "ICO Superstore" and its owners for acting as unregistered broker-dealers.[8] The SEC found that the company, which promoted its website as a marketplace for purchasing ICOs and as a secondary digital asset trading site, was soliciting investors for securities transactions and facilitating the sale of digital tokens as part of ICOs. This was the SEC's first case charging unregistered broker-dealers for selling digital tokens after the SEC issued the DAO Report. The SEC enjoined the defendants from violating Section 15(a) of the Exchange Act and Sections 5(a) and 5(c) of the Securities Act, and ordered the defendants to pay disgorgement and civil penalties.

Fraud

1. In June 2017, the SEC obtained a final judgment against two Bitcoin mining companies for defrauding investors.[9] The defendants offered shares to investors in their mining operation, but the defendants did not own enough computing power for the mining they promised to conduct. The SEC found that the companies sold what they did not own, misrepresented what they were selling, and robbed one investor

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[5] *See* Press Release, Two ICO Issuers Settle SEC Registration Charges, Agree to Register Tokens as Securities (Nov. 16, 2018); *available at* https://www.sec.gov/news/press-release/2018-264

[6] *See* Press Release, SEC Charges EtherDelta Founder With Operating an Unregistered Exchange (Nov. 8, 2018); *available at* https://www.sec.gov/news/press-release/2018-258

[7] *See* Press Release, SEC Charges Former Bitcoin-Denominated Exchange and Operator With Fraud (Feb. 21, 2018); *available at* https://www.sec.gov/news/press-release/2018-23

[8] *See* Press Release, SEC Charges ICO Superstore and Owners With Operating as Unregistered Broker-Dealers (Sept. 11, 2018); *available at* https://www.sec.gov/news/press-release/2018-185

[9] *See* Litigation Release No. 23852 (June 5, 2017).

to pay another. The U.S. District Court for the District of Connecticut enjoined the defendants from violating Sections 5 and 17(a) of the Securities Act and Section 10(b) of the Exchange Act, and ordered each defendant to pay disgorgement and civil penalties.

2. In September 2017, the SEC charged an individual and two companies with defrauding investors through the offering of ICOs backed by investments in real estate and diamonds. The SEC alleged that the defendants were selling unregistered securities and that the underlying assets did not exist.[10] Further, the defendants made material misstatements and misrepresentations to investors about how the ICO proceeds would be invested and how much money they had raised. The SEC sought to enjoin the defendants from violating Section 10(b) of the Exchange Act, and Rule 10b-5(a)-(c) promulgated thereunder.

3. In December 2018, the SEC obtained a final judgment against two executives for defrauding investors.[11] The defendants were accused of, among other things, offering and selling unregistered investments in their purported cryptocurrency by falsely depicting their company as a first-of-its-kind decentralized bank offering a variety of services to retail investors, but the firm was not authorized to conduct banking services and the defendants instead used investor money for personal expenses. The U.S. District Court for the Northern District of Texas enjoined the defendants from violating Section 10(b) of the Exchange Act and Rule 10b-5(b) promulgated thereunder, and ordered each defendant to pay disgorgement and civil penalties. Further, the defendants were also barred from participating in future offerings of digital securities. This is the first and only instance to date of such a bar being imposed.

F. CFTC Regulation

1. In a 2015 ruling, the CFTC issued an order against an online platform and its CEO for facilitating trading in Bitcoin options contracts.[12] The key takeaway was that the CFTC asserted that virtual currencies are considered commodities. This assertion is meaningful in three ways.

   (a) First, it means that the CFTC considers itself to have jurisdiction over virtual currency derivatives, as they could now be considered "commodity futures" or "commodity options."

   (b) Second, it means that the CFTC has jurisdiction over virtual currency OTC instruments such as "swaps."

   (c) Third, while the CFTC does not have jurisdiction over trading of digital assets, it can still assert jurisdiction over the spot market if it believes that manipulation of the spot market will affect the derivatives markets. The CFTC historically has brought enforcement actions for manipulation of the spot FX and agricultural markets — markets it technically does not have direct jurisdiction over. The CFTC could do the same for digital assets if it believes that it is affecting the derivatives market.

2. Impact on fund managers

   (a) Funds that are holding digital currency derivatives may be considered "commodity pools" and will need to either register with the CFTC or comply with the Commodity Pool Operator *de minimis* exemption.

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[10] *See* Press Release, SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds (Sept. 29, 2017); *available at* https://www.sec.gov/news/press-release/2017-185-0.

[11] *See* Press Release, Executives Settle ICO Scam Charges (Dec. 12, 2018); available at https://www.sec.gov/news/press-release/2018-280.

[12] *See In the Matter of Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan* (Sept. 17, 2015).

(b) While funds that are currently only holding digital assets but are not trading any CFTC-regulated instruments would not be commodity pools, those fund managers should also consider whether they need the capability to hedge this exposure with derivatives.

(c) Firms that offer to buy and sell Bitcoin derivatives will be considered "futures exchanges," which would require such firms to be registered with the CFTC as derivatives contract markets.

G. Compliance Policies

1. Personal trading.

2. MNPI issues.

3. Rule 144 holding periods.

4. Valuation.

IV. Tax Aspects

A. Characterization of Virtual Currency for U.S. Federal Tax Purposes

1. The Internal Revenue Service ("Service") provided guidance in Notice 2014-21 that virtual currency (e.g., Bitcoin, Ethereum, Litecoin, etc.) generally is treated as property for U.S. federal tax purposes and is not considered a "currency" that would trigger foreign currency gain or loss under Section 988 of the Code. As property, the character of gain or loss from the sale or exchange of virtual currency generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer. Accordingly, taxpayers who hold virtual currency as a capital asset should recognize capital gain or loss on the disposition of such virtual currency.

2. Unlike the CFTC, the Service has not clarified whether or not virtual currencies are characterized as commodities for U.S. federal tax purposes.

3. Some virtual currencies, such as Bitcoin, function as media of exchange. Others, however, exhibit characteristics that resemble securities or otherwise function as other than a medium of exchange. The tax treatment of such virtual currencies or other such digital assets may be characterized as equity interests in an underlying constructive joint venture or association, in which case owners of such digital assets may be taxable on their share of any items of income deemed allocated or deemed distributed from the constructive joint venture or association to them.

B. Considerations for Investment Funds Investing in Virtual Currencies

1. *Publicly Traded Partnerships.* Investment funds operating as partnerships for U.S. federal tax purposes generally operate in a manner so as to avoid being treated as "publicly traded partnerships" ("PTPs") taxable as corporations within the meaning of Section 7704 of the Code. Many investment funds (especially long-short equity funds) rely on the "qualifying income" exception for PTP purposes. The characterization of virtual currency as a "commodity," or otherwise, could affect an investment fund's ability to satisfy the qualifying income exception. Alternatively, virtual currency investment funds that offer frequent liquidity to their investors could restrict their investor base to fewer than 100 partners in order to satisfy the "100-partner" PTP safe harbor.

2. *Mark-to-Market Elections.* The mark-to-market election under Section 475(f) of the Code could apply to virtual currencies, if virtual currencies are characterized as "securities" or "commodities."

3. *Effectively Connected Income and the Trading Safe Harbors.* Investment funds generally rely on Section 864(b)(2) safe harbors to avoid treating income and gain from trading in securities and commodities as effectively connected with a U.S. trade or business. The Service has yet to provide guidance on whether or not virtual currencies constitute securities or commodities. Furthermore, even if virtual currencies constitute commodities, not all commodities fall under the commodities safe harbor — only those that are "of a kind customarily dealt in on an organized commodity exchange" and even then, only if the transactions effected in such commodities are "of a kind customarily consummated at such place." The Service currently does not offer guidance on these aspects of the commodities trading safe harbor.

4. *Virtual Currencies and ICOs as Deemed Equity Interests.* Virtual currencies that exhibit characteristics that resemble securities or otherwise function as other than a medium of exchange, such as certain ICOs, may be characterized by the Service as equity interests in an underlying constructive joint venture or association for U.S. federal tax purposes. An investment in such virtual currencies or ICOs that would be treated as constructive joint ventures or associations for U.S. federal tax purposes may cause non-U.S. investors or tax-exempt U.S. investors to earn effectively connected income or unrelated business taxable income, respectively. Furthermore, if the constructive joint venture or association were regarded as a foreign corporation, U.S. investors may be subject to certain anti-deferral rules (e.g., PFIC, CFC, etc.) with respect to any income or deemed income of the constructive joint venture or association.

V. Money Transmission

A. Fund managers that manage funds that invest in digital assets directly, or invest in companies that issue, sell or exchange digital assets, should be aware of the potential applicability of state and federal money transmission laws.

B. State Regulation

1. Nearly all U.S. states regulate money transmission, typically defined as: receipt of money or monetary value for transmission; sale or issuance of payment instruments; or sale or issuance of stored value that can be redeemed for cash or at multiple, unaffiliated merchants (commonly referred to as "open-loop" stored value). Many states also regulate currency exchange under money transmission regulations.

2. A small but increasing minority of states, by statute or guidance, have interpreted monetary value, "money or its equivalent" or similar terms to include certain digital assets, including virtual currency, that function as a medium of exchange. Accordingly, transmitting digital assets to a third party, issuing digital assets or storing digital assets for others, may require a state money transmission license.

3. For example, the Alabama Monetary Transmission Act, effective August 2017, defines "monetary value" as "[a] medium of exchange, including virtual or fiat currencies, whether or not redeemable in money." The act requires persons engaging in the business of receiving monetary value, including virtual currencies, to obtain a money transmitter license.

4. The New York State Department of Financial Services has also adopted regulations requiring a license (commonly known as a "BitLicense") for any person engaged in virtual currency business activity, which is defined as:

(a) Receiving virtual currency for transmission or transmitting virtual currency (subject to an exception for transactions undertaken for non-financial purposes and not involving a transfer of more than a nominal amount of virtual currency);

(b) Storing, holding or maintaining custody or control of virtual currency on behalf of others;

(c) Buying and selling virtual currency as a customer business;

(d) Performing exchange services as a customer business; or

(e) Controlling, administering or issuing a virtual currency.

5. Although the Texas Department of Banking has concluded that cryptocurrency is not “money or monetary value” because it is not currency and does not represent a claim that can be converted into currency, it has advised that *stablecoins* that are pegged to sovereign currency may be considered a claim that can be converted into currency and thus fall within the definition of money or monetary value under the [Texas Money Transmitter Act]. *See* Texas Supervisory Memo – 1037 (Jan. 2, 2019).

6. Applicable state laws do, however, contain certain exemptions:

   (a) Banks (generally exempt in all states);

   (b) Limited Purpose Trust Companies (generally exempt in many states); and

   (c) Registered broker-dealers (expressly exempt in certain states, to the extent of its operation as such a broker-dealer; registered broker-dealers may be exempt in many other states as a matter of policy; however, not exempt under NY BitLicense if engaging in virtual currency business activity).

C. Federal Regulation

1. On March 18, 2013, the Financial Crimes Enforcement Network (“FinCEN”) issued guidance entitled “Application of FinCEN’s Regulations to Persons Administering, Exchanging, or Using Virtual Currencies,” clarifying how the Bank Secrecy Act implementing regulations (“BSA Regulations”) apply to “users,” “administrators” and “exchangers” of “convertible virtual currency,” which is defined as virtual currency that “has either an equivalent value in real currency, or acts as a substitute for real currency.”

2. The guidance provides that an “administrator” or “exchanger” that (i) accepts and transmits a convertible virtual currency or (ii) buys or sells convertible virtual currency for any reason is a money transmitter and therefore a “money services business” (“MSB”) under the BSA Regulations, subject to any applicable limitation or exemption.

   (a) An “administrator” of virtual currency under the guidance is defined as “a person engaged as a business in issuing (putting into circulation) a virtual currency, and who has the authority to redeem (to withdraw from circulation) such virtual currency.”

   (b) An “exchanger” of virtual currency is defined as “a person engaged as a business in the exchange of virtual currency for real currency, funds or other virtual currency.”

   (c) The guidance also provides that “users” of convertible virtual currency are not considered MSBs under the BSA Regulations.

3. The BSA Regulations require all MSBs to establish and maintain an effective written anti-money laundering program reasonably designed to prevent the MSB from being used to facilitate money laundering and the financing of terrorist activities. Accordingly, any fund manager or fund engaged in activities involving convertible virtual currencies should assess the impact of the guidance on their obligations under the BSA Regulations.

D. Evaluation of the application of state and federal money transmission laws to activities involving digital assets, such as virtual currencies, and to the persons or companies, issuing, selling or exchanging such assets is an important component of investor diligence and as part of the fund's comprehensive compliance program. Fund managers should conduct diligence on all parties involved in the issuance, sale or exchange of digital assets (including digital assets created via ICOs) to ensure that all parties have the appropriate licenses/registrations. In addition, each fund engaging in activities involving digital assets will need to evaluate its own activities to ensure that the fund does not engage in activities that require a money transmission license/registration. In this context, important questions to consider are whether the fund is:

1. Holding digital assets (that function as a medium of exchange or convertible virtual currency) on behalf of others, or for its own account;

2. Performing exchange services for investors, or if it is only accepting investments in real currency for interests in the fund and redeeming those interests for the same type of real currency; or

3. Buying and selling digital assets (that function as a medium of exchange or convertible virtual currency) as a business, or solely as an investor.

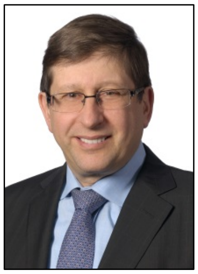
E. Fund managers should also be aware that an investment of the fund in any company that is engaging in, or proposes to engage in, a licensable activity, that aggregates to ownership interest in such a company of 10 percent or more, may require the fund to register as a "control person" under state money transmission laws. Such registration may require the provision of background, biographical and/or financial information to states. Ownership may be by shares or digital assets representing an ownership interest.

F. Internal Regulation

1. Increased regulation and cooperation among nations.

2. The Financial Action Task Force ("FATF"), an inter-governmental body established in 1989 to set standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the international financial system, updated its policies regarding digital currencies and firms involved in cryptocurrency-related activities in October 2019.

Tax Considerations for 2019



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Philippe focuses his practice on the tax aspects of investment funds, mergers and acquisitions, international transactions, real estate transactions and financial instruments. He has advised on many major transactions involving sales or spinoffs of investment fund managers, including Senator Investment Group LP's sale of a minority stake to The Blackstone Group LP, Caxton Associates LP's sale of a minority interest to the Petershill II Fund affiliated with the Goldman Sachs Group Inc., and Credit Suisse's sale of Strategic Partners to The Blackstone Group LP. Philippe advises on the tax aspects of securitizations, including his recent representation of affiliates of Fortress Investment Group LLC and affiliates of Highbridge Capital Management in the securitization of their leveraged facilities. He has also advised multiple alternative asset managers on the formation and structuring of funds, including Engineers Gate with the launch of a quant fund, Clearfield Capital with the launch of a hedge fund, Warlander Asset Management LP with the launch of a credit fund, and D1 Capital Partners in the formation of a new fund; Gunnar Overstrom, formerly a partner at Maverick Capital Ltd., in the formation of Three Corner Global Investors LP; Junto Capital Management LP on the launch of Junto Capital Partners LP and Junto Offshore Fund Ltd.; Trian Fund Management LP on all aspects of launching new co-investment hedge funds; Sachem Head Capital Management LP with the launch of hedge funds and the establishment of long/short equity funds; and Capstone Investment Advisors LLC, JANA Partners, MKP Capital Management LLC and Scopia Fund Management LLC in their respective sales of a passive minority interest to Neuberger Berman Group-managed private equity fund Dyal Capital Partners. Philippe's recent real estate transactions include advising the Related/Oxford joint venture developing Hudson Yards on closing nearly $1.4 billion in equity investments and debt financing for the center's first tower, and advising Oxford in over $5 billion in financing of three office towers, a retail center and a residential building for the project and advising Arel Capital in a number of equity investments, including operating multi-family properties with significant retail components and ground-up development projects for modern condominium buildings in Manhattan and Brooklyn.

Philippe earned his LL.M. in taxation and his J.D. from New York University School of Law. While pursuing his J.D., he was the recipient of a Gruss Fellowship and served on the staff of the *Journal of International Law and Politics*. He obtained his B.S., *summa cum laude*, from Adelphi University. *Chambers USA*, *The Legal 500 US*, *New York Super Lawyers* and *Tax Directors Handbook* have recognized Philippe as a leading lawyer. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and also speaks at prominent industry events, including PLI's Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances Conferences in New York, Chicago and San Francisco. He also recently presented on topics including FATCA, customized solutions for investors, and management company structuring and operations.

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

Nick is a Chartered Tax Adviser and associate of the Chartered Institute of Taxation, the leading body in the U.K. for taxation professionals dealing with all aspects of taxation. He is also a member of the Tax Committee of the Alternative Investment Management Association. Nick has written and spoken about U.K., EU and international tax issues for various publications and engagements, particularly in regards to how changes in tax codes and regulations affect hedge funds and their U.K. managers. He is listed in *The Legal 500 UK* as a leader in his field. Nick graduated from Corpus Christi College at the University of Oxford and completed his legal training at the College of Law in Guildford, England.

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David concentrates his practice on tax issues related to the formation and operation of onshore and offshore investment funds and their investment managers, as well as tax issues prospective investors face with such investments; tax considerations related to employee and executive compensation, including deferred compensation programs; and partnership taxation.

Recognized by *The Legal 500 US* as a leading tax lawyer, David has spoken on tax issues related to running investment management firms and their funds, as well as hedge fund tax considerations and compensation structures. He contributed to “Hedge Fund Employee Compensation,” published by *Practical Law*, and *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). David has presented on the topic of “Hedge Funds” at PLI’s Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances Conference for numerous years. He is a member of the American Bar Association and the New York State Bar Association. David holds an LL.M. in taxation and a J.D., *magna cum laude*, from New York University School of Law, where he was a Florence Allen Scholar and Order of the Coif, and an A.B., *cum laude*, from Harvard University.

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Christine focuses on the tax aspects of investment funds, private equity funds, joint ventures and registered investment companies. She provides advice with respect to structuring and formation of such entities as well as ongoing operations. Her practice also includes providing advice to lenders and borrowers in financing transactions and advising on transactions involving sales of investment fund managers.

A rising star in the industry, Christine is a contributor to *Private Equity Funds: Formation and Operation* (Practising Law Institute) and co-authored "Year-End FATCA Action Items for Investment Funds That Are Sponsored Entities or Have Investors that Are Sponsored Entities," an *SRZ Alert*. She received her J.D. from Cornell Law School and her B.S. from Cornell University.

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Shlomo has been recognized as a leader in his field by *Chambers USA*, *The Best Lawyers in America*, *The Legal 500 US*, *New York Super Lawyers* and the *Tax Directors Handbook*. He is a member of the Tax Section of the New York State Bar Association and regularly speaks at industry conferences and events. In addition, he has published on a range of topics, including FATCA provisions, FIRPTA and REIT rules, and compliance requirements for hedge funds. Most recently, he co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). Shlomo holds a J.D. from Hofstra University School of Law, where he was articles editor of the *Hofstra Law Review*.

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Elie focuses his practice on the tax aspects of onshore and offshore investment funds, private equity partnerships, real estate investment trusts (REITs) and real estate joint ventures. He represents investment managers in connection with the formation of funds and their ongoing operations, as well as sales of their investment management businesses. He also represents real estate sponsors in connection with operations, restructurings and workouts.

Elie has spoken on issues and topics of interest to the private investment funds industry. Most recently, he discussed “Regulatory and Tax” at SRZ’s 6th Annual Private Equity Fund Conference and “Tax Considerations for 2018” at SRZ’s 27th Annual Private Investment Funds Seminar. A published author, Elie recently contributed to the “United States Fundraising” chapter in *The Private Equity Review*, published by Law Business Research, and he co-authored “PATH Act: Recently Enacted Legislation Modifies the FIRPTA and REIT Rules,” an *SRZ Alert*. Elie earned his LL.M. in taxation from New York University School of Law, where he received the *Harry J. Rudick Memorial Award* for distinction in the Graduate Tax Program, his J.D. from Osgoode Hall Law School and his B.A., with distinction, from York University.

Tax Considerations for 2019

I. Partnership Audits

A. 2018 was the first taxable year subject to the new partnership audit tax regime created by the Bipartisan Budget Act of 2015. Under the new regime, tax adjustments and collections are made at the partnership level rather than at the partner level, unless the partnership elects to pass adjustments through to its partners.

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

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

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

2. Partnerships with partners that are other partnerships, trusts, IRAs, pension plans, disregarded entities or nominees cannot elect out.

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

4. The election must disclose the name, tax classification and taxpayer ID of each partner of the partnership, including each S corporation shareholder in the case of an S corporation partner.

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

1. The partnership representative does not need to be a partner but must have a substantial presence in the United States. This requirement is intended to ensure that the partnership representative will be available to the Internal Revenue Service ("IRS") in the United States when the IRS seeks to communicate or meet with the representative.

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

3. In the absence of a designation of a partnership representative by the partnership, the IRS has the authority to select any person as the partnership representative for a partnership.

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

1. An imputed underpayment is determined by netting all adjustments of similar items of income, gain, loss or deduction at the partnership level and multiplying by the highest tax rate for individuals or corporations for the year to which the tax audit rules relate (the "reviewed year").

2. If an adjustment involves reallocation of an item to another partner, only the tax increase, not the net adjustment, enters into the calculation of the imputed underpayment under the statute. This could cause the same income to be taxed twice.

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

(a) An imputed underpayment may be reduced to the extent that it is allocable to a partner that is a "tax-exempt entity" that would not owe tax on the adjusted income (e.g., the U.S. government, a tax-exempt U.S. organization, a foreign person or entity, etc.), a partner that is a C corporation (in the case of ordinary income) or an individual with capital gains or qualified dividends. In the case of a modification requested with respect to an indirect partner, the IRS may require information related to the pass-through partner through which the indirect partner holds its interest.

(b) If any partner files an amended return for the reviewed year, taking into account its allocable share of the adjustments and pays tax thereon, that payment can offset the partnership's imputed underpayment. Modification is allowed to the extent that the amended returns are filed and any necessary payments are made within the 270-day time period.

F. As an alternative to the partnership paying the imputed underpayment, the partnership may elect, under Section 6226 of the Code, within 45 days following the mailing by the IRS of the notice of final partnership adjustment to pass the adjustment through to its partners who were partners for the reviewed year.

1. The adjustment is passed through to the partners by issuing a statement to the reviewed year partners (or, in certain situations, indirect U.S. owners of a foreign partner that is a "controlled foreign corporation" or a "passive foreign investment company") with their share of adjustments. The reviewed year partners are required to take the adjustments into account on their returns in the year when the adjustment takes place (the "adjustment year") (rather than amend their returns for the reviewed year).

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

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

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

5. A partnership that passes the adjustment through to its non-U.S. partners may still be required to withhold under Chapters 3 and 4 on any adjustment that would have been subject to withholding in the reviewed year.

6. The Section 6226 election can be effected through partnership tiers, whereby each partnership in the chain generally may choose to either pay the tax directly or push it out to its own partners (e.g., from a master fund to its feeder fund, and then to the feeder fund's investors). Each upper-tier partnership would need to make such choice by the extended due date for the tax return for the adjustment year of the partnership that was audited.

G. A partnership can file an administrative adjustment request in the amount of one or more items of income, gain, loss, deduction or credit of the partnership for any partnership taxable year. A partnership has three years from the later of the filing of the partnership return or the due date of the partnership return (excluding extensions) to file an administrative adjustment for that taxable year. However, a partnership may not file an administrative adjustment for a partnership taxable year after the IRS has mailed notice of an administrative proceeding with respect to such taxable year.

1. Adjustments that result in underpayments will cause tax to be due at the partnership level in the year in which the administrative adjustment is filed, as described above, except that certain provisions related to modifications of such underpayment will not apply. In the alternative, such tax may be passed through to the partners under the election discussed above, except that the additional interest does not apply.

2. Adjustments that result in a refund must be passed through to the partners that were partners during the year to which the adjustment relates.

II. Dividend Equivalent Payments: Section 871(m)

A. Introduction

1. In 2010, Section 871(m) of the Code was enacted to treat as U.S. source dividends for U.S. withholding tax purposes:
   (a) "Dividend equivalent payments" on "specified notional principal contracts" that are based on a four-factor statutory definition; and
   (b) Substitute dividend payments on securities lending or sale-repurchase transactions.
2. On Sept. 17, 2015, the Treasury issued final and temporary regulations (the "2015 Final Regulations" and "2015 Temporary Regulations," respectively, and, together, the "2015 Regulations") implementing Section 871(m) of the Code.
3. On Dec. 2, 2016, the IRS released Notice 2016-76, which indicated the Treasury's intent to phase in the applicability of the 2015 Regulations differently for transactions entered into each of: (i) calendar year 2017; and (ii) calendar year 2018 and subsequent calendar years.
4. On Jan. 19, 2017, the Treasury issued final and temporary regulations (the "Final Regulations" and "Temporary Regulations," respectively, and, together, the "2017 Regulations") that adopted, with some modifications, the 2015 Regulations.
5. On Aug. 4, 2017, the IRS released Notice 2017-42, which further extends the phase-in and delays the effective dates of certain provisions of the 2017 Regulations.
6. On Sept. 20, 2018, the IRS released Notice 2018-72, which further extends the phase-in and delays the effective dates of certain provisions of the 2017 Regulations.

B. Statutory Provision

1. Under Section 871(m) of the Code, a notional principal contract ("NPC") (generally, an equity swap) is a "Specified NPC" subject to withholding under Section 871(m) if the NPC provides for one or more amounts that may be contingent upon, or determined by reference to, U.S.-source dividends and at least one of the following four factors is present:
   (a) In connection with entering into the NPC, a long party to the NPC transfers the underlying security to a short party to the NPC (known as "crossing in");
   (b) In connection with the termination of the NPC, a short party to the NPC transfers the underlying security to a long party to the NPC (known as "crossing out");
   (c) The underlying security is not readily tradable on an established securities market; or
   (d) The underlying security is posted as collateral by a short party to the NPC with a long party to the NPC.
2. Section 871(m) of the Code authorizes the Treasury to specify other transactions as being "Specified NPCs" or otherwise substantially similar to a transaction yielding a dividend equivalent payment. The 2017 Regulations, as modified by IRS Notice 2018-72, expand the universe of transactions subject to Section 871(m) of the Code, if such transactions are entered into (or significantly modified) after 2016 or 2020, as applicable.

C. The 2017 Regulations

1. Transactions that Can Give Rise to "Dividend Equivalent Payments" ("Section 871(m) Transactions")
   (a) A "dividend equivalent" is any of:
      (i) A substitute dividend that references a U.S.-source dividend made pursuant to a securities lending or sale-repurchase transaction;
      (ii) A specified NPC;

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

(iv) Another substantially similar payment.

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

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

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

2. Miscellaneous Issues Regarding Dividend Equivalent Amounts

(a) Any gross amount that references the payment of a U.S.-source dividend, whether actual or estimated, explicit or implicit, is treated as a dividend equivalent to the extent of the amount determined under the 2017 Regulations.

For example, the 2017 Final Regulations treat a price return swap as a transaction that provides for the payment of a dividend equivalent because the anticipated dividend payments are presumed to be taken into account in determining the other terms of the NPC.

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

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

3. The "Delta" and "Substantial Equivalence" Tests

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

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

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

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

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

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

4. Determining Delta/Substantial Equivalence

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

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

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

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

5. Time of Withholding

   Withholding is required at the later of:

   (a) The time the amount of the dividend equivalent is determined, which is the later of: (i) the day prior to the ex-dividend date; and (ii) the record date; and

   (b) The time a payment occurs. A payment is deemed to occur:

      (i) If money or other property is paid to the long party, which includes the economic benefit to the long party of netted payments within the contract that would otherwise have been made at such time; or

      (ii) The long party sells or disposes of the contract, including by virtue of termination of the contract, lapse of the contract, offsets or otherwise.

6. Baskets, Indices and Miscellaneous Situations

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

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

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

      (ii) The 2017 Final Regulations do not provide for the netting of a taxpayer's long and short positions, though the preamble to the 2015 Final Regulations leaves open the possibility of more expansive rules in the future.

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

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

This affects swaps on "master limited partnerships." Fund managers should have upfront communications with their brokers to understand how they intend to apply this set of rules, including whether they may be over-withholding on a swap if they cannot get sufficient comfort that the particular master limited partnership referenced under the swap is not a covered partnership.

(d) Indices. Transactions that reference a qualified index are generally excepted from Section 871(m). The qualified index exception is designed to provide a safe harbor for widely used passive indices that reference a diversified portfolio of long positions, and is not intended to apply to any index that: (i) is customized or reflects a trading strategy; (ii) is not generally available (i.e., the exception does not apply to over-the-counter transactions); or (iii) targets dividends. Entering into a short position that references component security of a qualified index may invalidate a qualified index Section 871(m) transaction. There is a "de minimis" safe harbor for a short position that reduces the exposure to referenced components securities of a qualified index by five percent or less of the value of the long positions in component securities in the qualified index.

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

D. Notices 2016-76, 2017-42 and 2018-72

1. Transactions Entered into During Calendar Years 2017-2020

(a) "Delta One" Transactions

(i) The term "delta one" was not defined in any of the notices. However, the language of the notices supports that only simple contracts can be "delta one" transactions.

(ii) A transaction is a Section 871(m) Transaction if it has a delta of 1.0 on the date of issuance.

(b) Combined transactions (as described above) that have a delta of 1.0 are within the scope of the Notices. However, a broker acting as a short party will only need to combine over-the-counter transactions that are priced, marketed or sold in connection with each other. Long parties would still be responsible for the substantive tax for transactions that are combined under the 2017 Regulations, even if the short party is not responsible for withholding any tax.

(c) The IRS will apply a good faith standard to determine whether long and/or short parties applied the combination, withholding and other rules during 2017-2020.

(d) "Qualified derivatives dealers" ("QDDs") will not be subject to tax on dividends and dividend equivalents received in 2017-2020 in their equity derivatives dealer capacity or withholding on dividends (including deemed dividends). QDDs must use good faith efforts to comply with the 2017 Regulations through the end of 2020.

2. Transactions Entered into After 2020

(a) All other transactions entered into after 2020 (or significantly modified after 2020) that are considered Section 871(m) Transactions under the 2017 Regulations will be subject to the withholding and substantive tax provisions.

(b) The IRS will apply a good faith standard for actions taken by taxpayers during 2021 for Section 871(m) Transactions entered into during 2021 that are not "delta one" transactions, including whether taxpayers are properly applying the "substantial equivalence" test.

E. Possible Further Changes

1. A Treasury official announced publicly in November 2017 that the government is considering whether or not to implement the 2017 Regulations for transactions that are "non-delta one" transactions.

2. The Treasury and the IRS separately are evaluating the 2017 Regulations to "consider possible agency actions that may reduce unnecessary burdens imposed by the regulations" in accordance with Executive Order 13777.

III. Cryptocurrency

A. Characterization of Virtual Currency for U.S. Federal Tax Purposes

1. The IRS provided guidance in Notice 2014-21 that virtual currency (e.g., Bitcoin, Ether, Litecoin, Ripple, etc.) generally is treated as property for U.S. federal tax purposes and is not considered a "currency" that would trigger foreign currency gain or loss under Section 988 of the Code. As property, the character of gain or loss from the sale or exchange of virtual currency generally depends on whether or not the virtual currency is a capital asset in the hands of the taxpayer. Accordingly, taxpayers who hold virtual currency as a capital asset should recognize capital gain or loss on the disposition of such virtual currency.

2. Cash-settled Bitcoin futures currently trade on the CBoE and CME, and it has been announced that Ether futures and physically settled Bitcoin futures are also expected to trade on these exchanges. As a result, these futures contracts can qualify as "regulated futures contracts" and are subject to the mark-to-market rules under Section 1256 of the Code.

3. Despite the fact that the CFTC has decided to treat virtual currencies as commodities for regulatory purposes, the IRS has not clarified whether or not some or all virtual currencies can be characterized as commodities for any or all U.S. federal tax purposes.

B. Considerations for Investment Funds Investing in Virtual Currencies

1. *Publicly Traded Partnership Status.* The uncertainty around the tax characterization of virtual currency (e.g., whether or not they are commodities for these purposes) can present challenges to investment funds that want to rely on "qualifying income" within the meaning of Section 7704(c) of the Code in order to avoid being taxed as a corporation under the publicly traded partnership ("PTP") rules. Until greater clarity on the treatment of virtual currency for PTP purposes is offered, investment funds should either rely on the "100 partner" safe harbor or limit investors' liquidity to avoid PTP status.

2. *Wash Sales, Straddles, Short Sales and Mark-to-Market Elections.* The applicability of certain rules relating to wash sales, straddles, short sales and Section 475(f) mark-to-market elections is uncertain as applied to virtual currency. Some of these rules only apply to "stock and securities" or "commodities," while others apply to "actively traded personal property."

3. *Partnership Tax Allocations.* Many investment funds rely on "aggregation" for purposes of making "reverse Section 704(c) allocations" as permitted for "securities partnerships" under Treasury Regulations Section 1.704-3(e)(3). An investment fund is a securities partnership for these purposes if at least 90 percent of the investment fund's non-cash assets are considered "qualified financial assets" or personal property that is "actively traded" as determined for purposes of the straddle rules. Clarity from the IRS with respect to the applicability of the straddle rules to virtual currency should help determine if an investment fund that invests in virtual currency can use aggregation.

4. *Effectively Connected Income and the Trading Safe Harbors.* Non-U.S. investment funds generally rely on the Section 864(b)(2) safe harbors to avoid treating income and gain from trading in securities and commodities as effectively connected with a U.S. trade or business. Absent guidance from the IRS, it is unclear whether either of these safe harbors could apply to virtual currency. For purposes of the "securities" trading safe harbor, the Treasury Regulations define "securities" as either corporate stock or evidence of indebtedness. For purposes of the "commodities" trading safe harbor, applicable guidance provides that the term commodities should be interpreted in its ordinary financial sense, thereby creating greater flexibility that virtual currency might be able to be considered a commodity for these purposes. However, the safe harbor only applies to trading that involves both (i) commodities that are "of a kind customarily dealt in on an organized commodity exchange" and (ii) transactions that are "of a kind customarily consummated at such place." While not free from doubt, it is helpful for purposes of the safe harbor analysis that Bitcoin futures (and eventually Ether futures) are actively traded on organized commodity exchanges in transactions customarily effected on those exchanges. However, the ability to extrapolate from Bitcoin futures to other transactions in virtual currencies that are not traded on the CME or CBoE remains unclear.

5. *Virtual Currencies and ICOs as Deemed Equity Interests.* Virtual currencies that exhibit characteristics that resemble securities or otherwise function as other than a medium of exchange, such as certain Initial Coin Offerings ("ICOs"), may be characterized by the IRS as equity interests in an underlying constructive joint venture or association for U.S. federal tax purposes. An investment in such virtual currencies or ICOs that would be treated as constructive joint ventures or associations for U.S. federal tax purposes may cause non-U.S. investors or tax-exempt U.S. investors to earn effectively connected income or unrelated business taxable income, respectively. Even if not considered effectively connected income, if determined to be U.S. source, non-U.S. investors may be subject to FDAP withholding on distributions received (or deemed received) from such virtual currencies. Furthermore, if the constructive joint venture or association were regarded as a foreign corporation, U.S. investors may be subject to certain anti-deferral rules (e.g., PFIC, CFC, etc.) with respect to any income or deemed income of the constructive joint venture or association.

IV. Tax Reform

A. Carried Interest/Incentive Allocation

1. Federal Changes to Taxation of Carried Interest/Incentive Allocation

(a) If an "Applicable Partnership Interest" is held by a taxpayer, then the taxpayer's long-term capital gain with respect to such interest necessitates a holding period exceeding three years.

(b) An "Applicable Partnership Interest" is a partnership interest transferred to a taxpayer in connection with the performance of substantial services by the taxpayer (or a related person) in an "Applicable Trade or Business."

(c) An "Applicable Trade or Business" is an activity conducted on a regular, continuous and substantial basis which consists of: (i) raising or returning capital; and (ii) either investing, disposing, identifying or developing "Specified Assets."

(d) "Specified Assets" are securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to the foregoing, and an interest in a partnership to the extent of the proportionate interest in any of the foregoing.

(e) An Applicable Partnership Interest does not include: (i) an interest held by a corporation; or (ii) a capital interest which provides the taxpayer with a right to share in partnership capital commensurate with (x) the amount of capital contributed (determined at the time of receipt of such interest) or (y) the value of such interest subject to tax under Section 83 upon the receipt or vesting of such interest.

(f) Under a technical reading of Section 1061 of the Code, not only is carried interest subject to the three-year holding period requirement, but any future earnings on carried interest may also need to meet the three-year requirement in order to qualify for the long-term capital gains tax rate.

2. State Proposals

(a) Income from the Provision of Personal Services

(i) Certain states, including New York and New Jersey, have proposals to treat income from the provision of "investment management services" as generating state-sourced income that is taxable in such states. This would pick up carried interest, taxing it the same way management fees are taxed.

(ii) New Jersey's legislature approved A3088, which includes this concept, on July 1, 2018, and the New Jersey legislation was signed into law by Governor Murphy.

a. Caveat: The provision is not operative unless New York, Connecticut and Massachusetts enact legislation with a provision having an identical effect.

b. Governor Cuomo's proposed New York State budget for the 2019-2020 fiscal year, released on Jan. 15, 2019, includes changes that are substantially similar to New Jersey's statute, except that it also requires Pennsylvania to enact legislation with substantially the same effect, along with New Jersey, Connecticut and Massachusetts.

(iii) State tax credits may not be available for residents of states that do not view carried interest as generating service-based income.

(iv) For states with market-based sourcing, such as California, such a rule could have far-reaching consequences.

(b) Soak-up Tax

(i) Various states, including New York, New Jersey, Connecticut, Massachusetts, California and Illinois, have introduced proposals to subject carried interest income to an additional tax ranging from 17 percent to 24 percent, which, at a minimum, collects the difference between the federal long-term and short-term capital gains rates.

(ii) The proposals largely ignore the actual tax character of the underlying income, meaning that a short term capital gain or ordinary income item would also generate this additional tax.

(iii) New Jersey's legislature approved A3088, which includes the additional 17 percent tax, on July 1, 2018, and the New Jersey legislation was signed into law by Governor Murphy.

a. As drafted, the provision may also pick up incentive fees and management fees, even though such items are already subject to full federal and state taxation.

b. Caveat: The provision is not operative unless New York, Connecticut and Massachusetts enact legislation having an identical effect.

c. Governor Cuomo's proposed New York State budget for the 2019-2020 fiscal year, released on Jan. 15, 2019, includes a similar "carried interest fairness fee," but it also requires Pennsylvania to enact legislation with substantially the same effect, along with New Jersey, Connecticut and Massachusetts. A similar proposal introduced into the New York State Senate on Jan. 9, 2019 does not require Pennsylvania to enact similar rules and uses a 19 percent rate rather than 17 percent.

(iv) The California and Illinois proposals are not contingent on actions by other states.

3. Switching from an Incentive Allocation to an Incentive Fee

(a) Fund Tax Considerations

(i) Offshore fund generally is indifferent and may benefit in an intermediate fund structure if the intermediate fund entity is eliminated as a result.

(ii) Onshore fund appears to have only downside risk. If the fund is an "investor" or has investments that are treated as investment activities, rather than trading activities, non-corporate taxable investors would not be able to deduct the incentive fee.

(b) Benefits to Manager

(i) If the manager is a limited partnership, the manager's profits allocations to its active limited partners are currently not subject to the 3.8-percent Medicare tax or the 3.8-percent tax on net investment income (i.e., Obamacare tax). However, there is increased audit activity regarding the applicability of the Medicare tax on profit allocations to limited partners. An incentive allocation remains subject to the 3.8-percent net investment income tax.

(ii) Cash method managers may get a year of deferral since the fee is typically paid in the following January, while allocation reflects income realized as of Dec. 31.

(iii) If the manager earns carry based on annual outperformance of an index, there should be no tax-based limitations on paying the fee as it is earned.

(iv) For states with an unincorporated business tax, a fee might help with state and local tax deductions.

(c) Potential Problems for the Manager

(i) Side pockets and multi-year fees are generally subject to Section 457A of the Code, including potential additional taxes of 20 percent and premium interest, whereas incentive allocations are generally not subject to those rules.

(ii) Long-term capital gains treatment still exists for "qualified dividends" and 60 percent of the mark-to-market income on "Section 1256 contracts."

(iii) Fees are generally subject to state and local taxes, if any, where the manager is based (e.g., the New York City Unincorporated Business Tax).

(iv) For investments held for longer terms, the fee may accelerate taxation.

(v) In the case of an offshore fund, U.S. withholding tax may reduce the profits on which the incentive fee is based, whereas such tax may be recoverable by the manager earning an incentive allocation.

B. Sale of Partnership Interests by Foreign Partners

1. The IRS held in a 1991 Revenue Ruling[1] that gain on the sale of a partnership interest by a foreign partner was subject to tax in the U.S. to the extent of such partner's share of unrealized net gain in any "effectively connected income" assets held by the partnership.

2. In 2017, the Tax Court held in *Grecian Magnesite*[2] that a foreign partner was not subject to U.S. federal income tax on gain from the sale of a partnership interest in a partnership conducting business in the U.S., except for gain attributable to the partnership's United States real property interests. The IRS has appealed the decision of the Tax Court.

3. Section 864(c)(8) of the Code effectively reverses *Grecian Magnesite* by providing that gain or loss realized by a foreign partner from the sale or exchange of a partnership interest occurring on or after

[1] Rev. Rul. 91-32

[2] *Grecian Magnesite Mining* v. *Commissioner*, 149 T.C. No. 3 (July 13, 2017).

Nov. 27, 2017 is treated as effectively connected with a U.S. trade or business ("ECI") to the extent that the seller of such interest would have had effectively connected gain or loss had the partnership sold all of its assets for their fair market value as of the date of the sale or exchange.

4. Under Proposed Regulations issued on Dec. 27, 2018, Treasury provided that a gain realized by the transfer of partnership interests pursuant to a nonrecognition transaction will not generate ECI under this new rule. However, Treasury has stated that it is continuing to consider whether gain should be treated as recognized for certain nonrecognition transactions that reduce the scope of what may be subsequently taxed.

5. In addition, Code Section 1446(f) requires the buyer of a partnership interest to withhold 10 percent tax on the amount realized by the seller on the sale or exchange of a partnership interest occurring after Dec. 31, 2017 if any portion of the seller's gain on the sale of the interest would be effectively connected income under Code Section 864(c)(8), unless the seller certifies that the seller is non-foreign. In the event the buyer fails to withhold the correct amount of tax, the partnership shall deduct and withhold from distributions to the buyer an amount equal to the tax that the buyer failed to withhold from the seller.

6. The IRS issued Notice 2018-08 on Dec. 29, 2017, which suspends withholding under Code Section 1446(f) on the transfer of any interest in a PTP as defined in Code Section 7704(b) until regulations or other guidance has been issued under Code Section 1446(f).

7. On April 2, 2018, the IRS issued Notice 2018-29, providing interim guidance upon which taxpayers may rely (pending the issuance of regulations or other guidance).

   (a) The Notice outlines methods to certify that Section 1446(f) withholding is not necessary.

      (i) No Section 1446(f) withholding is required if the transferor certifies to its non-foreign status. Transferors may use a modified FIRPTA certificate or a Form W-9 (so long as such Form W-9 contains the name and taxpayer identification number of the transferor and is signed and dated under penalties of perjury). A transferee may rely on a previously obtained Form W-9.

      (ii) No Section 1446(f) withholding is required if the transferor provides a certification that the transfer will not result in gain.

      (iii) No Section 1446(f) withholding is required if, within 30 days prior to a transfer, the transferor provides a certification that transferor's allocable share of "effectively connected taxable income" in each of the three taxable years prior to such transfer was less than 25 percent of its entire distributive share of partnership income in each such year. It should be noted that this exception does not apply when the transferor is disposing of the interest to the partnership (e.g., through a withdrawal).

      (iv) No Section 1446(f) withholding is required if the partnership provides a certification that a hypothetical sale of all of its assets at fair market value would generate less than 25 percent effectively connected gain (including, for these purposes, FIRPTA gain).

   (b) The Notice suspends withholding under Section 1446(f) for nonrecognition transactions if the transferor provides a notification of a nonrecognition transaction to the transferee, signed under penalties of perjury, containing the transferor's name, TIN, address and a brief description of the transfer and an explanation of why gain or loss is not recognized in such transaction.

   (c) The Notice also suspends withholding in situations in which the partnership would be required to withhold under Section 1446(f) due to a transferee's failure to withhold as required.

C. Deductibility Issues

   1. Limitation on Deductibility of Business Interest Expense

(a) Section 163(j) of the Code limits the deduction of business interest expense attributable to a trade or business generally to the sum of the taxpayer's (x) business interest income and (y) 30 percent of adjusted taxable income relating to a trade or business (unreduced by business interest expense and excluding business interest income). For these purposes, business interest expense and business interest income do not include "investment interest" or "investment income," respectively, within the meaning of Section 163(d) of the Code. For tax years beginning before January 2022, adjusted taxable income is generally equivalent to EBITDA. For tax years beginning on or after January 2022, adjusted taxable income is generally equivalent to EBIT.

(b) Generally, Section 163(j) applies after the application of provisions that subject interest expense to disallowance, deferral, capitalization or other limitation, but applies before the operation of the at-risk loss limitations, passive activity loss limitations and the limitation on excess business losses.[3]

(c) Any business interest expense not deductible pursuant to the foregoing limitation is treated as business interest expense of an eligible taxpayer that carries forward to succeeding taxable years, subject to the same limitation.

(d) The limitation on the deductibility of business interest expense does not apply to interest attributable to an electing real property trade or business and certain other businesses. Such activities, including the performance of services as an employee, are excluded from the meaning of trade or business for purposes of Section 163(j). Adjusted taxable income is computed without regard to income not properly allocable to a trade or business.

(e) Recently proposed regulations provide an expansive definition of "interest" and an anti-avoidance rule for amounts associated with the time value of money. This includes guaranteed payments for use of capital, a portion of the payments on swaps with significant nonperiodic payments, substitute interest payments on securities-lending transactions, income from hedging transactions in which the underlying security is an interest-bearing instrument, commitment fees, debt issuance costs and factoring income.

(f) Application to Partnerships.

  (i) In the case of a partnership, the limitation is determined at the partnership level. To the extent the limitation applies at the partnership level to reduce the business interest expense deductible for a year, such excess shall carry forward to succeeding years and, subject to certain limitations, may be deducted by an eligible partner to the extent the partnership has sufficient excess taxable income that was not offset by business interest expense in such year. Any amount not utilized will form part of the investor's adjusted basis in its interest in the partnership only at the time such investor disposes of its interest.

  (ii) Partner-level adjustments (e.g., Section 743 adjustments, remedial allocations, etc.) are not taken into account when determining the partnership's adjusted taxable income. Rather, they are taken into account at the partner level.

  (iii) As described above, 163(j) only applies to business interest expense and not to other types of interest expense such as investment interest expense. Notwithstanding the foregoing, the preamble to the proposed regulations indicates that for partnerships that are engaged in a trade or business, a partner that does not materially participate may be subject to the interest limitations under both Section 163(j) and Section 163(d).

  (iv) Business interest expense of a partnership disallowed as a deduction by the operation of Section 163(j) is allocated to the partners ("disallowed business interest"). Such amounts are carried forward and treated as paid in subsequent years, subject to certain limitations.

[3] Prop. Reg. § 1.163(j)-3(b)(3)

(v) Under recently proposed regulations, a partner may deduct its share of such disallowed business interest in a subsequent year to the extent of (a) its allocated excess business interest income from such partnership and (b) its allocated excess taxable income from such partnership (with the deduction of the amounts otherwise allowable under this clause (ii) capped at 30 percent of the sum of the partner's share of the excess taxable income from the partnership and adjusted taxable income from other sources). However, the Blue Book states that a partner can deduct its share of such disallowed business interest in a subsequent year only to the extent of its allocated excess business interest income and 30 percent of its share of the excess taxable income from the partnership).

(vi) If non-business interest expense of a partnership is allocated to a corporate partner, 163(j) limitations would apply at the corporate partner level because all interest expense and income of a corporation is treated as business interest expense and income.

(vii) Computation of a corporation's E&P does not take into account the application of 163(j). As a result, the limitations under 163(j) may not adversely impact investors in offshore feeder funds under certain circumstances.

(viii) Recently proposed regulations explicitly reserve on the application of 163(j) to tiered partnerships, partnership mergers and divisions and self-charged interest.

(g) Taxpayers may rely on recently proposed regulations before they are finalized, so long as the taxpayer consistently applies all the rules of such proposed regulations.

2. Limitation on Deductibility of Excess Business Losses; Changes to Rules on NOLs

(a) Under Section 461(l) of the Code, which applies to noncorporate taxpayers, if a trade or business activity generates losses in excess of a taxpayer's trade or business income, a maximum of $250,000 ($500,000 if filing a joint return) of the losses can be used to offset investment income for the year.

(i) Any excess business losses that are disallowed by this provision cannot be used to offset tax liability on investment income, but rather will be carried forward as net operating losses ("NOLs") that can be used in subsequent years.

(ii) This provision is not permanent; it applies only for taxable years beginning after Dec. 31, 2017 and before Jan. 1, 2026.

(b) For losses arising in taxable years beginning after Dec. 31, 2017, a deduction for NOLs is limited to 80 percent of taxable income.

(i) Any unused NOLs can be carried forward indefinitely.

(ii) NOLs can no longer be carried back (except for certain losses incurred in a farming trade or business).

(iii) NOLs carried forward from taxable years beginning before Jan. 1, 2018 are not subject to this new 80 percent limitation.

3. Suspension of Miscellaneous Itemized Deductions

Miscellaneous itemized deductions for individuals under Section 67 of the Code are suspended for any taxable year beginning after Dec. 31, 2017, and before Jan. 1, 2026.

4. Reduction in Corporate Tax Rate and Limitation on Deductibility of State and Local Taxes

(a) The corporate income tax rate is reduced from 35 percent to 21 percent for taxable years beginning after Dec. 31, 2017.

(b) For individual taxpayers, the amount of state and local taxes (including income and property taxes) permitted to be deducted is limited to $10,000 (aggregated).

The $10,000 aggregate limitation is scheduled to sunset in 2026; it applies only to tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026.

D. Deduction for Qualified Business Income of Pass-Through Entities

1. A deduction ("QBI Deduction") for taxpayers other than "C" corporations for certain qualified business income ("QBI") and certain other income is equal to the lesser of: (a) 20 percent of the taxpayer's QBI, plus 20 percent of the taxpayer's qualified REIT dividends and qualified PTP income and (b) 20 percent of the taxpayer's taxable income minus net capital gains. In no event may a taxpayer's QBI Deduction exceed 20 percent of the excess of the taxpayer's taxable income over such taxpayer's net capital gain for the relevant taxable year, thus ensuring that the QBI Deduction will not be applied to offset capital gain.

   (a) The QBI Deduction for taxpayers whose taxable income exceeds $157,500 ($315,000 in the case of a joint filer) (the "Threshold Amount") is subject to a wage/basis limitation equal to the greater of the taxpayer's allocable share of (x) 50 percent of the W-2 wages paid with respect to the qualified trade or business ("W-2 Wages") and (y) the sum of (i) 25 percent of W-2 Wages plus (ii) 2.5 percent of the "unadjusted basis immediately after acquisition" of all qualified property held by the trade or business ("UBIA").

   (b) The QBI Deduction is also available to offset income from qualified REIT dividends and qualified PTP income, without regard to the limitations described in (i) above.

2. Income earned with respect to a business that constitutes a "specified service trade or business" ("SSTB") is excluded from qualifying for the QBI Deduction (except for taxpayers that fall below the Threshold Amount).

   (a) On Jan. 18, 2018, final regulations were released to clarify certain of the provisions related to the QBI Deduction. Such regulations clarified that the determination of whether a business constitutes a SSTB is made at the entity level. Pass-through entities are required to report this determination to their owners. SSTBs include trades or businesses involving the performance of services in the investment management field.

   (b) Most investing funds are not "qualified trades or businesses." Funds whose trade or business does qualify (e.g., certain lending funds) generally do not pay W-2 wages. For most investment funds, the wage/basis limitation described will be $0.

3. Anti-Abuse Rules

   (a) The regulations provide that a SSTB includes any business that shares 50 percent common ownership (direct or indirect) with a SSTB. This provision prevents many structures that aim to segregate out certain activities in order to take advantage of the benefits of the QBI Deduction.

   (b) Amounts received for the performance of services as an employee are not eligible for the QBI Deduction. To prevent employees from changing employment status to take advantage of the new deduction, the regulations provide a rebuttable presumption that if an employee changes employment status but continues to provide substantially the same services to the former employer, the individual is presumed to be providing such services as an employee for three years following such change in status, and thus cannot offset any compensation income by the QBI Deduction.

   (c) The regulations exclude from treatment as a "qualified REIT dividend" eligible for the QBI Deduction any dividend received with respect to stock that has been held for 45 days or less, taking into account applicable rules under Section 246 that suspend holding periods for stock with respect to which the holder has a diminished risk of loss due to a hedge or straddle, during the 91-day period beginning on the date which is 45 days prior to the date on which the stock becomes ex-dividend. While the final regulations establish a holding period of 46 days, the Technical Corrections draft circulated on Jan. 2, 2019 indicates that this holding period is 60 days.

E. UBTI: Notice 2018-67

1. Section 512(a)(6) of the Code provides that UBTI must be calculated separately with respect to each separate trade or business with losses usable only against the same related trade or business and not against UBTI generally.

2. On Aug. 21, 2018, the IRS released Notice 2018-67 which noted that a tax-exempt organization may rely on a reasonable, good faith interpretation of Sections 511 through 514 of the Code, considering all of the facts and circumstances when determining whether an exempt organization has more than one unrelated trade or business.

   (a) A reasonable, good faith interpretation includes using the North American Industry Classification System six-digit codes.

   (b) Notice 2018-67 also provided interim and transition rules for partnership investments. Under such rules, an exempt organization may aggregate UBTI from its interest in a single partnership with multiple trades or businesses as long as the directly-held interest in the partnership meets the requirements of either the de minimis test or the control test (each, a "qualifying partnership interest"). An exempt organization may aggregate all qualifying partnership interests as a single trade or business for purposes of section 512(a)(6).

      (i) De Minimis Test: An exempt organization may aggregate UBTI from a single partnership so long as the entity holds no more than 2 percent of the profits interest and no more than 2 percent of the capital interest in the partnership. For purposes of this test, an exempt organization must combine the interests held by disqualified persons with respect to the exempt organization, a supporting organization or a controlled entity.

      (ii) Control Test: An exempt organization may aggregate UBTI from a single partnership so long as the organization holds no more than 20 percent of the capital interest and does not have control or influence over the partnership. For purposes of this test, an exempt organization must combine the interests held by disqualified persons with respect to the exempt organization, a supporting organization or a controlled entity. "Control or influence" will exist if an exempt organization may require the partnership to perform, or may prevent the partnership from performing, any act that significantly affects the operations of the partnership. An exempt organization also has control or influence over a partnership if any of the exempt organization's officers, directors, trustees or employees have rights to participate in the management of the partnership or conduct the partnership's business at any time, or if the exempt organization has the power to appoint or remove any of the partnership's officers, directors, trustees, or employees.

      (iii) Under an additional transition rule, an exempt organization may choose, for a partnership interest acquired prior to Aug. 21, 2018, to treat such partnership interest as a single trade or business.

V. Cayman Islands Economic Substance Requirements

A. The Cayman Islands has introduced legislation, effective Jan. 1, 2019, requiring certain entities resident in the Cayman Islands to demonstrate that they have appropriate economic substance in the jurisdiction.

B. Other commonly used fund and investment management jurisdictions, such as Jersey, Guernsey, the British Virgin Islands and Bermuda, either have or are expected to put in place similar legislation.

C. The introduction of these measures is intended to fulfil commitments made by these jurisdictions as members of the OECD in the context of the OECD's Base Erosion and Profit Shifting ("BEPS") initiative, and is also a response to their inclusion on the "grey list" of non-cooperative jurisdictions for tax purposes produced by the EU's Code of Conduct Group on Business Taxation.

D. Although the Cayman Islands has passed the relevant legislation effective Jan. 1, 2019, it is anticipated that the Cayman Islands will also issue regulations and guidance. It is hoped that the guidance, in particular, will clarify many matters related to the new legislation which are presently uncertain, especially in the context of outsourced activities, such as where a Cayman Islands manager delegates investment management and ancillary services to a sub-adviser in another jurisdiction (such as the U.K.).

E. The new Cayman Islands legislation is applicable to "Relevant Entities." Relevant Entities will include most Cayman limited companies, LLCs and LLPs, but not limited partnerships (although entities that are general partners of limited partnerships may be Relevant Entities).

F. Importantly, an "investment fund" is not a Relevant Entity (and so is not within the scope of the new legislation).

G. An "investment fund" is an entity whose principal business is the issuing of investment interests to raise funds or pool investor funds with the aim of enabling a holder of such an investment interest to benefit from the profits or gains from the entity's acquisition, holding, management or disposal of investments and includes any entity through which an investment fund directly or indirectly invests or operates. Most funds and their trading or subsidiary holding entities should therefore be outside the scope of the new rules.

H. Each Relevant Entity must make a report each year to the tax authority as to whether or not it is carrying on one or more "Relevant Activities." If it is, then it must meet an economic substance test in respect of such Relevant Activities and provide to the tax authority a detailed report describing the basis upon which it is meeting that economic substance test.

I. The "Relevant Activities" are:

   1. Fund management business
   2. Banking business
   3. Financing and leasing business
   4. Distribution and service center business
   5. Headquarters business
   6. Intellectual property business
   7. Shipping business
   8. Holding company business

   However, "investment fund business," meaning the business of operating as an investment fund, is excluded and is not a "Relevant Activity."

J. A Relevant Entity that carries on one or more Relevant Activities must satisfy the economic substance test. This requires the Relevant Entity to:

   1. Conduct Cayman Islands "core income generating activities" ("CIGA");
   2. Be "directed and managed" in an appropriate manner in the Cayman Islands;
   3. Having regard to the level of relevant income derived from a Relevant Activity:
      (a) Have an adequate amount of operating expenditure incurred in the Cayman Islands;
      (b) Have adequate physical presence (including maintaining a place of business or plant, property and equipment) in the Cayman Islands; and
      (c) Have an adequate number of full-time employees or other personnel with appropriate qualifications in the Cayman Islands.

K. CIGA are defined as those activities that are of central importance to the Relevant Entity in terms of generating activity and that are being carried out in the Cayman Islands. There are then further examples given of particular types of activity that may constitute CIGA for a Relevant Activity. For fund management, these examples include:

1. Taking decisions on holding and selling investments;
2. Calculating risks and reserves;
3. Taking decisions on currency or interest fluctuations and hedging positions; and
4. Preparing reports or returns to investors and the Cayman Islands Monetary Authority.

L. A Relevant Entity may still satisfy the CIGA requirements where its CIGA activities are conducted by another person on its behalf, provided that the Relevant Entity is able to monitor and control the carrying out of those activities.

M. In terms of the requirement that a Relevant Entity carrying on a Relevant Activity must be "directed and managed" in an appropriate manner in the Cayman Islands in order to meet the economic substance test, the legislation contains detailed provisions which require that:

1. The Relevant Entity's board of directors, as a whole, has the appropriate knowledge and expertise to discharge its duties;
2. That board meetings are held in the Cayman Islands with adequate frequency with a quorum of directors present in the Cayman Islands; and
3. That minutes of the board meetings record the strategic decisions taken and that such minutes and appropriate records are retained in the Cayman Islands.

N. Various penalties may be imposed on a Relevant Entity carrying on a Relevant Activity that fails to meet the economic substance test. In the first period of non-compliance, the Cayman Islands tax authorities may impose a $10,000 penalty and if the failure continues into subsequent periods, the penalty can be $100,000. There is also the possibility of criminal sanctions where any person (which might be a Relevant Entity or a director, manager, secretary of other officer of a Relevant Entity) knowingly or willfully supplies false or misleading information under these provisions or fails to provide information specifically requested by the tax authorities under these provisions.

O. Although the new law is effective as of Jan. 1, 2019, regulations and guidance are still awaited and there is much that remains unclear. Given that affected Cayman Islands entities have had little or no time to prepare, it is possible that regulations might defer the date upon which Relevant Entities carrying on a Relevant Activity are required to meet the economic substance test. Furthermore, the due date and form of the annual notification that a Relevant Entity must make to the tax authority that is potentially within the scope of the legislation has not yet been prescribed.

P. It is hoped that the promised guidance will clarify a number of the outstanding issues, such as the degree of economic substance required of a Relevant Entity that outsources activity, such as a Cayman Islands fund manager that delegates to an investment manager or sub-adviser in another jurisdiction (such as the U.K.). The Cayman Islands tax authority is required by the legislation to consult with the private sector prior to issuing its guidance and the industry will want to press its concerns as part of that consultation.

Q. Since the Cayman Islands is introducing these new rules with the intention of ensuring its removal from the EU's "gray list" of uncooperative tax jurisdictions, the EU is expected to review the legislation in early 2019 prior to its announcement of an updated "gray list." Depending upon the outcome of that review, it is possible that further changes will be made to the legislation.

VI. BEPS Implementation in the EU

A. Introduction

1. The EU has been an active participant in the BEPS initiative from the outset and has generally sought to enshrine BEPs-related measures into EU-wide law as a means of ensuring a smooth and cohesive implementation of these measures in all EU member states. In particular, the EU is introducing the Anti-Tax Avoidance Directive ("ATAD") and the DAC6 Directive amendments on mandatory disclosures of certain tax planning arrangement, and is actively supporting the adoption and ratification by EU member states of the Multi-Lateral Instrument and its measures aimed to prevent double tax treaty abuse.

B. The Multi-Lateral Instrument

1. Many countries, including all EU member states, have now adopted and ratified the OECD's Multi-Lateral Instrument ("MLI") to modify the application of their bilateral double tax treaties.

2. One of the key aims of the MLI is to implement the recommendations of Action 6 of BEPS on treaty abuse, which introduced minimum standards to prevent the granting of treaty benefits. Action 6 proposed that tax treaties should include either a principal purpose test ("PPT") alone or, if the jurisdictions in question choose it, both a PPT and a simplified limitation on benefits ("LOB") test.

3. The MLI presents the PPT as the default option and indeed it is the option that has been selected by most countries that have adopted the MLI.

4. The PPT denies a treaty benefit to an entity located in a treaty jurisdiction – most commonly, a reduced or zero rate of withholding tax on interest or dividend income paid by an entity in the other treaty jurisdiction – where it is reasonable to conclude, having regard to all the facts and circumstances, that obtaining the treaty benefit was one of the principal purposes of any arrangement that resulted directly or indirectly in that benefit.

5. There has been much discussion as to how the PPT should be interpreted and applied to funds and their investment-holding subsidiaries, particularly in the context of alternative investment funds (so-called non-CIVs). In January 2016, the OECD published a consultation document on non-CIV funds that includes three fact patterns where the OECD would regard the PPT as having been met. It is anticipated that this will be used as a guide to interpretation and application of the PPT by tax authorities and courts in many relevant jurisdictions.

6. The most useful of the three non-CIV examples describes a subsidiary established as a regional investment platform to invest across a wider economic area, such as the EU, and which earns dividends on its investments. This example concludes that the subsidiary is entitled to treaty benefits where it is set up for non-tax reasons and carries out material investment functions and other activities in the jurisdiction where it is established. Specified relevant functions include:

   (a) An experienced local management team which reviews investment recommendations;

   (b) Approval and monitoring of investments;

   (c) Treasury functions;

   (d) Maintenance of books and records and ensuring compliance with local regulatory requirements in investee jurisdictions;

   (e) A board of directors composed of a majority of locally resident directors with expertise in investment management; and

   (f) Payment of taxes and filing of tax returns in the jurisdiction.

7. It remains unclear how many of these functions need to be carried on, or to what extent, in order for the PPT to be satisfied. OECD Guidance is expected to continue to involve, as is the practice of investee jurisdictions in interpreting and applying the PPT that is now incorporated into their double tax treaties.

C. Anti-Tax Avoidance Directive ("ATAD")

1. The ATAD establishes a minimum standard that EU member states must meet in their domestic legislation in five key BEPS-related areas. ATAD requires EU member states to introduce:
   (a) Limitations on interest deductibility;
   (b) A general anti-abuse rule ("GAAR");
   (c) Controlled foreign company ("CFC") rules;
   (d) Hybrid mismatch rules; and
   (e) Exit taxation.
2. These measures generally need to be applied into domestic law with effect from Jan. 1, 2019, although there is a one-year delay permitted in relation to exit taxes and the rules on hybrid mismatches are not required until Jan. 1, 2020 (Jan. 1, 2022 in relation to reverse hybrid mismatches).

D. DAC6 — Mandatory Disclosure Rules

1. The DAC6 Directive amends a previous EU Directive with respect to the mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements. DAC6 in substance requires "intermediaries" such as tax advisers, accountants and lawyers that design and/or promote tax planning arrangements to report certain specified arrangements that are considered potentially abusive. If there is no such intermediary in relation to a specified arrangement, then the obligation shifts to the taxpayer. Following reporting, reported information is then automatically exchanged between EU member states.
2. The specified reportable arrangements are those that concern more than one EU member state, or an EU member state and a third country, and that have one or more "hallmarks." Although the hallmarks are intended to limit the reportable arrangements to potential tax-avoidance arrangements, a specific "main tax benefit" threshold test is not part of the regime.
3. The specific hallmarks include where an arrangement involves:
   (a) Confidentiality conditions
   (b) Standardized documentation
   (c) Success fees
   (d) Use or transfer of losses
   (e) Converting income into capital
   (f) Gifts or low/exempt income
   (g) Circular transactions
   (h) Transactions between related parties that include tax-exempt payers
   (i) Exempt or preferentially treated receipts
   (j) Taxpayers in non-cooperative jurisdictions
4. EU member states must implement DAC6 into their domestic law by no later than Dec. 31, 2019, so that the law applies from July 1, 2020 onwards. At present there is very little information available about how and when each EU member state will adopt these measures in their own domestic legislation. However, this raises a difficult issue since the Directive, once introduced and effective from July 1, 2020, will require disclosure in respect of any reportable arrangement where the first step in that reportable arrangement is implemented on or after June 25, 2018. DAC6 therefore has a retrospective effect, and intermediaries and taxpayers should be monitoring relevant transactions that they may have been

involved with since June 25, 2018 in case they may be required to make a report in respect of those transactions in August 2020.

VII. Qualified Opportunity Zones

A. Congress enacted, at the end of 2017, significant tax incentives for investments in Qualified Opportunity Zones ("QOZs"). The QOZ legislation was intended to spur investment in lower-income communities by allowing for the reinvestment of capital gain into a QOZ on a tax-favored basis, thus encouraging economic growth in such communities.

1. On Oct. 19, 2018, the Treasury Department issued Proposed Regulations under sections 1400Z-1 and 1400Z-2, a draft IRS Form with instructions, and Revenue Ruling 2018-29 (together, the "QOZ rules") to provide clarification on the legislation and to settle some open questions.

2. Additional guidance is expected in early 2019.

B. A QOZ is a low-income area that has been certified by the Secretary of the Treasury. As of this time, all QOZs have been certified. The QOZ designations expire on Dec. 31, 2028; however, for taxpayers with properly deferred gains generated prior to Dec. 31, 2026, the QOZ tax benefits remain available through Dec. 31, 2047.

C. Investment in a QOZ provides a taxpayer with three major benefits:

1. Deferral of tax on eligible capital gain until the earlier of the date the investor disposes of their interest in the QOZ investment or Dec. 31, 2026.

(a) If the investment is held through Dec. 31, 2026, there will be a tax on the deferred gain without corresponding cash available to pay the liability.

(b) Upon realization, the deferred gain will have the same tax attributes in the year of inclusion that it would have had if it had not been deferred under the QOZ rules.

2. A step-up in the basis of the QOZ investment in the amount of 10 percent of the amount of gain deferred if the interest is held for five years, and an additional 5 percent if held for seven years. Thus only 85 percent of the initial deferred amount will be subject to tax. Given that on Dec. 31, 2026 the deferred gain is realized, in order to obtain the step-up in basis, the five- and seven-year holding periods need to be met before such date.

3. The exclusion from taxation of any additional gain over the initial deferred amount upon the disposition of the investment interest if the interest is held for 10 years. Note that the interest in the QOF (as defined below) must be sold for the investor to realize this tax benefit.

D. An investor makes an investment in a QOZ by investing qualifying capital gain into a qualified opportunity fund ("QOF").

1. A QOF may be organized as a corporation or partnership for federal income tax purposes.

2. Only equity interests in a QOF are eligible, although a QOF equity interest may be pledged as collateral to obtain debt financing.

3. Deemed contributions due to allocations of partnership liabilities under Section 752 do not constitute investments in a QOF.

4. A QOF must hold 90 percent of its assets in "QOZ Property" as defined below (the "90-Percent Assets Test"). This is measured at the end of the first six months of the fund's taxable year and again at the end of each taxable year of the QOF.

(a) For purposes of the 90-Percent Assets Test, the value of the QOF's assets should generally be the book value reflected on the QOF's applicable financial statements. If the QOF has no such statements, the cost of the assets is used.

(b) Because the QOF interest must ultimately be disposed of after the 10-year holding period in order for the investor to enjoy tax-free gain on the investment, investors should consider setting up single-asset funds to facilitate disposition.

(c) If a QOF fails to satisfy the 90-Percent Assets Test for any month, the QOF will be subject to a penalty equal to the dollar amount by which it fails, multiplied by the then-effective IRS underpayment rate. The penalty calculation uses the yearly underpayment rate divided by 12.

5. A fund self-certifies as a QOF by filing a Form 8996 with its federal income tax return.

E. Any person that may recognize capital gain is eligible to invest in a QOF, including individuals, entities treated as partnerships, entities treated as corporations (including S corporations, regulated investment companies ("RICs") and real estate investment trusts ("REITs")), trusts and estates.

1. To qualify, capital gains must arise from a transaction with a person unrelated to the taxpayer.

2. Amounts other than qualifying capital gain may be invested, but the rules state that the investment will be bifurcated and such other amounts will not be subject to favorable tax treatment.

3. Capital gain recognized from Section 1256 contracts (e.g., regulated futures contracts, foreign currency contracts, non-equity options) is only eligible for the QOZ tax benefits to the extent of net gain from all of the investor's Section 1256 contracts.

4. Capital gain recognized from a position that is or ever has been part of an offsetting-positions transaction during the investor's holding period of the position is not eligible for the QOZ tax benefits under the QOZ rules.

(a) The QOZ rules suggest, however, that the net gain limitation applied to Section 1256 contracts, rather than a complete disallowance of the QOZ tax benefits, will apply to offsetting-positions transactions in which both positions are Section 1256 contracts.

(b) Straddles (as defined in Section 1092) are included in the definition, but the rule applies to the positions in a straddle whether or not the underlying property is actively traded.

(c) This rule may pose administrative burdens for pass-through entities that regularly hedge investments using offsetting-positions transactions.

F. Capital gain must be invested within 180 days of the date on which the investor would otherwise recognize the gain for federal income tax purposes.

1. In the case of a sale or exchange, this period begins on the date of the transaction.

2. In the case of a capital gain dividend received by a RIC or REIT shareholder, this period begins on the date the dividend is paid.

3. If a RIC or REIT shareholder is required under the Code to include an undistributed amount as capital gain, the shareholder's period begins on the last day of the RIC or REIT's taxable year.

4. If a partnership derives capital gain from a sale or exchange, the partnership may elect to defer the gain within 180 days of the transaction. If the partnership so elects, the gain will not be allocated to the partnership's partners. Instead, the gain will be allocated to the partners when the partnership recognizes it.

5. The partnership may instead allocate the gain to its partners, who then may choose to elect to defer the gain. In this instance, the partners' 180-day period begins on the last day of the partnership's taxable year.

6. Alternatively, partners may also invest their share of a partnership's gain within 180 days of the date the partnership realizes the gain, provided the partnership does not make the election.

(a) Gain that is allocated to a partner by a partnership is only eligible for deferral if the gain arose from a transaction with a person unrelated to both the partner and the partnership.

(b) The QOZ rules provide parallel treatment for other pass-through entities and their owners, including LLCs, S corporations, trusts and estates.

(c) Partnerships with partners who are interested in investing in QOFs may be asked for faster processing of Schedules K-1 and side letters or other agreements that the partnership will not elect to defer gain in a QOZ investment without the consent of the partners.

G. The assets that qualify for the 90-Percent Asset Test are QOZ stock, QOZ partnership interests and QOZ business property (together, "QOZ property").

1. QOZ stock means any stock in a domestic corporation if:

(a) Such stock is acquired by the QOF after Dec. 31, 2017 at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash;

(b) At the time the stock was issued, the corporation qualified as a QOZ business (as defined below) or was formed for such purpose; and

(c) During substantially all of the QOF's holding period for such stock, such corporation qualified as a QOZ business.

2. QOZ partnership interest means any capital or profits interest in a domestic partnership if:

(a) Such interest was acquired by the QOF after Dec. 31, 2017 from the partnership solely in exchange for cash;

(b) At the time the interest was acquired, the partnership qualified as a QOZ business or was formed for such purpose; and

(c) During substantially all of the QOF's holding period for such interest, such partnership qualified as a QOZ business.

3. QOZ business property means tangible property used in a trade or business of the QOF if:

(a) Such property was acquired by the QOF by purchase from an unrelated person after Dec. 31, 2017;

(b) The original use of such property in the QOZ commences with the QOF or the QOF substantially improves the property (as defined below); and

(c) During all of the fund's holding period for such property, substantially all of the use of such property was in a QOZ.

H. A QOZ business, as described above, means a business in which:

1. Substantially all of the tangible assets held by the business are QOZ business property. The proposed regulations state that the term "substantially all," as used in this provision, means "70 percent or greater."

2. At least 50 percent of the total gross income of the business is derived from the active conduct of a trade or business;

3. A substantial portion of any intangible property owned by the business must be used in the active conduct of a trade or business;

4. Less than 5 percent of the average of the aggregated unadjusted bases of the property in the business is attributable to "nonqualified financial property" (which includes debt, stock, partnership interests, derivatives, etc.); and

5. The underlying business is not a: private or commercial golf course; country club; massage parlor; hot tub facility; suntan facility; racetrack or other gambling facility; or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

I. Original Use or Substantial Improvement of QOZ business property

   1. "Original use" is undefined in the QOZ rules. Given the permanence of land, the original use of land can never commence with a QOF in a QOZ and thus the QOZ rules do not require land to meet the original-use requirement.

   2. Under the QOZ rules, property is considered to be substantially improved by a QOF if, during the 30-month period following the date on which the property is acquired, the QOF makes additions to the basis of the property equal to the acquisition cost of such property. In short, the QOF must double its basis in the property after purchasing it. If a QOF purchases a plot of land with an existing building on the land, the determination of whether a QOF has substantially improved land is made only with respect to the adjusted basis of the building (without regard to the basis allocable to the land) and separate improvements to the land are not required.

J. Realizing that developing businesses will have difficulty meeting some of the requirements under the QOZ rules, the rules provide a safe harbor for amounts deemed to be reasonable working capital.

   1. The safe harbor applies to cash and other financial property held by a QOZ business if the QOZ business:

      (a) Keeps written records that designate the use of the working capital for the acquisition, construction or improvement of QOZ business property;

      (b) Provides a reasonable schedule for the use of the working capital in the QOZ business within 31 months of acquisition; and

      (c) Actually uses the working capital in a manner that is substantially consistent with the written plan.

   2. Several benefits apply to working capital that fits within the safe harbor:

      (a) Working capital that meets the safe harbor can be set aside for use in acquiring, constructing and/or substantially improving tangible property that is expected to qualify as QOZ business property, and such property can thereby be considered QOZ business property, even if the working capital has not been fully invested, as long as the use of the capital is in accordance with the schedule required by the safe harbor;

      (b) Income derived from safe-harbored working capital will be counted toward the requirement that 50 percent of the total gross income of the business be derived from the active conduct of a trade or business;

      (c) Any intangible property of a business will be deemed used in the active conduct of a trade or business during the period of time that the business satisfies the three requirements in clause 1 above; and

      (d) Property that is deemed to be safe-harbored working capital will be excepted from the requirement that less than 5 percent of the business property be attributable to nonqualified financial property.

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Aneliya represents hedge funds and other large investors in matters concerning shareholder activism, proxy contests, hostile takeovers, corporate governance and mergers and acquisitions. Aneliya is one of the leading attorneys representing activist investors globally, with close to 200 major shareholder activism contests, including campaigns in the United States, United Kingdom, Canada, Australia and Latin America. Aneliya has extensive experience providing strategic guidance to investors on activist strategies, including proxy contests, settlement negotiations, corporate governance, consent solicitations, letter-writing campaigns, hostile takeovers and M&A transactions. She provides counsel to clients on their equity investments in public companies, and she also represents public and private companies in mergers and acquisitions and asset purchase and stock purchase transactions.

Aneliya was named to *Crain's* 40 Under 40 Class of 2018 and has been named a New York "Rising Star" by *Super Lawyers* magazine each year since 2014 for her shareholder activism and M&A practice. Most recently, she represented Trian Fund Management in the largest proxy contest to date. The successful campaign sought the addition of Trian CEO and founding partner Nelson Peltz to the Board of Directors of Procter & Gamble. Aneliya earned her M.L.A., *magna cum laude*, from Harvard University, her J.D. from Benjamin N. Cardozo School of Law, where she was a Dean's Scholar, and her B.A. from American University in Bulgaria.

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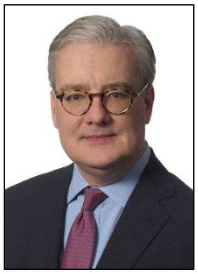
Kelly focuses her practice on securities enforcement and regulatory matters for broker-dealers, private funds, financial institutions, companies and individuals. Kelly also defends individuals and entities under investigation for or charged with securities fraud, mail/wire fraud, accounting fraud and insider trading. She advises clients on securities trading matters and, when necessary, represents them in regulatory investigations and enforcement actions by the SEC, DOJ, FINRA, and other self-regulatory organizations and state regulators. She also leads trading sessions for clients on complying with insider trading laws and best practices for electronic communications and related firm policies. Kelly also represents clients in civil litigation matters involving breach of contract, alter ego liability, fraud and cross-border disputes.

Kelly has been recognized by *New York Super Lawyers* as a Rising Star. Kelly earned her J.D. from Georgetown University Law Center, where she received the Georgetown University Law Center 2005 Advocacy Award, and her B.A. from Rutgers University.



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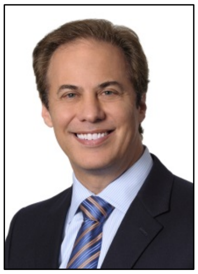
Joe represents private equity fund sponsors in connection with fund formation, the acquisition of portfolio investments and the implementation of exit strategies. In this capacity, Joe advises clients on securities, governance, ERISA, Investment Advisers Act and structural issues. He has extensive experience with all alternative asset classes, including venture capital and later-stage growth equity investments, leveraged buyouts, mezzanine investments, real estate ventures and opportunity funds, secondary investments and funds of funds. Joe has also represented many fund managers in connection with spinoffs and consolidations. In addition to domestic representations, Joe has advised private equity clients in connection with the acquisition and structuring of portfolio investments throughout Europe, Latin America and Asia. His representation of asset managers in the real estate sector includes advice concerning REIT offerings and privatizations, partnership roll-ups and cross-border investments.

Joe has been recognized as a leading practitioner by *Chambers Global*, *Chambers USA*, *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*, *The Legal 500 US* and *New York Super Lawyers*. Most recently, Joe was quoted by *Private Equity International* in the article "LPAs: Finding the Right Balance" and by *Private Funds Management* in the article "Ringing the Changes." Joe co-authored the "United States Fundraising" chapter in *The Private Equity Review* (Law Business Research Ltd.) and he contributed to the *Fund Formation and Incentives Report* (Private Equity International in association with SRZ). Joe received his J.D. from New York University School of Law and his A.B. from Columbia University.



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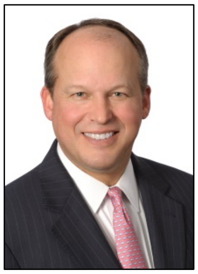
Michael is co-chair of the Litigation Group and head of the shareholder activism litigation practice. He focuses on complex commercial litigation and antitrust, particularly as it relates to mergers and acquisitions. His litigation practice includes shareholder activist litigation, M&A litigation and other corporate control disputes, as well as securities litigation. Michael has particular expertise with litigation involving Sections 10(b), 13(d), 14(a), 16(b) and 20(a) of the Securities Exchange Act. Recently, he represented Trian Fund Management LP in its proxy contest with Procter & Gamble, and a series of victories on behalf of venBio Select Advisor LLC in its proxy campaign at Immunomedics Inc. Among other things, for venBio, he obtained a TRO blocking the closing of a global license agreement, which effectively would have amounted to a sale of the company. Michael represented Cerberus Capital Management LP in its $9.2-billion acquisition of Safeway Inc. In addition, Michael analyzes transactions to determine whether they raise antitrust issues, develops strategies to address potential concerns and represents clients in front of the U.S. Department of Justice, the Federal Trade Commission, state attorneys general and others, and in litigation challenging transactions on antitrust grounds.

Michael has been recognized by his peers and clients in *Benchmark Litigation: The Definitive Guide to America's Leading Litigation Firms and Attorneys*, *The Legal 500 US* and *New York Super Lawyers* in the area of business litigation. His litigation victories have been featured in *The Hedge Fund Journal* ("Immunomedics Proxy Contest: SRZ Achieves Unprecedented Litigation Victories"), *Hedge Fund Legal and Compliance Digest* ("Schulte's Michael Swartz Discusses Section 16(b) Litigation, Exemptions and Strategies for Hedge Fund Managers to Reduce Risks of Non-Compliance") and, most recently, the Litigation Group, co-chaired by Michael, won *Law360*'s Asset Management Practice Group of the year for its representations of leading private investment funds. In addition, Michael's recent publications include contributing to *The Activist Investing Annual Review 2018* (Activist Insight, in association with SRZ) and the 2018 *Shareholder Activism Insight* report (published by SRZ in association with Activist Insight and Okapi Partners). He also co-authored the "Information Sharing with Market Professionals" chapter in the *Insider Trading Law and Compliance Answer Book 2018* (Practising Law Institute). He is currently the regional vice chair for the mid-Atlantic region of the Lawyers' Committee for Civil Rights Under Law and is also a member of the ABA's Litigation and Antitrust sections. A former law clerk to the Honorable Irving R. Kaufman, Circuit Judge for the U.S. Court of Appeals for the Second Circuit, Michael obtained his J.D. from Columbia Law School, where he was editor of the *Columbia Law Review*, and his B.A., *magna cum laude*, from the University of California, Los Angeles, where he was elected to Phi Beta Kappa.



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Pete is co-chair of the Litigation Group and a member of the firm's Executive Committee. He concentrates his practice on representing corporations and executives in managing crisis situations, including grand jury investigations, internal investigations, SEC enforcement proceedings, False Claims Act and qui tam lawsuits, and shareholder class actions. Pete has litigated disputes involving accounting and securities fraud, Foreign Corrupt Practices Act violations, government program fraud, false claims and statements, antitrust violations, public corruption, tax evasion, insider trading, environmental violations and other claims. A former Assistant U.S. Attorney for the Eastern District of Virginia and the District of Columbia, Pete has served as lead counsel in over 80 federal and local jury trials and many more bench trials.

A recipient of the Department of Justice Director's Award for Superior Performance as an Assistant U.S. Attorney, Pete has performed with comparable skill as a private practitioner. Pete is a fellow of the American College of Trial Lawyers, and has been recognized as a leading litigator by *Chambers USA*, *Benchmark*, *The Legal 500 US*, *Washington DC Super Lawyers*, *Washingtonian*'s "Washington's Top Lawyers" (criminal defense, white collar), *Who's Who Legal: Investigations, The Best Lawyers in America* (corporate compliance law, criminal defense: white collar, and litigation-securities), *Ethisphere: Attorneys Who Matter* and *The Washington Post* ("Their Own Defense"). Most recently, the Litigation Group, co-chaired by Pete, won *Law360*'s Asset Management Practice Group of the year for its representations of leading private investment funds. Pete obtained his B.A., with high honors, from University of Notre Dame and his J.D. from the University of Virginia School of Law, where he was Order of the Coif and on the management board of the *Virginia Law Review*. Upon graduation, he served as a law clerk to United States District Judge Richard L. Williams of the Eastern District of Virginia.

Crisis Management

I. Three Phases of Crisis Management

A. Prepare

B. Respond

C. Recover

II. Prepare

A. Designate a crisis management team.

1. Team may include the following key players:

(a) Partners

(b) GC

(c) CCO

(d) COO and other members of senior management

(e) Investor relations

(f) Representative from board of directors (if applicable)

(g) PR consultant

2. Identify individuals with prior experience with crisis management.

3. Define roles of members on the team.

B. Develop a crisis management plan.

1. Identify the goal(s) of the plan.

2. Tailor the plan to the firm.

3. Identify and evaluate potential crises:

(a) Threatened civil litigation

(b) Government subpoena

(c) Alleged insider trading

(d) Cybersecurity breach

(e) Fund performance

(f) Succession

4. Prepare template scripts or materials related to each potential crisis.

5. Develop a press strategy related to each potential crisis.

C. Develop and implement a policy regarding employee communication with the press, if not already in place.

III. Respond

A. Identify the crisis and consider timing of response.

B. Consult with counsel.

1. Internal vs. external counsel

2. Factors to consider when hiring external counsel:

(a) Experience with specific government agency

(b) Experience with underlying legal issues

(c) Experience with related litigation

(d) Experience with underlying industry

C. Litigation Hold

1. Preserve and retain, not delete or destroy.

2. Send to all relevant employees.

3. eDiscovery obligations:

(a) Firm hardware

(b) Personal hardware

4. Consequences of failing to preserve documents:

(a) Civil

(b) Criminal

5. General Data Protection Regulation ("GDPR") Issues

(a) GDPR is a data protection regulation that applies to all organizations established in the EU and organizations established outside of the EU that process personal data of natural persons located in the EU, and the processing relates to either (i) offering goods and services to persons located the EU; or (ii) monitoring behavior of natural persons located in the EU.

(b) What is personal data?

(i) Personal data means any form of information that relates to an identifiable natural person (i.e., individual) or allows one to identify such a natural person. Personal data includes name, contact details, social security number or equivalent and any other personal information (e.g., disciplinary history).

(ii) Certain categories of data referred to as "sensitive data" or "special categories of data" are afforded a greater level of protection under the GDPR. Examples of sensitive data include information about a person's racial or ethnic origin, health, political opinions or religious beliefs.

(c) GDPR has been in effect as of May 25, 2018.

D. Develop a message.

1. Identify groups receiving/requiring communication.

2. Craft a message and related talking points.

3. Consider timing of the message.

4. Consult with counsel to confirm the message protects privilege.

5. Understand consequences of the message.

E. Analyze disclosure obligations.

1. Required vs. voluntary disclosure

2. Potential audiences may include:

(a) Investors

(b) Fund board of directors

(c) Partners

(d) Employees

(e) Counterparties (e.g., prime brokers, lenders, etc.)

(f) Press

3. Self-reporting to regulators and/or government

F. Internal Investigation

1. Considerations:

(a) Scope

(b) Speed

(c) Internal vs. external counsel

2. Privilege Issues

(a) Establishing privilege

(i) Ensure counsel is directing the investigation and document that fact.

(ii) Document that the investigation is being conducted for the purpose of obtaining legal advice and/or in anticipation of litigation.

(b) Upjohn warnings

G. Whistleblower Issues

1. SEC Whistleblower Program

(a) Established in 2011 to administer the new whistleblower program under Section 21F of the Dodd-Frank Act

(b) The SEC is required to pay awards to eligible whistleblowers who voluntarily provide original information that leads to a successful enforcement action yielding monetary recovery of over $1 million.

(c) The award amount is required to be between 10 percent and 30 percent of the total monetary sanctions collected in the SEC action or any related action.

(d) Since August 2011, the SEC has received over 28,000 whistleblower tips.[1]

(e) Employees are protected from retaliation.

2. The False Claims Act (FCA)[2]

(a) The FCA prohibits any person from knowingly submitting a false claim to the government or causing another to submit a false claim to the government or knowingly making a false record or statement to get a false claim paid by the government.

(b) In addition to the federal False Claims Act, more than 29 states have passed similar state-specific legislation.

(c) The following actions are considered violations under the FCA:

(i) Knowingly presenting (or causing to be presented) to the federal government a false or fraudulent claim for payment;

(ii) Knowingly using (or causing to be used) a false record or statement to get a claim paid by the federal government;

[1] U.S. Securities and Exchange Commission, *Whistleblower Program: 2018 Annual Report to Congress* (https://www.sec.gov/files/sec-2018-annual-report-whistleblower-program.pdf).

[2] U.S. Department of Justice, *The False Claims Act: A Primer* (https://www.justice.gov/sites/default/files/civil/legacy/2011/04/22/C-FRAUDS_FCA_Primer.pdf); *see also* American Bar Association, *An Introduction to Whistleblower/Qui Tam Claims* (Aug. 21, 2013) (https://www.americanbar.org/groups/young_lawyers/publications/the_101_201_practice_series/an_introduction_to_whistleblower_qui_tam_claims/).

(iii) Conspiring with others to get a false or fraudulent claim paid by the federal government; and

(iv) Knowingly using (or causing to be used) a false record or statement to conceal, avoid or decrease an obligation to pay money or transmit property to the federal government.

H. Indemnification Issues

1. Separate Counsel

(a) Witness

(b) Subject

(c) Target

2. Joint Defense Agreement[3]

(a) Usually narrow and arises from litigation.

(b) Can be between co-plaintiffs, co-defendants and/or nonparties.

(c) Creates an exception to waiver of privilege.

(d) To maintain privilege, parties must demonstrate that:

(i) Communications were made pursuant to a joint defense;

(ii) Communications were made to further the goals of a joint defense; and

(iii) Privilege was not otherwise waived.

3. Common Interest Agreement

(a) Usually broader and does not need to arise from litigation.

(b) Creates an exception to waiver of privilege.

I. Cooperation

1. SEC

(a) Entities

(i) In 2001, the SEC released the Seaboard Report, which established criteria for the SEC staff to consider when determining whether and how to credit entities for self-policing, self-reporting, cooperation and remediation when making enforcement decisions.[4]

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[3] Shari L. Klevens**,** Dentons, *Joint Defense vs. Common Interest Agreements*, (Sept. 30, 2015) (https://www.dentons.com/en/insights/newsletters/2015/september/30/practice-tips-for-lawyers/joint-defense-vs-common-interest-agreements).

[4] U.S. Securities and Exchange Commission, *Enforcement Manual* (Nov. 28, 2017) (https://www.sec.gov/divisions/enforce/enforcementmanual.pdf).

(ii) These criteria include: nature of the misconduct, circumstances around which the misconduct arose, duration of the misconduct, harm inflicted upon investors and other corporate constituents, detection of the misconduct, remedial steps taken after learning of the misconduct, nature and extent of the firm's cooperation with the SEC and adequacy of the newly adopted internal controls and procedures.[5]

(b) Individuals

(i) In January 2010, the SEC issued a policy statement announcing the analytical framework it would use to evaluate cooperation by individuals.[6]

(ii) The SEC announced consideration of the following:

(1) Assistance provided by the cooperating individual in the SEC's investigation or related enforcement actions;

(2) The importance of the underlying matter in which the individual cooperated;

(3) The societal interest in ensuring that the cooperating individual is held accountable for his or her misconduct; and

(4) The appropriateness of cooperation credit based upon the profile of the cooperating individual.

2. DOJ

(a) Current Policy

(i) A revised policy was outlined in public remarks by Deputy Attorney General Rod Rosenstein on Nov. 29, 2018 and codified in the Justice Manual.[7]

(ii) The revised policy provides that in order to receive cooperation credit in criminal investigations companies "must identify all individuals substantially involved in or responsible for the misconduct at issue" and provide prosecutors with "all relevant facts relating to that misconduct."[8]

(iii) In the civil context, companies should focus on identifying individuals who were "substantially involved in or responsible for the misconduct." In particular, companies "must identify all wrongdoing by senior officials, including members of senior management or the board of directors" in order to receive credit.[9]

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[5] *Id*.

[6] U.S. Securities and Exchange Commission, *Policy Statement Concerning Cooperation by Individuals in its Investigations and Related Enforcement Actions* (Jan. 13, 2010) (http://www.sec.gov/rules/policy/2010/34-61340.pdf).

[7] Rod J. Rosenstein, Deputy Attorney General, U.S. Department of Justice, Remarks at the American Conference Institute's 35th International Conference on the Foreign Corrupt Practices Act (Nov. 29, 2018) (https://www.justice.gov/opa/speech/deputy-attorney-general-rod-j-rosenstein-delivers-remarks-american-conference-institute-0).

[8] U.S. Department of Justice, *Justice Manual*, *Section 9-28.700 - The Value of Cooperation* (https://www.justice.gov/jm/jm-9-28000-principles-federal-prosecution-business-organizations?utm_medium=email&utm_source=govdelivery#9-28.700).

[9] *Id*.

(b) Previously, pursuant to the Yates memorandum, in effect from September 2015 through November 2018, the DOJ focused on bringing criminal charges against individuals bearing responsibility for corporate misconduct based on an "all or nothing" approach.[10] Corporations were required to provide all evidence related to all individual misconduct in order to be considered for cooperation credit.

IV. Recover

A. Evaluate and address, as needed:

1. Reputational damage;

2. Disruption to business operations; and

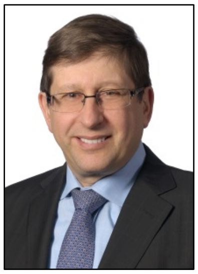
3. Loss of business.

B. Conduct an after-action review.

C. Reevaluate efficacy of crisis management plan and improve.

[10] Sally Quillian Yates, Deputy Attorney General, U.S. Department of Justice, *Individual Accountability for Corporate Wrongdoing* (Sept. 9, 2015) (https://www.justice.gov/archives/dag/file/769036/download).

Main Program



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Philippe focuses his practice on the tax aspects of investment funds, mergers and acquisitions, international transactions, real estate transactions and financial instruments. He has advised on many major transactions involving sales or spinoffs of investment fund managers, including Senator Investment Group LP's sale of a minority stake to The Blackstone Group LP, Caxton Associates LP's sale of a minority interest to the Petershill II Fund affiliated with the Goldman Sachs Group Inc., and Credit Suisse's sale of Strategic Partners to The Blackstone Group LP. Philippe advises on the tax aspects of securitizations, including his recent representation of affiliates of Fortress Investment Group LLC and affiliates of Highbridge Capital Management in the securitization of their leveraged facilities. He has also advised multiple alternative asset managers on the formation and structuring of funds, including Engineers Gate with the launch of a quant fund, Clearfield Capital with the launch of a hedge fund, Warlander Asset Management LP with the launch of a credit fund, and D1 Capital Partners in the formation of a new fund; Gunnar Overstrom, formerly a partner at Maverick Capital Ltd., in the formation of Three Corner Global Investors LP; Junto Capital Management LP on the launch of Junto Capital Partners LP and Junto Offshore Fund Ltd.; Trian Fund Management LP on all aspects of launching new co-investment hedge funds; Sachem Head Capital Management LP with the launch of hedge funds and the establishment of long/short equity funds; and Capstone Investment Advisors LLC, JANA Partners, MKP Capital Management LLC and Scopia Fund Management LLC in their respective sales of a passive minority interest to Neuberger Berman Group-managed private equity fund Dyal Capital Partners. Philippe's recent real estate transactions include advising the Related/Oxford joint venture developing Hudson Yards on closing nearly $1.4 billion in equity investments and debt financing for the center's first tower, and advising Oxford in over $5 billion in financing of three office towers, a retail center and a residential building for the project and advising Arel Capital in a number of equity investments, including operating multi-family properties with significant retail components and ground-up development projects for modern condominium buildings in Manhattan and Brooklyn.

Philippe earned his LL.M. in taxation and his J.D. from New York University School of Law. While pursuing his J.D., he was the recipient of a Gruss Fellowship and served on the staff of the *Journal of International Law and Politics*. He obtained his B.S., *summa cum laude*, from Adelphi University. *Chambers USA*, *The Legal 500 US*, *New York Super Lawyers* and *Tax Directors Handbook* have recognized Philippe as a leading lawyer. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and also speaks at prominent industry events, including PLI's Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances Conferences in New York, Chicago and San Francisco. He also recently presented on topics including FATCA, customized solutions for investors, and management company structuring and operations.

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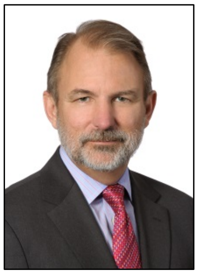
Stephanie R. Breslow

Stephanie is co-head of the Investment Management Group and a member of the firm's Executive Committee and Operating Committee. She maintains a diverse practice that includes liquid funds, private equity funds and the structuring of investment management businesses. She focuses her practice on the formation of private equity funds (including LBO, mezzanine, distressed, real estate and venture) and liquid-securities funds (including hedge funds, hybrid funds, credit funds and activist funds) as well as providing regulatory advice to investment managers. She also represents fund sponsors and institutional investors in connection with seed-capital investments in fund managers and acquisitions of interests in investment management businesses and funds of funds and other institutional investors in connection with their investment activities, including blockchain technology and virtual currency offerings and transactions.

Recently serving as chair of the Private Investment Funds Subcommittee of the International Bar Association, Stephanie is a founding member and former chair of the Private Investment Fund Forum, a member of the Advisory Board of former Third Way Capital Markets Initiative, a former member of the Board of Directors and current member of 100 Women in Finance, a member of the Board of Visitors of Columbia Law School and a member of the Board of Directors of the Girl Scouts of Greater New York. Stephanie has received the highest industry honors. She was named to the inaugural *Legal 500 US* Hall of Fame in the category of "Investment Fund Formation and Management: Alternative/Hedge Funds." Stephanie is also listed in *Chambers USA: America's Leading Lawyers*, *Chambers Global: The World's Leading Lawyers*, *Crain's* Notable Women in Law, *IFLR1000*, *Best Lawyers in America*, *Who's Who Legal: The International Who's Who of Business Lawyers* (which ranked her one of the world's "Top Ten Private Equity Lawyers"), *Who's Who Legal: The International Who's Who of Private Funds Lawyers* (which ranked her at the top of the world's "Most Highly Regarded Individuals" list), *Expert Guide to the Best of the Best USA*, *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*, *Expert Guide to the World's Leading Women in Business Law* and *PLC Cross-border Private Equity Handbook*, among other leading directories. Stephanie was named the "Private Funds Lawyer of the Year" at the Who's Who Legal Awards 2014 and the Euromoney Legal Media Group's "Best in Investment Funds" at the inaugural Americas Women in Business Law Awards. She is also recognized as one of *The Hedge Fund Journal*'s 50 Leading Women in Hedge Funds and was named one of the 2012 Women of Distinction by the Girl Scouts of Greater New York. Stephanie's representation of leading private investment funds has won numerous awards, including most recently *Law360*'s Asset Management Practice Group of the Year. She is a much sought-after speaker on fund formation and operation and compliance issues, and she regularly publishes articles on the latest trends in these areas. Stephanie co-authored *Private Equity Funds: Formation and Operation* (Practising Law Institute), co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), contributed a chapter on "Hedge Fund Investment in Private Equity" for inclusion in *PLC Cross-border Private*

Equity Handbook 2005/06 (Practical Law Company), contributed a chapter on “Advisers to Private Equity Funds — Practical Compliance Considerations” for *Mutual Funds and Exchange Traded Funds Regulation, Volume 2* (Practising Law Institute), and wrote *New York and Delaware Business Entities: Choice, Formation, Operation, Financing and Acquisitions* (West) and *New York Limited Liability Companies: A Guide to Law and Practice* (West). Stephanie earned her J.D. from Columbia Law School, where she was a Harlan Fiske Stone Scholar, and her B.A., *cum laude*, from Harvard University.



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Charles J. Clark

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

Charles has been recognized as a leading litigator by *Chambers USA*, *The Legal 500 US* and *Benchmark Litigation*. A frequent speaker and panelist, Charles has addressed a wide variety of topics of interest to the white collar defense community, including, most recently, the Wells and settlement process at the SEC and responding to the DOJ and SEC's focus on individual accountability. He also serves as a resource for numerous media publications, including *Bloomberg News*, *Financial Times*, *The Wall Street Journal* and *The Washington Post*. Charles received his J.D. from New York University School of Law and his B.A., with high distinction, from University of Virginia.

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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 SEC, the CFTC and the NFA. 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 advisors.

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. *Chambers Global* and *Chambers USA* list Brian as a “leading individual” in investment funds. In addition, Brian is a member of the Managed Funds Association’s Outside Counsel Forum and its CTA/CPO Forum (of which he was formerly a Steering Committee member) and of the CFTC Working Group of the Alternative Investment Management Association. He formerly was a member of the New York City Bar Association’s Private Investment Funds Committee and the MFA’s General Counsel Forum, its CTA, CPO & Futures Committee, and its Investment Advisory Committee. In addition to his legal practice, Brian taught legal ethics at Yale Law School. Brian received his J.D., with distinction, from Stanford Law School.

Chief Executive Officer and Chief Investment Officer

Bardin Hill Investment Partners LP

Jason Dillow

Jason is the Chief Executive Officer and Chief Investment Officer of Bardin Hill Investment Partners LP. He chairs the firm's Operating Committee and Executive Committee and is a member of the Risk Oversight Committees. Jason rose through the leadership ranks of the firm over more than a decade, becoming Chief Investment Officer of the firm's opportunistic credit strategy in January 2016, and assumed responsibility for oversight of all of the firm's investments, including performing credit, in January 2017.

Prior to joining the firm, Jason worked in the Special Situations Group at Goldman Sachs, a global multi-billion dollar investing business specializing in stressed and distressed debt and event-driven equities investing within Goldman Sachs' Fixed Income, Currency and Commodities Division. In that role, he was responsible for investments in the energy, power, industrial and financial industries. He began his career in the Financial Institutions Group of Goldman Sachs' Investment Banking Division. Jason received an A.B., with honors, from Princeton University.

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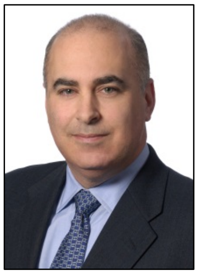
Jennifer advises hedge funds, private equity funds (including mezzanine and distressed funds), hybrid funds, funds of funds and investment advisers in connection with their structuring, formation and ongoing operational needs, general securities laws matters and regulatory and compliance issues. Her experience includes structuring and negotiating seed and strategic investments, advising investment managers regarding the structure and sale of their investment management businesses and the structure of their compensation arrangements, and representing investment managers in connection with managed accounts and single investor funds.

Most recently, Jennifer was named among the world's 50 Leading Women in Hedge Funds by *The Hedge Fund Journal*. A member of the board of directors of 100 Women in Finance, Jennifer is recognized by *The Legal 500 US*, *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers* (Investment Funds), *Expert Guide to the World's Leading Women in Business Law* (Investment Funds) and has been named an *IFLR1000* "Rising Star" (Investment Funds). She co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and recently presented at conferences on topics including attracting and retaining capital, operational due diligence, compliance issues, hedge funds and management company structures and considerations for emerging hedge fund managers. Jennifer earned her J.D. from Columbia Law School, where she was a Harlan Fiske Stone Scholar, and her B.A., *cum laude*, from the University of Pennsylvania.



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

David is listed in *Chambers Global*, *Chambers USA*, *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*, *The Legal 500 US* and *Who's Who Legal: The International Who's Who of Private Funds Lawyers*. A recognized thought leader, David was quoted in the article "Divorcing Your Seeder: Exit Strategy Considerations for Hedge Fund Managers Entering Seeding Arrangements" in the *Hedge Fund Legal & Compliance Digest* and the articles "Schulte Roth Partners Discuss Hedge Fund Seeding" and "Co-Investments with SRZ's Leading Fund Formation Group," both published in *The Hedge Fund Journal*. David also contributed to the article "Hedge Fund Employee Compensation," published by *Practical Law* and co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). He is a sought-after speaker for hedge fund industry conferences and seminars, as well as a frequent guest lecturer at New York-area law and business schools. He has presented on current trends with emerging managers in a prime brokerage (consulting services) presentation, and on product and marketing strategies for growth for hedge fund COOs and CFOs. David received his B.A. from Vassar College, his J.D., *cum laude*, from Syracuse University College of Law and an LL.M. degree in securities regulation, with distinction, from the Georgetown University Law Center.

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

Marc is frequently invited to discuss current industry-related topics of interest at leading professional and trade association events. He has presented on whistleblowing, regulatory and compliance issues for private funds and SEC inspections and examinations of hedge funds and private equity funds, among many other topics. *Chambers USA*, *Chambers Global*, *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 has been 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*, to name a few. Marc 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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William H. Gussman, Jr.

Bill focuses on complex commercial litigation, including securities fraud actions, fraudulent transfer actions, M&A litigation and partnership disputes. Bill's clients have included domestic and foreign hedge funds, private equity firms, major corporations, investment banks, prime brokers, lenders and individuals. Bill has substantial trial experience, having tried cases in federal and state courts throughout the United States and in a variety of alternative dispute resolution venues, including AAA, FINRA and JAMS arbitrations. Bill frequently litigates in bankruptcy court, often representing creditors in disputed matters in the plan confirmation process. He also has particular expertise in litigating issues concerning the Section 546(e) safe harbor in fraudulent transfer actions. He has extensive experience representing both buyers and sellers in deal-related disputes concerning a broad range of industries, including the telecommunications, energy, retail and automotive industries. Bill also has expertise in matters relating to litigation finance and regularly advises clients with respect to champerty risk and the risk/reward profile of litigation-related assets.

Bill's jury trial experience includes the successful defense of a leading prime broker in a $141.4-million fraudulent transfer action brought by the trustee of a defunct hedge fund. In that two-week federal trial, he helped to secure a unanimous verdict in favor of the prime broker. Bill successfully defended a former officer and director of Merck & Co. in a high-profile securities class action and related cases concerning the painkiller Vioxx. That matter included the defense of federal and state securities law claims, breach of duty claims, product liability claims and other matters. Bill is listed in *The Legal 500 US*. He received his J.D. from Harvard Law School and his B.A., *summa cum laude*, from Dartmouth College, where he was Phi Beta Kappa.

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Christopher Hilditch

Chris is co-head and co-founding partner of the firm's London office. With over 20 years of experience advising many of the highest profile hedge funds, Chris focuses his practice on entrepreneurial and institutional investment managers, other financial services firms and investment funds, especially hedge funds, hybrid funds, co-investment funds and distressed funds. He provides practical and strategic advice on the structuring and operation of funds and investment managers, including fundraising, investor issues, investment transactions and financing, as well as regulatory and compliance matters.

Chris is listed as a leading funds lawyer in *Chambers UK*, *Chambers Europe*, *Chambers Global*, *The Legal 500 UK*, *The Expert Guide to the Best of the Best* (which named him as one of the top 25 funds lawyers worldwide), *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*, *IFLR1000*, *PLC Cross-Border Investment Funds Handbook*, *Who's Who Legal: The International Who's Who of Private Funds Lawyers* and *Who's Who of Professionals*. Chris received an "Outstanding Contribution" award for his services to the hedge fund industry (*The Hedge Fund Journal* Awards 2017). Chris was invited to participate in the U.K. Financial Services Authority's Legal Experts Group in respect of AIFMD and has been an active participant on various AIMA and other industry committees on matters relating to the hedge fund industry. He is a frequent speaker at industry conferences and seminars, including invitation-only conferences for clients of prime brokers and other industry participants. He has also written on a wide range of hedge fund and regulatory topics, authored a chapter on "Conflicts of Interest" in *Investment Management, Law and Practice* (Oxford University Press) and co-authored a chapter on "United Kingdom Considerations" in *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). Chris attended law school at the College of Law, Guildford and holds an M.A., with honours, from Oxford University.

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Daniel F. Hunter

Dan has more than 15 years of experience guiding investment management firms from formation through fund launch. He counsels managers on the formation and operation of a range of private investment funds across the liquidity spectrum, with a focus on complex credit funds. The credit funds Dan helps design target distressed, stressed or performing credit assets and may offer no liquidity rights, hybrid liquidity rights or general liquidity rights. These types of credit funds are often referred to in the industry as private debt funds, credit funds, loan funds, opportunity funds or special situation funds. Dan also advises more traditional hedge funds (long-short equity, macro, quant and multi-strategy), fund of hedge funds, fund of private equity funds, growth equity private equity funds and traditional private equity funds. Dan has represented many investment managers in complex negotiations of seed-capital arrangements and capital raising, and he is also an expert on succession planning and change of control of investment managers.

Dan is ranked by *Chambers USA* and *Chambers Global* in the Investment Funds: Hedge Funds category. He is also listed in *The Legal 500 US*. A recognized thought leader, Dan was interviewed on conflicts of interest for the *HFMWeek* article “Don’t Play Favourites with Your Investors.” In addition, he spoke on “Succession Planning” at the Goldman Sachs Twentieth Annual Hedge Fund conference. He also presented at AIMA’s Navigating the Landscape of Side Letter Terms Seminar. Dan received his A.B., *cum laude* and with high honors in history, from the University of Michigan and his J.D. from the University of Michigan Law School, where he was articles editor of the *University of Michigan Journal of Law Reform*.

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Jason S. Kaplan

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

Jason has been recognized as a leading lawyer by *Chambers USA*, *The Legal 500 US*, *IFLR1000* and *New York Super Lawyers*. He publishes and speaks often on topics of concern to private investment funds. A co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), Jason was quoted in the *Financial Times FundFire* article "Hedge Co-Investing Gains Ground" and *The Hedge Fund Journal* articles "Schulte Roth Partners Discuss Hedge Fund Seeding" and "Co-Investments with SRZ's Leading Fund Formation Group." Jason has presented at the Goldman Sachs Annual Hedge Fund Conference, Financial Executives Alliance's Regulatory Hot Topics for Private Equity Firms conference and at ALM's Hedge Fund General Counsel & Compliance Officer Summit. Jason earned his J.D. from Fordham University School of Law and his B.S. from the University of Michigan.

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Energy

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Securities & Capital Markets

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Ele is co-chair of the firm's global Shareholder Activism Group and serves as a member of the firm's Executive Committee. He practices in the areas of shareholder activism, mergers and acquisitions, securities law and regulatory compliance. He represents activists, investment banks and companies in matters ranging from corporate governance and control to proxy contests and defensive strategies. His recent representations have included representing Trian Fund Management in multiple matters; Elliott Management in Akamai Technologies, Hess Corp and Marathon Petroleum; JANA Partners in Jack in the Box, Whole Foods, Bristol-Myers Squibb and Tiffany; Greenlight Capital in General Motors; Cevian Capital in Autoliv, ABB and LM Ericsson; Starboard Value in Stewart Title; Blue Harbour in Investors Bancorp; venBio Select Advisor in Immunomedics; Saba Capital in First Trust; Oasis Capital in Stratus Properties; Altimeter Capital Management in United Continental Holding; SRS Investment Management in Avis Budget Group; Clinton Group in Campus Crest Communities; and Anchorage in connection with board representation at Houghton Mifflin. Ele works on numerous activist campaigns and related transactions every year for some of the largest private investment groups and investment banks in the United States and abroad. In addition, he advises on private investments in public equity (PIPEs), initial public offerings and secondary offerings, venture capital financing, and indenture defaults and interpretation, and he counsels clients in the regulatory areas of insider trading, short selling, Sections 13 and 16, Rule 144, insider trading and Regulation M/Rule 105.

Ele is recognized as a leading lawyer in *Chambers USA*, *The Legal 500 US*, *New York Super Lawyers – New York Metro Top 100* and *Super Lawyers Business Edition*. He has served as a moderator and speaker at numerous conferences and events addressing shareholder activism, regulatory and reporting issues, PIPEs, M&A deals, the capital markets and other topics of interest to the alternative investment industry. He contributed to *The Activist Investing Annual Review 2018* (produced by Activist Insight in association with SRZ) and the 2018 *Shareholder Activism Insight* report (published by SRZ in association with Activist Insight and Okapi Partners). Ele received his J.D. from Yale Law School, where he was senior editor of *The Yale Law Journal*.

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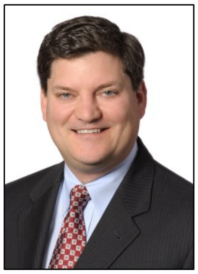
Brian focuses on complex commercial litigation, securities litigation, fraudulent transfer actions, partnership disputes and M&A litigation. Brian also regularly represents clients in connection with SEC and other regulatory inquiries and investigations, and frequently litigates in bankruptcy court. Brian's clients include asset managers for hedge funds and private equity firms, investment banks, prime brokers and individuals.

In his pro bono practice, Brian frequently works with the Innocence Project, a nonprofit legal clinic focused on exonerating wrongly convicted individuals. Brian is a *cum laude* graduate of the Benjamin N. Cardozo School of Law, where he served as managing editor of the *Cardozo Law Review* and worked on litigation resulting in several exonerations as a member of the Innocence Project.



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Regulatory & Compliance

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

John is listed in *The Legal 500 US* and *Washington, DC Super Lawyers*. A recipient of the SEC Capital Markets Award, he serves as an adjunct professor at The George Washington University Law School and is the former chair of the Corporate Finance Committee of the Corporation, Finance and Securities Law Section of the District of Columbia Bar. John has spoken and written on topics ranging from SEC regulations and disclosure obligations to public and private capital raising structures, 1940 Act regulated funds and M&A issues. John was interviewed for *The Hedge Fund Journal* article “BDC and RIC Research and Issuance Proliferating” and he was quoted in the *S&P Global Market Intelligence* article “BDCs Step Into Spotlight With Moves on Leverage, Fees.” John recently spoke on “Specialty Activism: REITs, Banking, Litigation and ‘40 Act Funds” at SRZ’s 9th Annual Shareholder Activism Conference. John holds a J.D. from the Georgetown University Law Center and a B.S.B.A., *cum laude*, from the University of Richmond, where he was a member of Beta Gamma Sigma.

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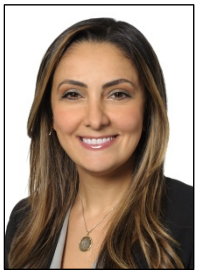
Anna Maleva-Otto

Anna concentrates her practice on advising asset managers on a range of U.K. financial services regulatory matters, including the impact of EU directives and regulations. She advises clients on the establishment of regulated businesses, financial crime (including market abuse, money laundering and bribery), financial promotion and offers of securities, regulatory reporting and disclosure obligations, regulatory capital, and conduct of business rules. She frequently participates in industry working groups in connection with new and emerging regulatory initiatives, and has advised asset managers on several key pieces of recent EU legislation (including GDPR, Short Selling Regulation, Alternative Investment Fund Managers Directive, MiFID II, MAR, EMIR and SFT Regulation). Anna began her career as a regulatory consultant assisting clients in the financial services sector with the design and implementation of compliance procedures, conduct of internal compliance investigations, compliance audits and remediation exercises.

Anna is listed in *Chambers UK* and *The Legal 500 UK*. She has also been recognized as one of *The Hedge Fund Journal*'s 50 Leading Women in Hedge Funds. Anna frequently speaks and writes on topics related to her areas of expertise. She recently worked with AIMA to produce *MiFID2 – A Guide for Investment Managers*, authored the "Insider Trading Law in the United Kingdom" chapter in *Insider Trading Law and Compliance Answer Book* (Practising Law Institute) and co-authored "Brexit: What Alternative Asset Managers Can Expect," published in *The Hedge Fund Journal*. Her recent speaking engagements have addressed topics such as market abuse, insider dealing and payments for research under MiFID II. Anna is admitted to practice in England and Wales, and New York. She received her J.D. from Emory University School of Law and her M.A. from Saint Petersburg State University (Russia).



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Kristine focuses her practice on corporate restructuring and bankruptcy with an emphasis on representing secured and unsecured creditors, ad hoc groups, hedge funds, private equity funds, debtors, agents and other major stakeholders in a range of domestic and cross-border restructurings. Kristine has extensive experience advising on financing and cash collateral matters, plan confirmation issues, 363 sales and other matters arising in the context of in- and out-of-court restructurings. She currently represents an ad hoc group of secured lenders in the Westmoreland Coal Company Chapter 11 cases and a senior secured lender and purchaser of assets of the debtors in the Relativity Media Chapter 11 cases.

Kristine is listed in *New York Super Lawyers*. She received her J.D. from University of Maryland School of Law, her M.A. from Columbia University School of International and Public Affairs and her B.A. from Brigham Young University.

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David is co-head of the Investment Management Group and a member of the firm's Executive Committee. He primarily represents institutional and entrepreneurial investment managers, financial services firms and private investment funds in all aspects of their businesses. He structures investment management and financial services firms along with credit, hedge, private equity, distressed investing, activist and hybrid funds, as well as energy funds, co-investments, funds of funds and scalable platforms for fund sponsors. David also advises on fundraising, management company partnerships, compensation plans, succession plans, seed and strategic investments and spinoffs of investment teams. His work includes counseling clients on finding practical solutions to regulatory and compliance requirements, including the Volcker Rule, and managing conflicts of interest with an emphasis on reducing legal risk to the business.

Clients often seek David's advice on business matters and strategy. He has been named a "Leader in His Field" by *Chambers Global* and *Chambers USA* and has been recognized by *The International Who's Who of Private Funds Lawyers*, *PLC Cross-border Private Equity Handbook*, *The Legal 500 US* and *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*. A past member of the Advisory Board of The Financial Executives Alliance and the Banking Law Committee of the New York City Bar Association, David is a sought-after writer and speaker. Works he has authored or co-authored include the chapter "Management Company Structures and Terms" in *Hedge Funds: Formation, Operation and Regulation*, published by ALM Law Journal Press; "Just Like Starting Over: A Blueprint for the New Wall Street Firm," published by *The Deal*; and "Succession Planning," published by SRZ. He has spoken at conferences and seminars on a range of topics, including fundraising, merchant bank structures, liquidity events, credit and lending funds and co-investment vehicles. David earned his J.D. from Brooklyn Law School and his B.A. from the State University of New York at Albany.

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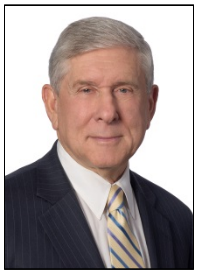
Ron is co-head of the Employment & Employee Benefits Group. His practice concentrates on the litigation of employment and employee benefits cases in federal and state courts throughout the United States involving trade secrets, non-competition, nonsolicit, and breach of confidentiality and breach of loyalty issues. Ron defends employee benefit plans, fiduciaries, and employers in class actions and in cases brought by individual plaintiffs. He represents employee benefit plans before the U.S. Department of Labor, the Pension Benefit Guaranty Corporation and the Internal Revenue Service in connection with novel issues of law concerning plan mergers, terminations, spin-offs, fiduciary duties and prohibited transactions, and various aspects of withdrawal liability and mass withdrawal liability. He litigated, arbitrated and advised on several hundred withdrawal liability matters for multiemployer pension funds and employers. Ron also represents employers (particularly hedge and private equity funds), employees and partners with respect to executive compensation and partnership issues.

Ron is listed in *Chambers USA*, *The Best Lawyers in America* and *New York Super Lawyers* as a leading labor and employment litigation attorney. He is a fellow of the American College of Employee Benefits Counsel and a member of the CPR Employment Dispute Committee of the CPR Institute for Dispute Resolution. A former adjunct professor in New York University School of Continuing Education's Certified Employee Benefits Specialist Program, Ron frequently speaks and writes on employee benefit and employment topics. This year, he has spoken twice on legislative developments affecting multiemployer plans and the PBGC. Ron received a B.S. from the Industrial and Labor Relations School at Cornell University and a J.D. from Columbia Law School, where he was a Harlan Fiske Stone Scholar and the recipient of the Emil Schlesinger Labor Law Prize.



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Paul N. Roth

Paul is a founding partner of the firm and chair of the Investment Management Group. Throughout his career, Paul has acted as counsel to leading public and private companies in financial services and to their boards of directors. His extensive private investment funds practice, an area in which he has more than 45 years of experience, includes the representation of hedge funds, private equity funds, offshore funds, investment advisers and broker-dealers in connection with fund formations and compliance, securities regulation, mergers and acquisitions (domestic and cross-border) and other financial transactions. Considered the "dean of the hedge fund bar," Paul serves as a special adviser to the board of directors of the Managed Funds Association (MFA) and is a former member of the Legal Advisory Board to the National Association of Securities Dealers (NASD). He chairs the Subcommittee on Hedge Funds of the American Bar Association's Committee on Federal Securities Regulation and is a former chair of the NYC Bar Association's Committee on Securities Regulation.

Paul has been consistently recognized as a leading funds lawyer by *The Best Lawyers in America*, which also named him NYC Private Funds/Hedge Funds Law Lawyer of the Year. He is also recognized by *Chambers Global*, *Chambers USA* and *The Legal 500 US*, as well as many other ranking publications. Paul was honored at *The Hedge Fund Journal* Awards for his outstanding achievements in the industry, and he received a Lifetime Achievement Award from Hedge Funds Care in recognition of his prominence in the hedge funds industry and his extraordinary commitment to philanthropy. In addition, he was named to *HFMWeek*'s 2010 list of the 50 most influential people in hedge funds. Paul is a senior director of the Legal Defense Fund of the NAACP and a member of the Advisory Board of the RAND Center for Corporate Ethics and Governance, and he is a fellow of the New York Bar Foundation and the Phi Beta Kappa Society. He served on the Advisory Board of Harvard Law School's Center on Lawyers and the Professional Services Industry and formerly served as president, vice president and a trustee of the Harvard Law School Alumni Association of NYC. He is also a member of The Economic Club of New York. Additionally, Paul has served as a lecturer at the University of Pennsylvania's Wharton School, where he taught "Responsibility in Professional Services." He is also an adjunct professor of finance at NYU Stern School of Business, where he has taught "Managing Financial Businesses," and an adjunct professor of law at NYU School of Law, where he teaches "Advising and Managing Financial Services Businesses." He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). Paul received his J.D., *cum laude*, from Harvard Law School, after which he was awarded a Fulbright Fellowship to study law in the Netherlands. He received his A.B., *magna cum laude*, from Harvard College, where he was Phi Beta Kappa.

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Practices

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Regulatory & Compliance

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Craig is co-head of the Structured Finance & Derivatives Group. His practice focuses on structured finance and asset-backed transactions and swaps and other derivative products, including prime brokerage and customer trading agreements. He represents issuers, underwriters, collateral managers and portfolio purchasers in public and private structured financings, including collateralized loan obligations.

Craig is recognized as a leading lawyer by *Chambers USA*, *Chambers Global*, *The Legal 500 US* and *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers* (Structured Finance and Securitization). He is a member of the Loan Syndications and Trading Association, the International Swaps and Derivatives Association and the Structured Finance Industry Group. He is a much sought-after speaker for hedge fund industry conferences and webinars and the author of numerous articles on advanced financial products. He recently authored "U.S. CLOs: Past and Present" in *The Journal of Structured Finance* and co-authored "U.S. CLOs: The End of U.S. Risk Retention for Collateral Managers?" for *The International Comparative Legal Guide to: Securitisation 2018*. Craig holds a J.D., *cum laude*, from the University of Pennsylvania Law School and his B.A., *cum laude*, from Colgate University.

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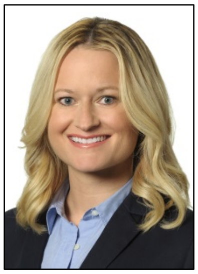
Shlomo is co-head of the Tax Group and focuses his practice on the tax aspects of onshore and offshore investment funds, registered investment companies and business development companies, private equity partnerships, real estate and corporate transactions, restructurings and workouts, securitizations, and existing and emerging financial instruments. Shlomo's most recent representations have addressed hedge fund and management company structures, funds in the energy space, tax considerations for private investment funds and FATCA.

Shlomo has been recognized as a leader in his field by *Chambers USA*, *The Best Lawyers in America*, *The Legal 500 US*, *New York Super Lawyers* and the *Tax Directors Handbook*. He is a member of the Tax Section of the New York State Bar Association and regularly speaks at industry conferences and events. In addition, he has published on a range of topics, including FATCA provisions, FIRPTA and REIT rules, and compliance requirements for hedge funds. Most recently, he co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). Shlomo holds a J.D. from Hofstra University School of Law, where he was articles editor of the *Hofstra Law Review*.



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Practices

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Heather focuses her practice on advising private investment funds and has provided comprehensive legal services to institutional and emerging asset managers, proprietary trading firms, family offices, banks and broker-dealers on a wide range of issues including formation and structuring of domestic and offshore hedge funds, private equity funds, real estate funds and managed account platforms, among others. Heather has extensive experience representing funds and advisers who employ a wide range of investment strategies across all asset classes.

Heather is listed in *New York Super Lawyers*. She earned her J.D. from Fordham University School of Law and her A.B. from Dartmouth College.

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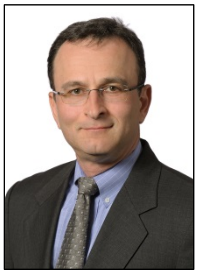
Ji Hye focuses her practice on private equity funds, hedge funds and investment banks in a wide range of domestic and cross-border financing transactions, including asset-based and cash-flow facilities, acquisition and leveraged finance facilities, working capital facilities, secured financings, syndicated credit facilities and subordinated debt financings. Her most recent transactions include representing a private equity fund in a $200-million senior secured financing facility to support the construction of a major New York City tourist attraction; a private equity fund in a $195-million split-collateral financing facility to a supplier of home building products; a private equity fund as the agent for a syndicate of lenders in a senior secured credit facility to finance the acquisition of a national wealth management company; a private equity fund in a SEK 180-million term loan facility to a Swedish software company secured by foreign collateral a foreign bank in a $240-million working capital credit facility to a refiner and retailer of petroleum products; and a global manufacturing services company, as borrower, in a $208-million restructuring credit facility.

Ji Hye was named a "Rising Star" by *New York Super Lawyers* and was selected to serve on *The American Lawyer*'s inaugural Young Lawyer Editorial Board. She received her J.D. from Fordham University School of Law and her B.S., with distinction, from Cornell University.



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Practices

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Boris is co-head of the firm's Structured Finance & Derivatives Group. With almost 25 years of experience across diverse asset classes, Boris focuses on asset-backed securitizations, warehouse facilities, secured financings and commercial paper conduits. His practice encompasses a variety of asset classes, including life settlements, equipment leases, structured settlements, lottery receivables, timeshare loans, litigation funding and cell towers, in addition to other esoteric asset classes such as intellectual property, various insurance-related cash flows and other cash flow producing assets. He also represents investors, lenders, hedge funds, private equity funds and finance companies in acquisitions and dispositions of portfolios of assets and financings secured by those portfolios.

Recognized as a leading lawyer in the industry, Boris is ranked in *Chambers USA*, *Chambers Global* and *The Legal 500 US* for his work in structured finance. He serves as outside general counsel to the Institutional Longevity Markets Association (ILMA) and is a member of the Structured Finance Committee of the New York City Bar Association, the New York State Bar Association, and the Esoteric Assets Committee and Risk Retention Task Force of the Structured Finance Industry Group. A frequent speaker at securitization industry conferences, Boris has conducted various securitization, litigation funding and life settlement seminars in the United States and abroad. Most recently, Boris was interviewed for the articles "Attorneys Must Tread Carefully in Litigation Funding's Next Stage" published in *Law360* and the articles "SRZ's Leading Litigation Finance Practice: Holistic Expertise for a Booming Asset Class" and "Life Settlements and Longevity Swaps: Opportunities for Investors, Individuals, Insurers and Pension Funds," both published in *The Hedge Fund Journal*. His speaking engagements have included "Flash Briefings on Alternative & Emerging Asset Classes — Structured Settlements" at SFIG and IMN Vegas 2018 and "Investing in Litigation Finance" at SRZ's 27th Annual Private Investment Funds Seminar. Boris earned his J.D. from New York University School of Law and his B.A., with honors, from Oberlin College.

Market Update: Terms, Customized Products and Co-Investment Vehicles

I. U.S. Trends

A. Performance and Investor Outlook

1. Performance is mixed.

(a) Hedge Funds

(i) Hedge funds on average lost 4.07 percent in 2018, barely beating the S&P 500.[1]

(ii) *Financial Advisor* reports that the worst-performing hedge fund strategies were equity hedge (-7.8 percent) and CTA/managed futures (7.2 percent); best performing were fixed income directional (0.2 percent) and fixed income relative value (1.3 percent).[2]

(iii) Yet, despite the challenging market conditions, many hedge fund managers beat the market.[3]

(b) Private Capital (PE, Private Debt, RE, Infrastructure and Natural Resources)

(i) Meanwhile, the private capital industry returned about 15 percent.[4]

2. Current fundraising environment is challenging, for some.

(a) Hedge Funds

(i) *Pensions & Investments* reports that new assets invested in hedge funds and hedge funds of funds are down approximately 13 percent compared with 2017 and down approximately 22 percent from five years earlier.[5]

(b) Private Capital

(i) *Preqin* reports that the first three quarters of 2018 saw more money raised than in any year other than 2017, and, as more information becomes available, 2018 could mark the second highest fundraising year of all time.[6]

(1) 1,733 private capital funds closed in 2018, 28 percent down from 2017.

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[1] "The average fund fell 4.07 percent last year, according to research firm *HFR*'s Fund Weighted Composite Index, while an asset-weighted version of the index fell 0.84 percent. That beat a return, including dividends, of negative 4.39 percent for the S&P 500 SPX, +0.45 percent. It also marked the first time the hedge fund index outperformed since 2008, when it fell 19.03 percent versus a 37-percent negative return for the S&P 500, according to FactSet data." https://www.marketwatch.com/story/hedge-funds-lose-money-in-2018-but-outperform-sp-500-by-a-whisker-2019-01-08

[2] https://www.fa-mag.com/news/almost-every-hedge-fund-strategy-marked-by-painful-declines-in-2018-42639.html

[3] https://www.bloomberg.com/news/articles/2019-01-04/hedge-funds-returning-20-show-all-is-not-lost-for-smart-money

[4] *Preqin* calculates North American Private Capital Horizon IRR (one year to June 2018) to be 15.6 percent. https://www.preqin.com/user/PE/HorizonIRRSummary.aspx

[5] https://www.pionline.com/article/20181224/PRINT/181229939/hedge-funds-bit-by-both-drop-in-inflows-more-redemptions

[6] http://docs.preqin.com/reports/Preqin-Private-Capital-Fundraising-Update-Q4-2018.pdf

(2) $757 billion aggregate capital raised by private capital funds in 2018, down from the record $925 billion raised in 2017.

(ii) Mega-funds are raising capital (*Preqin* reports that 17 funds are each currently seeking $10bn or more from investors).[7]

3. Investor Outlook

(a) Hedge Funds

(i) Redemptions have increased.

(1) *Pensions & Investments* reports that redemptions from hedge funds rose approximately 15 percent compared with 2017 and were up approximately 13 percent compared with five years earlier.[8]

(ii) Institutional investors maintain their investments.

(1) *Pensions & Investments* reports that institutional investors are maintaining their investments in hedge funds as part of efforts to protect their portfolios against expected down market conditions in 2019 and beyond.[9]

(b) Private Capital

(i) *Preqin* reports that large proportions of investors expect to commit more capital in 2019 than they did in 2018.[10]

B. Private Fund Strategies

1. Popular hedge fund strategies (based on number of funds launched):

(a) Equity

(b) Macro

(c) Crypto

(d) Credit

(e) Multi-Strategy

2. Popular private equity fund strategies (based on number of funds launched):

(a) Venture

(b) Real Estate

[7] http://docs.preqin.com/reports/Preqin-Private-Capital-Fundraising-Update-Q4-2018.pdf

[8] https://www.pionline.com/article/20181224/PRINT/181229939/hedge-funds-bit-by-both-drop-in-inflows-more-redemptions

[9] https://www.pionline.com/article/20181224/PRINT/181229939/hedge-funds-bit-by-both-drop-in-inflows-more-redemptions

[10] http://docs.preqin.com/reports/Preqin-Private-Capital-Fundraising-Update-Q4-2018.pdf

(c) Growth

(d) Buyout

(e) Early Stage

C. Convergence and Customization

1. Continue to see increase in hybrid and customized structures.

2. Continue to see increased use of funds of one and managed accounts.

3. Trend towards customized, multi-strategy vehicles for large investors with fee aggregation across strategies.

4. Some interest in long-term core strategy PE funds, especially real estate.

5. Interest in emerging niche strategies such as litigation finance, fintech venture structured products – non correlation is a plus in choppy markets.

6. Interest in co-investment vehicles remains high, including "springing" vehicles that can be activated when market conditions warrant.

7. Less seed capital activity; some institutional seed platforms have closed down.

D. Other Trends

1. Hedge Fund Trends

(a) There is a lot of interest in multiple share classes offering different ratios of carry vs. management fees and fee breaks for early or large investors.

(b) "2 and 20" model is no longer the norm.

(i) Management fees vary (depending on size of investment, timing of investment, lock-up period, etc.), but the average remains around 1.5 percent.

(ii) Incentive remains around 17 percent.

(iii) There is little interest in "1 or 30" fee structure.

(c) Some large investors expect MFN treatment based on aggregate investment in the fund complex and MFNs that extend across multiple funds.

(d) Investors seek to ensure management fees aren't a profit center; budgets/fee reductions upon creation of successor fund and sliding fee rates based on fund size are ways to control.

(e) Some managers who are limiting capacity in their funds to prevent cash drag are taking "soft commitments" from investors; this is committed capital that is available to be drawn down when investment opportunities become available. Unlike in PE-style commitments, no fees are charged on the commitment, and there are no penalties for default.

2. Private Equity Trends

(a) More pressure for European waterfalls

(b) Interim clawbacks

(c) Joint vs. several personal guarantee of clawbacks

(d) Expense granularity

(e) Budgets for management fees

(f) Management fees only on invested capital

(g) Allocation of broken deal expenses

(h) Renegotiation of fees at end of term

(i) Shorter fundraising period (12 months)

(j) Increased use of alternative strategies in the closed-end space

(i) Litigation finance

(ii) Loan origination

(iii) Distressed

(iv) Activist

(v) Permanent/evergreen vehicle

(vi) Core real estate

(vii) Digital assets – blockchain venture

(k) Less liquid investments moving out of open-end funds

(i) Co-investments

(ii) Terms; hardwiring

(iii) Side pockets

(l) Secondary market bridges the liquidity gap.

(m) Increased interest in Environmental, Social and Governance ("ESG") investing

II. U.K. and EU Trends

A. London remains the core hedge fund center in Europe, both for European-based firms and for European offices of non-European firms. Some firms have looked to establish a presence in Ireland, Luxembourg or Malta as well.

B. The downward pressure on management fees is causing a number of managers problems given the high capital costs of running a European-based fund manager and the need to maintain regulatory capital.

C. The vast majority of funds established by London-based managers continue to be Cayman funds. However, there is a small trend towards Irish and Luxembourg funds, especially where the cornerstone investor is European or European investors are the primary target. In some cases, Irish or Luxembourg funds are part of a master-feeder structure including Cayman funds and in other cases, they run in parallel to a Cayman flagship fund.

D. UCITs

1. After a number of years constant growth, the alternative UCITS sector saw a falling-off in 2018 due to reduced allocations, increased withdrawals and poor performance.

2. The sector is around $370 billion, but the funds are often complementary funds to flagship offshore funds. It is rare for a manager only to offer a UCITS fund, although some institutional managers focus on UCITS over offshore funds. Distribution capability is key. The vast majority of the money is concentrated on a relatively small number of very large, often institutional, managers.

3. UCITS (and their managers) are highly regulated, subject to significant investment restrictions (including an inability to short) and required to allow withdrawals at least twice a month. In practice, most funds are at least weekly dealing and a significant number offer daily dealing.

III. Trends in the Activism Space

A. Co-investment Vehicles and SPVs

1. 13D Disclosure Issues

(a) A Schedule 13D is required to be filed by any person who acquires beneficial ownership of more than 5 percent of any class of voting "equity securities" registered under Section 12 of the Securities Exchange Act of 1934 and is not "passive."

(b) Item Six of Schedule 13D requires disclosure of all agreements relating to securities of the relevant issuer and Item Seven requires that certain agreements be attached as exhibits to Schedule 13D, including those agreements that relate to allocation of profits and losses on the position.

(c) Activist investors structuring co-invests and SPVs need to consider these disclosure requirements when documenting/structuring activist investment vehicles.

2. Group Issues

(a) When two or more persons agree (whether formally or informally, orally or in writing) to act together for the purpose of acquiring, holding, voting or disposing of securities they will be deemed to be a "group."

(b) If considered a group, the securities held by the group members must be aggregated when determining whether the 5-percent threshold has been crossed.

(c) Group status is often judged in hindsight based on circumstantial evidence, so investors need to consider this when structuring activist vehicles. If the investors in your co-invest or SPV own the position outside of your vehicle, it may appear that you do not have an agreement as to those securities.

B. Regulatory Issues

1. An activist manager may need to have greater control over the ability of investors to withdraw capital/force a sale of the securities in order to comply with applicable regulatory requirements, including insider trading rules and avoid 16(b) profit disgorgement issues.

(a) *Insider Trading*. Activist investors with board seats or otherwise in possession of MNPI with respect to an issuer will often be restricted from trading and may not be able to sell securities at times of investor withdrawals.

(b) *Section 16*. Activist investors that beneficially own more than 10 percent or have board seats may be subject to Section 16, which requires disclosure of all trading and requires disgorgement of "profits" on purchases and sales that occur within a period of less than six months.

C. Emulated Funds

1. Emulated funds are a new type of product where managers are paid a fee for a model portfolio, but the client ultimately has discretion with respect to the position (i.e., whether to buy, sell and how to vote the position) and does its own execution.

2. Emulated funds can raise beneficial ownership and group concerns depending on the facts.

IV. Trends in the Regulated Funds and Public Vehicle Space

A. Alternative asset managers, particularly from the credit side, continue to move into the regulated funds space.

1. Two key drivers for growth are:

(a) Focus on increasing the investor base, through retail or high-net worth individual investors; and

(b) Taking advantage of some of the potential tax benefits offered to offshore and tax-exempt investors from investing through a regulated investment company rather than a partnership structure.

2. Recent BDC legislation doubling the amount of available leverage has also helped increase manager interest in the regulated fund space.

(a) This legislation has in part helped foster a trend toward private BDCs, which report like public funds but operate with a capital call and distribution structure that more closely mirrors a private credit funds model.

B. Managers continue to look at offshore public vehicles, which typically conduct a public offering outside the United States, coupled with a U.K. or EU exchange listing.

1. For example, this could be a public offering in the United Kingdom for a London Stock Exchange-listed investment vehicle, coupled with a U.S. private placement to qualified purchasers.

2. If structured properly, those offshore public vehicles can provide access to permanent capital while remaining outside the scope of the 40 Act restrictions U.S. public funds face.

C. Continue to see interest in sponsoring or investing in special purpose acquisition vehicles ("SPACs"), including using offshore structures that can provide greater flexibility than the traditional domestic SPAC model.

Regulatory Outlook 2019

I. Current Trends in SEC Examinations

A. Current State of the Investment Adviser Examination Program – The Office of Compliance Inspections and Examinations ("OCIE") completed 2,114 investment adviser examinations in FY 2017 and estimates that it has completed 2,120 in FY 2018. In its 2019 budget request, OCIE is seeking to restore 13 investment adviser examiner positions so that it can examine a total of 2,160 investment advisers in FY 2019. The budget request noted that OCIE staffing has not kept pace with industry growth, as over the last five years "the number of registered advisers has grown by over 15 percent and the assets under management of these firms has increased by more than 40 percent." According to the staff, 35 percent of all registered investment advisers have not yet been examined.[1]

B. Most Common Deficiencies – The most frequently cited deficiencies identified by the examination staff in the New York Regional Office during FY 2017 were:

1. *Compliance Policies and Procedures Insufficient or Not Reasonably Tailored to the Adviser's Business* (*identified in 49 percent of examinations).* The examination staff found that these deficiencies typically fell into four categories.[2]

   (a) Policies and procedures were incomplete or inaccurate. Typically this deficiency was cited because either a policy was inconsistent with disclosure in the adviser's offering documents or Form ADV, or the adviser's legal and compliance personnel did not have a complete understanding of what front office or operational personnel were doing in practice.

   (b) Policies and procedures were not modified in light of new business practices or products.

   (c) Policies and procedures were not adequately documented (e.g., the review, update, or approval of a valuation or trading model was not documented).

   (d) Policies and procedures were outdated. To the examination staff, this reflects that the adviser is not reviewing its policies regularly.

   Deficiencies in this area are so frequent because examination staff will cite advisers for compliance failures when they also cite an adviser for related substantive deficiencies, noting that the substantive deficiency highlights an insufficiency in the adviser's policies and procedures (e.g., an adviser might be cited for an expense allocation error and having insufficient policies and procedures regarding expense allocations). Examination staff will also cite advisers for the insufficiency of their policies and procedures where no such substantive deficiency has been identified, but where the examination staff believes there could be significant risk of such a lapse in the future.

2. *Form ADV Issues (identified in 46 percent of examinations).* Examiners tended to find issues related to conflicts of interest disclosure, specifically identified were side-by-side management and shared office space as areas where advisers had inaccurate or incomplete disclosure. Further, examiners found that

[1] U.S. Securities and Exchange Commission, Congressional Budget Justification Annual Performance Plan 27, (2018), available at https://www.sec.gov/files/secfy19congbudgjust.pdf.

[2] *New York Regional Office Investment Adviser Compliance Outreach Netcast, Part 1*, U.S. Securities and Exchange Commission, (Sept. 12, 2018), https://www.sec.gov/info/complianceoutreach/webcasts.htm.

advisers often did not have sufficient documentation under Rule 204-2 to support the RAUM calculations in their Form ADV.[3]

3. *Code of Ethics Issues (identified in 21 percent of examinations).* Examiners found that advisers often failed to identify all access persons subject to their code of ethics and failed to timely obtain reporting and certification required under their code of ethics.[4]

4. The examination staff also identified as frequent deficiencies insufficient recordkeeping (identified in 15 percent of examinations) and the failure to conduct an annual compliance review or a general lack of compliance testing (identified in 15 percent of examinations).[5]

5. Though not included in the top five most frequently cited deficiencies, examination staff indicated that the custody rule continues to be a consistent source of deficiencies for advisers. For those advisers that rely on the "private fund exemption" under Rule 206(4)-2(b)(4), OCIE notes frequent failures to confirm that the accountant being used for their funds' annual audits is registered with the Public Company Accounting Oversight Board, and failures to distribute audited financial statements within 120 days of a fund's fiscal year end.[6]

C. Increasing Number of Deficiencies – Those areas where an uptick in deficiencies was identified by the examination staff in the New York Regional Office during the 2017 Fiscal Year were:

1. *Regulation D Filings*. Examiners found an increase in instances where advisers do not file Form D, are late in filing Form D, do not complete the form according to its instructions, or that the information contained therein is inconsistent with the advisers' other filings (e.g., Form ADV). [7]

2. *Whistleblower Rules*. Many of the issues identified in the Oct. 24, 2016 Risk Alert issued by the OCIE on compliance with Rule 21F-17 were a source of deficiencies for advisers.[8]

   NOTE: While the staff did not identify the nature of these deficiencies, advisers are often cited for having language in their compliance manuals or employee agreements that is either incomplete or inconsistent with Rule 21F-17.

   An uptick of deficiencies in this area is not altogether unsurprising as the 2016 Risk Alert stated that, "OCIE is including in certain examinations a review of registrants' compliance with rules impacting whistleblowers and potential whistleblowers that arose out of the Dodd Frank Act."

3. The examination staff also noted an increase in deficiencies for advisers who did not meet the eligibility requirements for the internet adviser registration exception under Rule 203A-2(e), and for advisers who failed to keep written cash solicitation agreements in accordance with Rule 206(4)-3.[9]

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[3] *Id*.

[4] *Id*.

[5] *Id*.

[6] *Id*.

[7] *New York Regional Office Investment Adviser Compliance Outreach Netcast, Part 2*, U.S. Securities and Exchange Commission (Sept. 12, 2018), https://www.sec.gov/info/complianceoutreach/webcasts.htm.

[8] *Id*.

[9] *See* Securities and Exchange Commission, Office of Compliance Inspections and Examinations, *Risk Alert: Investment Adviser Compliance Issues Related to the Cash Solicitation Rule* (Oct. 31, 2018), available at https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Cash%20Solicitation.pdf.

D. Examination Process

1. The staff cited the following reasons advisers are examined.[10]

   (a) The adviser's risk profile meets that which the examination staff is concerned about at a given time.

   (b) The examination staff received a tip, complaint or referral regarding the adviser.

   (c) The examination staff is reviewing a specific compliance area which may be a risk for the adviser.

   (d) The adviser was randomly selected for examination.

   Examination staff typically will not inform advisers why they are being examined, or into which of the above categorizations they fit. However, as the examination progresses the adviser can glean the examination staff's focus based on the subject matter of the materials requested and questions asked during interviews and phone calls.

2. OCIE notes the following tips on how to make examinations run more smoothly, which are consistent with our longstanding approach:[11]

   (a) Have a first-day presentation ready to identify and describe key risks and key personnel.

   NOTE: We have long advocated for the use of first-day presentations as an important first step in opening an adviser's dialogue with the examination staff. They are an opportunity to present an affirmative case as to the strength of the adviser's internal controls, recordkeeping and compliance program, rather than just responding to the staff's requests.

   (b) Update your compliance program regularly, and document any testing or review, including the annual review. Having this documentation will help expedite the examination staff's review of an adviser's process.

   (c) Ensure that books and records are up-to-date so that you can respond to the examination staff's requests promptly.

   (d) Keep in communication with the examination staff during the examination process, make sure responses are complete and unambiguous, and be forthcoming and transparent with the examination staff.

E. National Exam Analytics Tool ("NEAT")

1. In FY 2014, the Quantitative Analytics Unit ("QAU") of the SEC developed NEAT, a data analytics tool, which allows the staff review trading and other data in a time-efficient manner rather than engaging in labor-intensive manual review.[12]

[10] *Id*.

[11] *Id*.

[12] U.S. Securities and Exchange Commission, Agency Financial Report Fiscal Year 2014 31, (2014), available at https://www.sec.gov/about/secpar/secafr2014.pdf.

2. Examiners use NEAT to analyze trading data during examinations, including the trade blotter, restricted list, and holdings reports. The tool is used to identify potential insider trading, front-running client accounts, cross trades, principal trades, window dressing and the misallocation of investment opportunities, among others. An inability to produce a trade blotter, or the production of an incomplete or erroneous trade blotter would raise questions about an adviser's recordkeeping and compliance program.[13]

3. Principal trades and cross trades are types of transactions that can be identified by NEAT, and so they are squarely in the examination staff's analytical capabilities. If an adviser engages in principal or cross trades, the examination staff may focus on the pricing of these transactions, and what if any conflict of interest disclosure or policy governs such transactions.[14]

II. SEC Staff Guidance

A. The SEC staff frequently make their views known with respect to a variety of issues through speeches, guidance, no-action letters, answers to FAQs and risk alerts.

B. In a public statement issued on Sept. 13, 2018, SEC Chairman Jay Clayton reinforced that "[t]he Commission's longstanding position is that all staff statements are nonbinding and create no enforceable legal rights or obligations of the Commission or other parties," and explained that he "instructed the directors of the Division of Enforcement and the Office of Compliance Inspections and Examinations to further emphasize this distinction to their staff."[15]

C. Chairman Clayton also indicated that the SEC's divisions and offices would be reviewing whether prior expressions of staff views or guidance should be modified, supplemented or rescinded in light of recent developments.

D. This was part of a broader effort to reiterate the legal status of guidance provided by federal government agencies. The Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, the Office of the Comptroller of the Currency and the Bureau of Consumer Financial Protection released a similar joint statement on Sept. 11, 2018, clarifying the role of supervisory guidance issued by the staffs of those agencies.[16]

III. Fiduciary Rule Proposal

A. On April 18, 2018, the Commission issued three proposals addressing the duties and standards applicable to broker-dealers and investment advisers:

1. "Regulation Best Interest" would require registered broker-dealers and their associated persons to act in the best interest of retail investors when recommending investment strategies or securities transactions to retail customers.[17]

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[13] *New York Regional Office Investment Adviser Compliance Outreach Netcast*, *Part 1*, *supra* note 2.

[14] *Id*.

[15] Public Statement, Chairman Jay Clayton, Statement Regarding SEC Staff Views (Sept. 13, 2018), available at https://www.sec.gov/news/public-statement/statement-clayton-091318.

[16] News Release, Office of the Comptroller of the Currency, Interagency Statement Clarifying the Role of Supervisory Guidance (Sept. 11, 2018), available at https://www.occ.gov/news-issuances/news-releases/2018/nr-ia-2018-97a.pdf.

[17] Regulation Best Interest, Exchange Act Release No. 83062, 83 Fed. Reg. 21574 (Apr. 18, 2018).

2. A rule that would require registered investment advisers and registered broker-dealers to deliver a relationship summary to retail investors.[18]

3. A proposed interpretation of the fiduciary duty that an investment adviser owes to its clients.[19]

B. Proposed Fiduciary Interpretation

1. While focusing mostly on the adequacy of disclosure of conflicts, the Proposed Interpretation also indicates that in some circumstances disclosure is insufficient to satisfy an adviser's fiduciary obligations. The Proposed Interpretation indicates that "[d]isclosure of a conflict alone is not always sufficient to satisfy the adviser's duty of loyalty and section 206 of the Advisers Act," and consent would not be effective where "the material facts concerning the conflict could not be fully and fairly disclosed."[20]

2. When describing an investment adviser's fiduciary duty of loyalty, the Proposed Interpretation indicates that "an adviser must *seek to avoid* conflicts of interest with its clients, and, at a minimum, make full and fair disclosure of all material conflicts of interest that could affect the advisory relationship."[21]

3. The proposal identifies "informed consent" as the basis for permitting a conflict of interest, but does not articulate a standard for informed consent.

4. The proposal does not differentiate between fiduciary duties in the context of retail investors and institutional investors.

IV. SEC Enforcement Activity and Other Litigation

A. Introduction

1. SEC staff have indicated that the pendulum is swinging away from a broken windows approach. Under former SEC Chair Mary Jo White, the SEC pursued many cases over even the smallest legal violations to sweep the entire field. The SEC would also press for admissions of fault by firms and individuals, rather than allowing defendants to resolve probes by paying penalties and neither admitting nor denying the allegations.

2. Steven Peikin, Co-Director of the Enforcement Division, has stated, "I view individual accountability as perhaps the most effective general deterrent tool in our arsenal, because it can have a broad effect on corporate culture in a way that immeasurably benefits individual investors, preventing misconduct before it starts … Of course, our emphasis on individual accountability has costs, because building and prosecuting cases against individuals is inherently resource-intensive … But we ultimately believe that

[18] Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles, Exchange Act Release No. 83062, Advisers Act Release No. 4888, 83 Fed. Reg. 21416 (Apr. 18, 2018).

[19] *See* Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, Advisers Act Release No. IA-4889, 83 Fed. Reg. 21203 (Apr. 18, 2018) (hereinafter "Proposing Release").

[20] *Id*. at 17, 18 ("For example, in some cases, conflicts may be of a nature and extent that it would be difficult to provide disclosure that adequately conveys the material facts or the nature, magnitude and potential effect of the conflict necessary to obtain informed consent and satisfy an adviser's fiduciary duties. In other cases, disclosure may not be specific enough for clients to understand whether and how the conflict will affect the advice they receive. With some complex or extensive conflicts, it may be difficult to provide disclosure that is sufficiently specific, but also understandable, to the adviser's clients. In all of these cases where full and fair disclosure and informed consent is insufficient, we expect an adviser to eliminate the conflict or adequately mitigate the conflict so that it can be more readily disclosed.").

[21] Proposing Release, *supra* note 19, at 15-16 (emphasis added). In other contexts, however, the Proposed Interpretation quotes the "eliminate, or at least . . . expose" language from *SEC v. Capital Gains*. *Id.* at 6 (quoting *SEC v. Capital Gains*, 375 U.S. 180, 191 (1963)).

the cost is worth it; … the deterrent effect of individual accountability has outsized effects on our markets."[22]

3. At the same time, the Enforcement Division states that it will continue to charge individuals where appropriate. In Fiscal Year 2018, individuals were named in more than 70 percent of the standalone actions the SEC brought, including CEOs, CFOs, accountants, auditors, and other gatekeepers. (2018 Enforcement Annual Report at 2).

4. And, certain "strict liability" violations continue to be enforced, including political contributions and Rule 105 violations.

5. Enforcement against investment advisers remains 20 percent of all enforcement cases. This remains the second largest category of enforcement, surpassed only by securities offerings (which increased notably as the staff investigates to ensure initial coin offerings are in compliance with all applicable laws).

6. The SEC continues to increase the number of enforcement actions year-over-year, although the total value of all monetary judgments ordered decreased slightly. Fiscal Year 2018 once again set a new record with 821 enforcement actions. The SEC may have to forego approximately $900 million in disgorgement ordered in prior cases following the Supreme Court's ruling in *Kokesh v. SEC*. 2018.[23]

B. Recent Activity

1. Insider Trading

(a) Visium Asset Management LP (May 8, 2018) – An adviser was censured, forced to return all investor capital, and withdraw as an investment adviser, and was required to pay $5,475,934 in disgorgement with interest, and a $4,755,223 civil penalty, for insider trading and an asset mismarking scheme. One trader obtained and traded on the same confidential information about U.S. Centers for Medicare and Medicaid Services ("CMS") rate changes. Another trader obtained material nonpublic information about upcoming approvals of generic drugs from a former employee of the FDA's Office of Generic Drugs he had hired as a consultant. This adviser had policies that prohibited its traders from trading on the basis of material nonpublic information and required its employees to report potential material nonpublic information to its chief compliance officer. The SEC, however, found that the adviser did not enforce these policies or monitor traders' communications with consultants.[24] The SEC obtained disgorgement with interest of $127,496 from the FDA employee.[25] The trader who received the FDA approval information pleaded guilty but has not yet been sentenced as he is cooperating with the prosecution, and the SEC's civil case against him is still pending.[26] All charges against the CMS-rate-change trader were dropped following his death.

[22] Steven Peikin, Co-Director, Division of Enforcement, Keynote Address to the UJA Federation (May 15, 2018), available at https://www.sec.gov/news/speech/speech-peikin-051518.

[23] U.S. Securities and Exchange Commission, Division of Enforcement, Annual Report 11-12, (2018), available https://www.sec.gov/files/enforcement-annual-report-2018.pdf.

[24] *In the Matter of Visium Asset Mgmt., LP*, Release No. IA-4909 (May 8, 2018), available at https://www.sec.gov/litigation/admin/2018/33-10494.pdf.

[25] *SEC Announces Settlement with Former Government Official in Insider Trading Case*, Litigation Release No. 23688 (Nov. 14, 2016).

[26] U.S. Attorney's Office for the Southern District of New York, Press Release, *Four Defendants Sentenced Following Convictions At Trial For Stealing Confidential Government Information And Using It To Engage In Illegal Trading* (Sept. 13, 2018), https://www.justice.gov/usao-sdny/pr/four-defendants-sentenced-following-convictions-trial-stealing-confidential-government.

(b) Deerfield Management Co. (Aug. 21, 2017) – A former CMS employee opened a political intelligence firm that consulted for a number of investment advisers. He obtained information about upcoming agency decisions from a friend and former colleague who still worked at the agency. Some of the investment advisers who received material nonpublic information traded on it, generating in some cases millions of dollars in trading profits.[27] The U.S. Attorney's Office brought criminal charges against the government employee, the consultant and two of the investment adviser's partners. The consultant was sentenced to a year and a day in prison and the government employee was sentenced to 20 months.[28] The adviser's two partners, however, were sentenced to three years in prison and ordered to pay more than $1.3 million.[29] The SEC brought civil charges alleging that the adviser failed to establish, maintain and enforce policies and procedures reasonably designed to prevent the misuse of material nonpublic information and which considered the risks of its business practices.[30] In particular, the SEC faulted the adviser for engaging political intelligence consultants and other firms as part of the industry research that drove its investment decisions while explicitly excluding research firms from the policies and procedures it had in place regarding expert networks. The SEC also faulted the adviser for ignoring red flags that the information its consultants provided had come from confidential sources, including the consultant's "CMS guys." Several of those communications reached senior executives at the adviser but no corrective actions followed. The adviser itself paid $4.6 million to settle the SEC's oversight failure charges.[31]

(c) Considerations from 2018 Insider Trading Cases

(i) Electronic Communications – Regulators continue to find transmissions of material non-public information ("MNPI") through the use of texting[32] and electronic messaging platforms. Regulators will not hesitate to review communications on these platforms as part of their examination or enforcement efforts.

(ii) Covered Accounts – In many cases, individuals will trade on the basis of MNPI in accounts in the names of their family members.[33] Ensuring that all covered accounts and related information are reported by an adviser's access persons can avoid blind spots in an adviser's compliance program.

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[27] Brendan Pierson, *Ex-Deerfield partners get prison in case over U.S. agency leaks*, Reuters (Sept. 13, 2018), https://www.reuters.com/article/us-usa-crime-healthcare-insidertrading/ex-deerfield-partners-get-prison-in-case-over-u-s-agency-leaks-idUSKCN1LT2YG.

[28] *Id.*

[29] *Id.*; Christian Berthelsen & Bob Van Voris, *'King of Political Intelligence' Sentenced to Prison for Insider Trading*, Bloomberg (Sept. 13, 2018), https://www.bloomberg.com/news/articles/2018-09-13/-king-of-political-intelligence-gets-one-year-in-insider-case.

[30] *In the Matter of Deerfield Mgmt. Co.*, Release No. IA-4749 (Aug. 21, 2017), available at https://www.sec.gov/litigation/admin/2017/ia-4749.pdf.

[31] *Id.* (disgorgement with interest of approximately $800,000 plus a civil penalty of almost $4 million).

[32] *See* Complaint, *Securities and Exchange Commission v. Hamed A. Ettu*, Case No. 2:2018-cv-04739 (E.D. Pa Nov. 2, 2018), available at https://www.sec.gov/litigation/complaints/2018/comp-pr2018-251.pdf.

[33] *See* Complaint, Securities and Exchange Commission v. Bryan R. Ziegenfuse, No. 2:18-cv-04192-CMR (E.D. Pa. Sept. 28, 2018), available at https://www.sec.gov/litigation/complaints/2018/comp24298.pdf; Complaint, *Securities and Exchange Commission v. Rong Chen*, No. 2:18-cv-07840 (W.D. Ca. Sept. 10, 2018), available at https://www.sec.gov/litigation/complaints/2018/comp24269.pdf; and *In the Matter of Joseph Jennings*, Release No. 83889 (Aug. 20, 2018), available at https://www.sec.gov/litigation/admin/2018/34-83889.pdf.

(iii) Loss Avoidance – Cases are often brought in situations where individuals trade before negative news becomes public to avoid significant losses.[34] Incorporating loss avoidance monitoring as part of forensic trade testing can be an important safeguard.

(iv) Sources of MNPI – Corporate insiders[35] and service providers such as attorneys, auditors[36] and investment bankers[37] are an ever-present potential source of MNPI. Contacts with corporate insiders specifically are a recent focus of examination staff.

2. Other Areas to Have, Update and Test Policies and Procedures

(a) Electronic Communications – In 2017, OCIE conducted a sweep of many investment advisers to test their policies and procedures for maintaining adequate records of business-related electronic communications. As technology advances, traders and contacts often do not communicate exclusively through email and Bloomberg chat, and may be communicating over platforms that the investment adviser is not yet logging or which are difficult to archive because the messages delete automatically once read. OCIE asserted that Rule 204-2(a)(7) requires investment advisers to maintain all communications about investment advice, orders to buy or sell securities, the receipt and distribution of securities or funds, and the performance of the investments, no matter what platform they are communicated over.

(b) Affiliate Transactions – Cushing Asset Management LP (Sept. 14, 2018) – An adviser decided that it would sell and have a related fund buy a certain amount of units and MLP on the date the units the adviser held would become unrestricted. The adviser obtained advice from counsel on how to do this without conducting a cross trade, but the traders did not follow the instructions they received. The adviser used two separate brokers and incurred significant brokerage fees, and ultimately conducted an affiliate sale in violation of Section 17(a) of the Investment Company Act, which prohibits any affiliate of a registered investment company from selling a security to that investment company absent an exemption order from the SEC. The SEC imposed a civil penalty of $100,000.[38]

(c) Whistleblower and Anti-Retaliation – *Digital Realty Trust, Inc. v. Somers* (2018) – One recent development in interpreting the Dodd-Frank Act's effect on the Securities and Exchange Act of 1934 was the Supreme Court's highly anticipated decision on whether the definition of "whistleblower" in the anti-retaliation provisions of Dodd-Frank covers those individuals who report possible violations *only* internally and not directly to the SEC.[39] The Supreme Court resolved a circuit split with its unanimous decision. Based on the plain language of the Dodd-Frank Act, which the Court viewed as "unequivocal"— the act protects only individuals who report securities

[34] *See* Complaint, *Securities and Exchange Commission v. Amer Deeba*, No. 3:18-cv-05346 (N.D. Ca. Aug. 30, 2018), available at https://www.sec.gov/litigation/complaints/2018/comp24251.pdf and *In the Matter of James Lentz*, Release No. 10535 (Aug. 22, 2018), available at https://www.sec.gov/litigation/admin/2018/33-10535.pdf.

[35] *See* Complaint, *Securities and Exchange Commission v. Christopher Collins*, No. 1:18-cv-07128 (S.D.N.Y. Aug. 8, 2018), available at https://www.sec.gov/litigation/complaints/2018/comp-pr2018-151.pdf and Complaint, *Securities and Exchange Commission v. Saverio Barbera*, No. 2:18-cv-02033 (E.D.N.Y. Apr. 5, 2018), available at https://www.sec.gov/litigation/complaints/2018/comp24104.pdf.

[36] *See In the Matter of Joseph Jennings*, Release No. 83889, *supra* note 33 and *In the Matter of Michael Johnson*, Release No. IA-4954 (July 6, 2018), available at https://www.sec.gov/litigation/admin/2018/34-83602.pdf.

[37] *See* Complaint, *Securities and Exchange Commission v. Woojae Jung*, No. 1:18-cv-04811 (S.D.N.Y. May 31, 2018), available at https://www.sec.gov/litigation/complaints/2018/comp24153.pdf and Complaint, *Securities and Exchange Commission v. Bovorn Rungruangnavarat*, No. 1:18-cv-03196 (N.D. Il. May 4, 2018), available at https://www.sec.gov/litigation/complaints/2018/comp24136.pdf.

[38] *In the Matter of Cushing Asset Management, LP*, Release No. IC-33226 (Sep 14, 2018), available at https://www.sec.gov/litigation/admin/2018/ic-33226.pdf.

[39] *Digital Realty Trust, Inc. v. Somers*, 583 U.S. ___ (2018).

law violations to the SEC. The Court buttressed its decision by referring to the purpose of Dodd-Frank, as reflected in its legislative history — "to motivate people who know of securities law violations to tell the SEC." The Court contrasted the limited purpose of Dodd-Frank with the broader purpose of the Sarbanes-Oxley Act — to disrupt the "corporate code of silence" after Enron. Accordingly, the Sarbanes-Oxley Act protects internal-only whistleblowers from retaliation, while Dodd-Frank does not.

3. Forms and Reporting

   (a) LKL Investment Counsel, LLC (Jan. 3, 2018) – A firm principal directed a fund to invest in other private funds he managed, without updating Form ADV to disclose his ownership and proprietary interests in client transactions.[40]

   (b) On June 1, 2018 the SEC announced settlements with 13 registered investment advisers for failure to file Form PF, a filing used by the SEC to monitor risk. All thirteen of the advisers agreed to be censured, to cease and desist from future violations, make the necessary filings and pay a civil penalty of $75,000. [41]

4. Conflicts of Interest

   (a) LendingClub Asset Management LLC ("LCAM") (Sept. 28, 2018) – LCAM, its founder, and former CFO and General Counsel consented to the entry of an order under which the SEC found that all three violated Sections 204(a), 206(1), 206(2), 206(4) and 207 of the Advisers Act and Rules 204-1(a), 206(4)-7 and 206(4)-8 thereunder, by among other things, failing to disclose conflicts of interest to investors in a private fund they managed, and failing to follow their own policies meant to mitigate such conflicts. According to the SEC's order, LCAM and its two principals failed to disclose to their investors that LCAM had purchased soon-to-be-expired and unfunded longer-term loans from its parent company's lending platform ("LendingClub"). At the time, the fund managed by LCAM was already over-allocated in longer-term loans according to its policy and shorter-term loan opportunities were available for purchase. The SEC found that LCAM had purchased the longer-term loans for the benefit of its parent company, as those longer-term loans were set to expire on the LendingClub platform, a conflict of interest which should have been disclosed. Prior to the consent to the entry of the order, LCAM undertook to take significant remedial efforts during the course of the investigation including reimbursing $1 million to fund investors, engaging a third-party compliance consultant to redesign its compliance program and disclosures, and establishing a new largely independent governing board to supervise whether LCAM is fulfilling its fiduciary duty. LCAM was ordered to pay a civil penalty of $4 million. One of the principals agreed to pay a $200,000 penalty, and the other, a $65,000 penalty.

   (b) WCAS Management Corporation ("WCAS") (Apr. 24, 2018) – WCAS consented to the entry of an order under which the SEC found that WCAS violated Sections 206(2) and 206(4) of the Advisers Act, and Rule 206(4)-8 thereunder, by failing to disclose conflicts of interest to investors in private funds they managed. According to the SEC's order, WCAS did not disclose the terms of a services agreement which would cause WCAS to be paid fees based on the amount of services provided through a vendor to portfolio companies held by the funds (i.e., the more services that were provided through the vendor, the more WCAS was paid). The SEC found that WCAS did not seek

[40] *In the Matter of LKL Investment Counsel LLC and Mark H. Love*, Release No. IA-4836 (Jan. 3, 2018), available at https://www.sec.gov/litigation/admin/2018/ia-4836.pdf.

[41] Press Release, U.S. Securities and Exchange Commission, SEC Charges 13 Private Fund Advisers for Repeated Filing Failures (Jun. 1, 2018), available at https://www.sec.gov/news/press-release/2018-100.

approval from the funds' investor committees — which were set up under the funds' organizational documents — for transactions which posed conflicts of interest for WCAS. Upon contact from the SEC, WCAS stopped receiving the fees under the services agreement. WCAS was ordered to pay disgorgement of $623,035, prejudgment interest of $65,748.78 and a civil penalty of $90,000.[42]

(c) Harbour Investments Inc. (Sept. 13, 2018) – An adviser failed to disclose to investors that it had a marketing services agreement with a particular custodian, which created a conflict of interest for the adviser by incentivizing it to choose that custodian over others when giving investment advice to its clients. This violated Sections 206(2), 206(4), and 207 and Rule 206(4)-7 of the Advisers Act. The SEC censured the adviser, imposed an undertaking, disgorgement and interest totaling approximately $165,000 and a civil penalty of $75,000. The SEC created a fair fund with these payments.[43]

(d) Hamlin Capital Management LLC (Aug. 10, 2018) – An adviser routinely engaged in cross trade transactions among client accounts, but by using different prices for the buy and sell side it favored the purchasing clients over the selling clients though it owed both the same fiduciary obligations. Adviser also arranged purchases of fixed income securities at above-market prices and then arranged cross trades at those higher prices without attempting to obtain more favorable prices from the secondary market, contrary to its obligation to achieve the best price for execution. This violated Section 206(2), 206(4), and 207 and Rules 206(4)-7 and 206(4)-8(a)(2). The SEC censured the adviser and imposed a civil penalty of $900,000.[44]

(e) Putnam Investment Management LLC (Sept. 27, 2018) – A portfolio manager had certain clients who wished to sell particular positions that he viewed as desirable and wanted to purchase them for other clients. The portfolio manager arranged with broker-dealers to temporarily sell and repurchase these securities; however, he sold at the highest bid and repurchased at a small markup over the sale price, thus favoring purchasers despite his fiduciary duties to both purchasers and sellers. This violated Section 17(a) of the Investment Company Act, Sections 203(e)(6), 206(2), 206(4), and 207 and Rule 206(4)-7 of the Advisers Act. The SEC suspended the portfolio manager and imposed a civil penalty of $1 million on the adviser and $50,000 on the portfolio manager.[45]

(f) Yucaipa Master Manager LLC (Dec. 13, 2018) – The firm did not disclose its practice of charging to the funds the cost of some in-house employees who assisted in preparing the funds' tax returns, nor its financial arrangements with certain service providers (which posed potential conflicts of interest), the expenses from which were misallocated. This violated Sections 206(2), 206(4) and Rules 206(4)-7 and 206(4)-8 of the Advisers Act. The SEC imposed a civil penalty of $1,000,000.[46]

(g) THL Managers V LLC and THL Mangers VI LLC (June 28, 2018) – THL Managers V and VI did not adequately disclose to investors and potential investors their potential receipt of accelerated fees upon the sale or initial public offering of certain portfolio companies. The SEC found that this

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[42] *In the Matter of WCAS Management Corporation*, Release No. IA-4896 (Apr. 24, 2018), available at https://www.sec.gov/litigation/admin/2018/ia-4896.pdf.

[43] *In the Matter of Harbour Investments, Inc.*, Release No. IA-5006 (Sept. 13, 2018), available at https://www.sec.gov/litigation/admin/2018/34-84115.pdf.

[44] *In the Matter of Hamlin Capital Management, LLC*, Release No. IA-4983 (Aug. 10, 2018), available at https://www.sec.gov/litigation/admin/2018/ia-4983.pdf.

[45] *In the Matter of Putnam Investment Management, LLC and Zachary Harrison*, Release No. IA-5050 (Sept. 27, 2018), available at https://www.sec.gov/litigation/admin/2018/ia-5050.pdf.

[46] *In the Matter of Yucaipa Master Manager, LLC*, Release No. IA-5074 (Dec. 13, 2018), available at https://www.sec.gov/litigation/admin/2018/ia-5074.pdf.

violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, for failure to adopt policies and procedures to prevent such a violation. THL Managers V and VI were required to pay a civil money penalty in the amount of $1,500,000.[47]

(h) Lyxor Asset Management, Inc. (June 4, 2018) – Lyxor failed to disclose a conflict of interest regarding an arrangement between itself and a third-party adviser, which would compensate Lyxor based on the amount of its clients' assets invested into funds managed by the third-party adviser. Lyxor also failed to maintain adequate books and records with respect to the receipt of fees, and adopt adequate policies and procedures with respect to preventing such a conflict of interest. The SEC found these actions violated Sections 204(a), 206(2), and 206(4) of the Advisers Act and Rules 206(4)-2(a)(2) and 206(4)-7 thereunder. Lyxor was censured and ordered to pay a civil penalty of $500,000.[48]

5. Valuation

(a) Much like how fiduciary duties ground conflict of interest cases, improper valuations can violate advisers' fiduciary duties in addition to constituting straightforward misstatements.

(b) Premium Point Investments LP (May 9, 2018) – An adviser obtained inflated broker quotes for its mortgage-backed securities in exchange for sending trades to that broker-dealer, and used "imputed mid-point valuations" that further inflated the value of its securities. The SEC filed an enforcement action seeking disgorgement and civil penalties; the U.S. Attorney's Office brought criminal charges; and those actions are still pending. The staff noted the importance of valuation, especially in opaque markets.[49]

(c) Stefan Lumiere (June 15, 2016, settled Feb. 20, 2018) – An investment adviser mismarked securities held by a hedge fund using sham broker quotes, generating inflated returns and net asset values in order to obtain more than $5.9 million in inflated management and performance fees. The SEC filed an enforcement action alleging violations of Section 10(b) and Rule 10b-5 of the Exchange Act and Section 206 and Rule 206(4)-8 of the Advisers Act. The U.S. Attorney's Office filed criminal charges, and after trial, Mr. Lumiere was found guilty of wire fraud, securities fraud and conspiracy to commit those offenses.[50]

(d) VSS Fund Management LLC and Jeffrey Stevenson (Sept. 7, 2018) – VSS managed a private equity fund into its seventeenth year, at which point several investors sought a liquidity option, as only two portfolio companies remained. VSS' owner and managing partner offered to purchase the limited partnership interests of certain investors based on a December 2014 valuation, but VSS did not disclose certain information which indicated that that fund NAV had increased since then. The SEC found these actions violated Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. VSS was censured and VSS and Stevenson were ordered to pay, jointly and severally, a civil penalty of $200,000.[51]

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[47] *In the Matter of THL Managers V, LLC and THL Mangers VI, LLC*, Release No. IA-4952 (Jun. 29, 2018), available at https://www.sec.gov/litigation/admin/2018/ia-4952.pdf.

[48] *In the Matter of Lyxor Asset Management, Inc.*, Release No. IA-4932 (Jun. 4, 2018), available at https://www.sec.gov/litigation/admin/2018/ia-4932.pdf.

[49] Complaint, *Securities and Exchange Commission v. Premium Point Investments LP*, Case 1:18-cv-04145 (S.D.N.Y. May. 9, 2018), available at https://www.sec.gov/litigation/complaints/2018/comp24138.pdf.

[50] *In the Matter of Stefan Lumiere*, Release No. IA-4861 (Feb. 28, 2018), available at https://www.sec.gov/litigation/admin/2018/ia-4861.pdf; Judgment, *United States v. Lumiere*, Dkt. 112, No. 16-cr-483 (S.D.N.Y. June 16, 2017); *United States v. Lumiere*, 249 F. Supp. 3d 748, 751 (2017).

[51] *In the Matter of VSS Fund Management LLC*, Release No. IA-5001 (Sept. 7, 2018), available at https://www.sec.gov/litigation/admin/2018/ia-5001.pdf.

6. False Statements

(a) Crypto Asset Management LP and Timothy Enneking (Sept. 11, 2018) – The firm principal raised over $3.6 million from investors by claiming to be the "first regulated crypto asset fund in the United States" when in fact the fund had not registered with the SEC, thereby conducting an unregistered non-exempt public offering, and failed to register as an investment company despite investing more than 40 percent of these assets in "digital asset securities." This violated Sections 5(a) and (c) and 17(a)(2) of the Securities Act, Section 7(a) of the Investment Company Act, and Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. The SEC censured the respondents and imposed a joint and several civil penalty of $200,000. The respondents had already conducted a rescission offering and later properly began offering securities pursuant to the Regulation D Rule 506(c) exemption from registration.[52]

(b) Goldsky Asset Management LLC (Sept. 28, 2018) – An adviser filed a Form ADV that falsely stated it had agreements with various service providers, managed over $100 million in assets, and had significant historical returns when in fact it had no such agreements and had never had any assets at all. The SEC filed an enforcement action seeking civil penalties, which is still pending.[53]

(c) Lemelson Capital Management LLC (Sept. 12, 2018) – In a "short and distort scheme," an adviser established a short position in a pharmaceutical company and then disseminated false statements over social media, in written reports and interviews, to drive down the price of the stock and increase the value of its short position. This violated Section 10(b) and Rule 10b-5(a), (b) and (c) of the Exchange Act and Section 206(4) and Rule 206(4)-8 of the Advisers Act. The SEC filed an enforcement action seeking disgorgement and civil penalties, which is still pending.[54]

(d) Arlington Capital Management Inc. (Apr. 16, 2018) – An adviser solicited investors using materials that presented the current refinement of its algorithm as if it had always existed, backcasting the performance it would have generated historically and disclosing only in fine print or otherwise concealed ways that the algorithm had been and would continue to be refined. This violated Sections 206(2) and 206(4) and Rules 206(4)-1(a)(5) and 206(4)-7 of the Advisers Act. The SEC required undertakings, imposed a civil penalty of $125,000, and censured the adviser and its principal.[55]

(e) Massachusetts Financial Services Company (August 31, 2018) – A registered investment adviser, Massachusetts Financial Services Company ("MFS"), made material misstatements and omissions to its investors regarding its blended research strategies combining research ratings from MFS's fundamental analysts and quantitative models. MFS failed to disclose that some its quantitative ratings were determined using a retroactive, back-tested application of MFS's quantitative model, and in some cases MFS claimed that the hypothetical portfolio was based on its own quantitative ratings going as far back as the 1990s, even though MFS did not have a quantitative department

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[52] *In the Matter of Crypto Asset Management LP and Timothy Enneking*, Release No. IA-5004 (Sept. 11, 2018), available at https://www.sec.gov/litigation/admin/2018/33-10544.pdf.

[53] Complaint, *Securities and Exchange Commission v. Goldsky Asset Mgmt., LLC*, Case 1:18-cv-08870-VEC (S.D.N.Y. Sept. 9, 2018), available at https://www.sec.gov/litigation/complaints/2018/comp24291.pdf.

[54] Complaint, *Securities and Exchange Commission v. Gregory Lemelson and Lemelson Capital Mgmt., LLC*, Case 1:18-cv-11926 (S.D.N.Y. Sept. 12, 2018), available at https://www.sec.gov/litigation/complaints/2018/comp-pr2018-190.pdf.

[55] *In the Matter of Arlington Capital Management, Inc. and Joseph F. LoPresti*, Release No. IA-4885 (Apr. 16, 2018), available at https://www.sec.gov/litigation/admin/2018/ia-4885.pdf.

before 2000. The SEC found that MFS violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-1(a)(5) thereunder. MFS was ordered to pay a civil penalty of $1.9 million.[56]

7. Misappropriation

(a) Willow Creek Investments LP (Feb. 2, 2018) – A firm's principal misrepresented his investment management experience and the size of his assets under management in order to raise over $5.3 million from a small number of individuals, which he then misappropriated for trading in his personal brokerage account and to fund his lavish lifestyle. This violated Section 17(a) of the Securities Act, Section 10(b) and Rule 10b-5 of the Exchange Act, Sections 206(1), 206(2), 206(4) and Rule 206(4)-8 of the Advisers Act. The SEC filed an enforcement action seeking to freeze remaining assets, disgorgement and civil penalties. The U.S. Attorney's Office filed criminal charges. These cases are still pending.[57]

V. Regulatory Outlook in the European Union

A. Brexit

1. Passporting

The two key EU Directives that shape the regulatory regime applicable to U.K. alternative asset managers – Alternative Investment Fund Managers Directive ("AIFMD") and the Markets in Financial Instruments Directive ("MiFID II") – contain passporting regimes for cross-border services within the EU and establishment of branches in other member states based on the principle of common market access embedded in EU legislation.

The AIFMD and MiFID II also include so-called "third-country" regimes which give preferential access to EU markets to non-EU firms on the basis of an "equivalence" determination (that is, where such firms are subject to equivalent regulatory supervision in a non-EU jurisdiction). An equivalence determination involves a country-by-country assessment of the regulation and supervisory arrangements of the relevant third-country jurisdiction followed by the enactment of EU legislation to give effect to this determination.

The AIFMD contains two types of passporting regimes: a management passport and a marketing passport. A U.K. manager may currently utilize the management passport to act as the alternative investment fund manager ("AIFM") of, for example, an Irish or Luxembourg fund. The marketing passport is currently only available in respect of EU-domiciled funds managed by an EU manager and has not been used widely by the alternative management community, as most alternative investment funds ("AIFs") are established outside the EU (e.g., Cayman Islands). The European Securities and Markets Authority ("ESMA") has been charged with advising the European Commission on the possible extension of the marketing passport to third countries. To date no legislation has been proposed to give effect to the third-country passport in AIFMD.

U.K. managers authorized to provide MiFID services (e.g., portfolio management, and reception and transmission of orders) typically utilized the MiFID cross-border passport to offer managed account services to institutional investors in those EU member states where the local regime does not exclude

[56] *In the Matter of Massachusetts Financial Services Company*, Release No. IA-4999 (Aug. 31, 2018), available at https://www.sec.gov/litigation/admin/2018/ia-4999.pdf.

[57] Complaint, *Securities and Exchange Commission v. Nicholas J. Genovese, Willow Creek Investments, LP, and Willow Creek Advsiers, LLC*, Case 1:18-cv-942 (S.D.N.Y. Feb. 2, 2018), available at https://www.sec.gov/litigation/complaints/2018/comp24038.pdf.

activities of overseas firms from the scope of the licensing requirements. Some MiFID firms also utilize the MiFID passport to provide distribution services in respect of UCITS and AIFs in countries where such passport is required as an alternative to local licensing as a broker or placement agent.

Under a "hard Brexit" scenario these passports will cease to be available.

2. MiFID II Third-Country Regime

Article 46 of Markets in Financial Instruments Regulation ("MiFIR")[58] establishes a regime for registration and passporting of third country firms that provide services to per se professional clients and eligible counterparties without establishing a branch in an EU member state (that is, on a cross-border basis). ESMA will keep a publicly available register under Article 48 of MiFIR that lists the third-country firms permitted to provide investment services or activities in the EU.

Once registered, a third-country firm is able to provide investment and ancillary services or activities to both eligible counterparties and per se professional clients throughout the EU. Article 46(2) sets out the eligibility criteria for third-country firms registering with ESMA:

(a) The firm must have been authorised and be subject to effective supervision and enforcement within that third-country jurisdiction;

(b) The European Commission must have adopted an equivalence determination with respect to the relevant jurisdiction of the firm's head office; and

(c) Cooperation arrangements must have been established between the EU and the third country.

Under Article 46(3) of MiFIR when all three criteria have been met, no additional requirements may be placed upon third-country firms by individual Member States. However, such third-country firms will be required inform their clients that they are unable to provide services to clients other than eligible counterparties and per se professional counterparties and must also offer their clients the option to submit any disputes relating to those services or activities to the jurisdiction of an EU Member State's court or tribunal.

As noted above, the ability for a third-country firm to register and provide their services is dependent upon the existence of an equivalence determination in respect of the firm's country of establishment. The requirements applicable to such equivalence determinations are provided under Article 47(1) of MiFIR which specifies that the European Commission will examine the third country's legal and supervisory arrangements to ensure that authorized firms comply with legally binding prudential and business conduct requirements which have equivalent effect to those contained in EU legislation. The regulatory framework of the third country must also provide for its own effective equivalence system for the recognition of third-country legal regimes and as such, allow reciprocal access to EU firms.

3. Reverse Solicitation Exception

The concept of services provided on the "own initiative" of the EU client or investor exists under both AIFMD (in respect of offers of fund products to EU clients) and MiFID II (e.g., in respect of offers of separately managed account services, or "portfolio management" as termed in MiFID II, to EU clients).

[58] *See* Regulation (EU) No 600/2014 of the European Parliament and of the Council, *Official Journal of the European Union*, (Dec. 6, 2014), https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0600&from=EN.

The text of MiFID II makes it clear that the third-country regime does not affect the possibility for persons established in the EU to receive investment services by a third-country firm at the own exclusive initiative of the client. For these purposes, the services or activities are not viewed as taking place within the EU and are not subject to the third-country regime. Unlike AIFMD, MiFID II attempts to define the concept of "own initiative." In particular:

(a) Where a third-country firm solicits clients or potential clients in the EU or promotes or advertises its investment services, its services should not be deemed as being provided at the own exclusive initiative of the client; and

(b) A third-country firm may not rely on the "own initiative" exemption to market new categories of investment products or services to the client.

4. U.K. Temporary Permissions Regime

In December 2017, the U.K. Government announced that, if necessary, it would introduce a temporary permissions regime for inbound passporting EEA firms and funds. If there is not an implementation period and the passporting regime falls away when the United Kingdom leaves the EU, the temporary permissions regime will provide a backstop to ensure firms and funds can continue their business with minimal disruption.

The temporary permissions regime will allow EU firms to continue operating in the United Kingdom within the scope of their current passports for a limited period after exit day (up to three years, under current proposals), while seeking full U.K. authorization. The temporary permissions regime will also allow UCITS funds and EU-domiciled alternative investment funds with a passport to continue to be marketed in the United Kingdom. The FCA has published two consultation papers: CP18/29[59] and CP18/36[60] on the rules which will apply to EU firms and funds under this regime.

5. EU No-Deal Brexit Contingency Plan

The European Commission has implemented a Contingency Action Plan[61] for a number of specific sectors in the event of a no-deal Brexit, including adopting acts to provide temporary and conditional equivalence to U.K. Central Clearing Counterparties ("CCPs") and central depositary services, as well as two delegated regulations to facilitate the novation of certain OTC derivatives. The following acts were adopted on Dec. 19, 2018:

(a) A temporary and conditional equivalence decision[62] for a fixed, limited period of 12 months with respect to U.K. CCPs to ensure that there will be no immediate disruption in the central clearing of derivatives.

(b) A temporary and conditional equivalence decision[63] for a fixed, limited period of 24 months with respect to U.K. Central Depositories to ensure that there will be no disruption in central depositaries services for EU operators currently using U.K. operators.

[59] *See* CP18/29: Temporary Permissions Regime for Inbound Firms and Funds, *Financial Conduct Authority*, available at https://www.fca.org. U.K./publications/consultation-papers/cp18-29-temporary-permissions-regime-inbound-firms-and-funds.

[60] *See* CP18/36: Brexit: Proposed Changes to the Handbook and Binding Technical Standards – Second Consultation, *Financial Conduct Authority*, available at https://www.fca.org. U.K./publications/consultation-papers/cp18-36-brexit-proposed-changes-handbook-and-binding-technical-standards-second-consultation.

[61] *See* European Commission Delegation Regulation, (Sept. 19, 2019), available at https://ec.europa.eu/info/sites/info/files/com-2018-890-final.pdf.

[62] *See* European Commission Implementing Decision, (Sept. 19, 2019), available at https://ec.europa.eu/info/sites/info/files/c_2018_9139_fisma_9674_en_act.pdf.

(c) Two Delegated Regulations (regarding the date at which the clearing obligation takes effect for certain types of contracts[64] and regarding the date until which counterparties may continue to apply risk management procedures for certain OTC contracts not cleared by a CCP[65]) facilitating novation, for a fixed period of 12 months, of certain over-the-counter derivatives contracts, where a contract is transferred from a U.K. to an EU27 counterparty.

B. EU Fund Regulation

1. Distribution of Alternative Investment Funds

In March 2018, the European Commission published the following two legislative proposals:

(a) A legislative proposal for a Directive on the cross-border distribution of collective investment funds ("Cross-border Distribution Directive").[66] This Directive contains amendments to the UCITS Directive and the Alternative Investment Fund Managers Directive.

(b) A legislative proposal for a Regulation on facilitating cross-border distribution of collective investment funds (Cross-border Distribution Regulation).[67] This Regulation sets out a harmonized framework concerning certain aspects of the cross-border distribution of funds.

The proposed Cross-border Distribution Directive contains amendments to the AIFMD relating to:

(c) *Pre-Marketing.* The Cross-border Distribution Directive inserts a new Article 30a to set out the conditions under which an EU AIFM can engage in pre-marketing activities. Under these proposals, an AIFM will be allowed to test an investment idea or an investment strategy with professional investors but it will not be allowed to promote an established AIF without notification.

(d) *Discontinuation of Marketing.* The Cross-border Distribution Directive inserts a new Article 32a on the conditions for AIFMs that wish to stop their marketing activities in a member state. An AIFM is permitted to de-notify the marketing of an EU AIF only if there are a maximum of ten investors who hold up to 1 percent of assets under management of this AIF in an identified member state.

The proposals are currently subject to the trialogue negotiation process (between the European Commission, Parliament and the Council). The Commission intends for these proposals to be adopted before the European Parliament elections in May 2019.

2. Enhanced Local "Substance" Requirements

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[63] *See* European Commission Implementing Decision, (Sept. 19, 2019), available at https://ec.europa.eu/info/sites/info/files/c-2018-9138_fisma_9673_1_en_act_part1_v6.pdf.

[64] *See* European Commission Delegation Regulation, (Sept. 19, 2019), available at https://ec.europa.eu/info/sites/info/files/regulatory-technical-standards-clearing-com-2018-9122_en.pdf.

[65] *See* European Commission Delegation Regulation, (Sept. 19, 2019) available at https://ec.europa.eu/info/sites/info/files/regulatory-technical-standards-margins-com-2018-9118_en.pdf.

[66] European Commission: Proposal for a Directive amending Directives 2009/65/EC and 2011/61/EU with regard to cross-border distribution of collective investment funds, *Reuters*, (March 12, 2018), https:// U.K..practicallaw.thomsonreuters.com/w-017-7517?originationContext=document&transitionType=DocumentItem&contextData=(sc.Default)&firstPage=true&comp=pl U.K.&bhcp=1.

[67] European Commission: Proposal for a Regulation on facilitating cross-border distribution of collective investment funds and amending Regulations (EU) 345/2013 and (EU) 346/2013, *Reuters*, (March 12, 2018), https:// U.K..practicallaw.thomsonreuters.com/w-017-7552?originationContext=document&transitionType=DocumentItem&contextData=(sc.Default).

In July 2017, ESMA published its Opinion to Support Supervisory Convergence in the Area of Investment Firms in the Context of the United Kingdom Withdrawing from the European Union. The aim of the opinion was to address the regulatory arbitrage risks arising as a result of financial services firms seeking to relocate to EU27 countries following Brexit.

In August 2018, Luxembourg regulator, CSSF, issued circular 18/698 concerning (i) the approval process and organization of Luxembourg fund management companies and (ii) specific requirements applicable to both fund management companies and transfer agents in the fight against money laundering and terrorist financing. The objective of the new circular was to set out, in a single document, all substance-related aspects concerning both UCITS management companies and alternative investment fund managers. The increased number of Luxembourg alternative investment fund managers, together with the efforts on regulatory convergence in a Brexit context, has led to the creation of a new circular applicable to all types of Luxembourg fund management companies. The provisions of the new circular mirror, to a large extent, the administrative practice developed by the CSSF in the recent past, but it also includes some new requirements which are likely to be more onerous than CSSF's supervisory approach in the past. The main section of the circular sets out detailed rules concerning the shareholders of management companies, the minimum equity requirements, corporate bodies, administrative organization, internal governance and internal controls. The provisions applicable to the delegation of key functions, including portfolio management, the fund administration and marketing are likely to be of particular interest to fund managers.

The Central Bank of Ireland has published Brexit FAQ – Financial Services Firms which, among other things, addresses CBI's expectations of non-EU firms seeking to establish a presence in Ireland. In November 2018, CBI also published Discussion Paper 8 – Outsourcing – Findings and Issues for Discussion. The CBI noted that "[t]he level of board awareness and quality of governance and risk management remains far from satisfactory." The regulator found that "significant and proactive action was still required by boards and senior management of regulated firms across all sectors to meet minimum supervisory expectations in relation to [outsourced service providers (OSPs)] governance arrangements and risk management controls." Several key weaknesses were found in the areas of governance, risk management and business continuity management.

C. MiFID II Payments for Research and Inducements

Article 24 of MiFID II Directive[68] bans investment firms providing portfolio management services, or investment advice on an independent basis, from accepting fees, commission or any monetary or non-monetary benefits from third parties in relation to the provision of services to clients. This is on the basis that such fees or benefits would be "inducements" and would create conflicts of interest between a firm and its clients. Investment research provided by execution brokers or other third parties to portfolio managers is considered to be such a banned "inducement," unless the conditions relating to the method for payment for such research set out below are met.

"Research" for these purposes is defined as follows:

"Research material or services concerning one or several financial instruments or other assets, or the issuers or potential issuers of financial instruments, or be closely related to a specific industry or market such that it informs views on financial instruments, assets or issuers within that sector. That type of material or services explicitly or implicitly recommends or suggests an investment strategy and provides a substantiated opinion as to the present or future value or price of such instruments or assets, or

[68] *See* Directive 2014/65/EU of the European Parliament and of the Council, (May 15, 2014), available here https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN.

otherwise contains analysis and original insights and reach conclusions based on new or existing information that could be used to inform an investment strategy and be relevant and capable of adding value to the investment firm's decisions on behalf of clients being charged for that research."

MiFID II rules distinguish between "research" and "minor non-monetary benefits." Under the inducements rule, firms are permitted to receive "minor non-monetary benefits" that are capable of enhancing the quality of service provided to a client and are of a scale and nature such that they could not be judged to impair compliance with the investment firm's duty to act in the best interests of the client. Examples of "minor non-monetary benefits" include: (1) "non-substantive material or services consisting of short-term market commentary on the latest economic statistics or company results, for example, or information on upcoming releases or events, which is provided by a third party and contains only a brief summary of its own opinion on such information that is not substantiated nor includes any substantive analysis such as where they simply reiterate a view based on an existing recommendation or substantive research material or services" and (2) "written material from a third party that is commissioned and paid for by a corporate issuer or potential issuer to promote a new issuance by that company, or where the third party is contractually engaged and paid by the issuer to produce such material on an ongoing basis."

An investment manager may only receive research if it is paid for in one of the following two ways:

(a) Direct payments by the investment manager out of its own resources; or

(b) Payments from a separate research payment account ("RPA") controlled by the investment manager and funded by a specific research charge to the client, provided that the conditions relating to the operation of such an RPA (including regular budgeting for, and valuations of, research, allocation of costs between clients, disclosure, and client consent obligations) are met.

D. EU General Data Protection Regulation

The General Data Protection Regulation[69] ("GDPR") is an EU regulation designed to protect the privacy of individuals in the EU and regulate businesses that collect and process data of such EU individuals globally. GDPR came into effect on May 25, 2018, and applies to investment managers located in the European Union, including the United Kingdom. It may also apply to investment managers located outside the EU, if they have access to, store, or use the personal data of EU individuals.

Unlike the earlier EU data protection regime, Article 3 of GDPR specifies the territorial scope of its protections. As a starting point, GDPR applies to processing of personal data in the context of the activities of an establishment of a controller or processor in the EU. That is the case even if the processing activities take place outside the EU.

Entities established outside the EU, such as US investment advisers, Delaware or Cayman funds may also be subject to GDPR, if their processing of personal data relates to (i) the offering of goods or services to data subjects in the EU or (ii) monitoring of the behavior of data subjects which takes place in the EU. A "data subject" for these purposes means a natural person.

The European Data Protection Board has published a public consultation[70] of its draft guidelines in March 2018 on the territorial scope of the GDPR (Article 3). Among other things, the draft guidelines contain

[69] GDPR, https://ec.europa.eu/info/law/law-topic/data-protection_en.

[70] Guidelines 3/2018 on the territorial scope of the GDPR (Article 3), available at https://edpb.europa.eu/our-work-tools/public-consultations/2018/guidelines-32018-territorial-scope-gdpr-article-3_en.

examples of the types of activities that may fall within the "offering of goods or services" prong of the Article 3 test, and examine the concept of "targeting" the offers of goods or services at natural persons in the EU.

E. EU Short-Selling Regulation

The EU Regulation[71] on Short Selling and Certain Aspects of Credit Default Swaps ("SSR") became directly applicable in all EU Member States on Nov. 1, 2012. The SSR created a harmonized framework for notification requirements and restrictions relating to short positions in shares and sovereign debt in the EU and prohibits uncovered positions in sovereign credit default swaps ("CDS"). The SSR also gives powers to EU Member State regulators and ESMA to restrict or prohibit short selling and CDS transactions in certain circumstances.

The SSR applies in relation to short positions in "shares" and "sovereign debt." "Shares" for these purposes are shares admitted to trading on an EU trading venue (which includes a regulated market and a multi-lateral trading facility) ("EU Shares"). "Sovereign Debt" in this context is the debt issued by the EU, any EU Member State (including agencies or ministries), a consortium of EU Member States and the European Investment Bank ("EU Sovereign Debt"). The SSR does not cover corporate debt.

Net short positions in EU Shares must be notified to Member State regulators when they reach (or fall below) 0.2 percent of the issued share capital, and at each 0.1-per cent movement. Net short positions of 0.5 percent (and each movement of 0.1 percent above that) must be disclosed publicly. The above disclosure requirement will not apply where the "principal trading venue" for the shares is located outside of the EU (or in a "third country"). ESMA publishes a list of such shares on its website.[72]

As with shares, long positions in EU Sovereign Debt must be deducted from short positions leaving a reportable net short position.[73] Cash positions in EU Sovereign Debt are calculated using a "nominal value duration adjusted method" specified in Annex II of the Delegated Regulation 918/2012 and described in ESMA's Q&A.[74] Net short positions held *via* derivative instruments should be calculated on a delta-adjusted basis (as with shares, above).[75]

The thresholds for significant net short positions in EU Sovereign Debt vary according to the liquidity of the sovereign debt. ESMA publishes a list of net short position thresholds for each sovereign issuer on its website.[76] Unlike shares, short positions in sovereign debt only need to be notified to Member State regulators and are not made public.

Net short positions must be determined by midnight at the end of each trading day, and disclosures must be made by 3:30 pm (local time) on the next trading day. ESMA publishes a list of links to the websites maintained by the Member State regulators for the purposes of notification and public disclosure of net short positions.[77]

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[71] *Regulations*, Official Journal of the European Union, https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:086:0001:0024:EN:PDF.

[72] ESMA, 'Short Selling,' available at https://www.esma.europa.eu/regulation/trading/short-selling.

[73] A list of financial instruments conferring a financial advantage in the event of an increase or a decrease in the price of EU Sovereign Debt is in Part 2 of Annex I to the Delegated Regulation 918/2012. Positions held through baskets of sovereign debt must also be taken into account. The sale of a sovereign CDS is regarded as being a long position and the purchase of a sovereign CDS would be a short position for these purposes.

[74] ESMA Q&A, Q.4.

[75] For these purposes, positions in CDS are calculated on a nominal basis (delta of one).

[76] ESMA, 'Short Selling,' available at https://www.esma.europa.eu/regulation/trading/short-selling.

[77] ESMA, 'Short Selling,' available at https://www.esma.europa.eu/regulation/trading/short-selling.

Net short positions related to several funds or managed portfolios for which the “same” investment strategy is pursued in relation to a particular issuer[78] must be aggregated by the investment manager for reporting purposes. ESMA’s view is that the position holder for reporting purposes is always the investment manager even where only one fund or managed account has a reportable net short position.[79]

[78] That is, the strategy to be long or short in a particular issuer.

[79] ESMA Q&A, Q.5K.

Tax Update

I. Partnership Audits

A. 2018 was the first taxable year subject to the new partnership audit tax regime created by the Bipartisan Budget Act of 2015. Under the new regime, tax adjustments and collections are made at the partnership level rather than at the partner level, unless the partnership elects to pass adjustments through to its partners.

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

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

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

2. Partnerships with partners that are other partnerships, trusts, IRAs, pension plans, disregarded entities or nominees cannot elect out.

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

4. The election must disclose the name, tax classification and taxpayer ID of each partner of the partnership, including each S corporation shareholder in the case of an S corporation partner.

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

1. The partnership representative does not need to be a partner but must have a substantial presence in the United States. This requirement is intended to ensure that the partnership representative will be available to the Internal Revenue Service ("IRS") in the United States when the IRS seeks to communicate or meet with the representative.

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

3. In the absence of a designation of a partnership representative by the partnership, the IRS has the authority to select any person as the partnership representative for a partnership.

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

1. An imputed underpayment is determined by netting all adjustments of similar items of income, gain, loss or deduction at the partnership level and multiplying by the highest tax rate for individuals or corporations for the year to which the tax audit rules relate (the "reviewed year").

2. If an adjustment involves reallocation of an item to another partner, only the tax increase, not the net adjustment, enters into the calculation of the imputed underpayment under the statute. This could cause the same income to be taxed twice.

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

(a) An imputed underpayment may be reduced to the extent that it is allocable to a partner that is a "tax-exempt entity" that would not owe tax on the adjusted income (e.g., the U.S. government, a tax-exempt U.S. organization, a foreign person or entity, etc.), a partner that is a C corporation (in the case of ordinary income) or an individual with capital gains or qualified dividends. In the case of a modification requested with respect to an indirect partner, the IRS may require information related to the pass-through partner through which the indirect partner holds its interest.

(b) If any partner files an amended return for the reviewed year, taking into account its allocable share of the adjustments and pays tax thereon, that payment can offset the partnership's imputed underpayment. Modification is allowed to the extent that the amended returns are filed and any necessary payments are made within the 270-day time period.

F. As an alternative to the partnership paying the imputed underpayment, the partnership may elect, under Section 6226 of the Code, within 45 days following the mailing by the IRS of the notice of final partnership adjustment to pass the adjustment through to its partners who were partners for the reviewed year.

1. The adjustment is passed through to the partners by issuing a statement to the reviewed year partners (or, in certain situations, indirect U.S. owners of a foreign partner that is a "controlled foreign corporation" or a "passive foreign investment company") with their share of adjustments. The reviewed year partners are required to take the adjustments into account on their returns in the year when the adjustment takes place (the "adjustment year") (rather than amend their returns for the reviewed year).

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

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

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

5. A partnership that passes the adjustment through to its non-U.S. partners may still be required to withhold under Chapters 3 and 4 on any adjustment that would have been subject to withholding in the reviewed year.

6. The Section 6226 election can be effected through partnership tiers, whereby each partnership in the chain generally may choose to either pay the tax directly or push it out to its own partners (e.g., from a master fund to its feeder fund, and then to the feeder fund's investors). Each upper-tier partnership would need to make such choice by the extended due date for the tax return for the adjustment year of the partnership that was audited.

G. A partnership can file an administrative adjustment request in the amount of one or more items of income, gain, loss, deduction or credit of the partnership for any partnership taxable year. A partnership has three years from the later of the filing of the partnership return or the due date of the partnership return (excluding extensions) to file an administrative adjustment for that taxable year. However, a partnership may not file an administrative adjustment for a partnership taxable year after the IRS has mailed notice of an administrative proceeding with respect to such taxable year.

1. Adjustments that result in underpayments will cause tax to be due at the partnership level in the year in which the administrative adjustment is filed, as described above, except that certain provisions related to modifications of such underpayment will not apply. In the alternative, such tax may be passed through to the partners under the election discussed above, except that the additional interest does not apply.

2. Adjustments that result in a refund must be passed through to the partners that were partners during the year to which the adjustment relates.

II. Dividend Equivalent Payments: Section 871(m)

A. Introduction

1. In 2010, Section 871(m) of the Code was enacted to treat as U.S. source dividends for U.S. withholding tax purposes:
   (a) "Dividend equivalent payments" on "specified notional principal contracts" that are based on a four-factor statutory definition; and
   (b) Substitute dividend payments on securities lending or sale-repurchase transactions.
2. On Sept. 17, 2015, the Treasury issued final and temporary regulations (the "2015 Final Regulations" and "2015 Temporary Regulations," respectively, and, together, the "2015 Regulations") implementing Section 871(m) of the Code.
3. On Dec. 2, 2016, the IRS released Notice 2016-76, which indicated the Treasury's intent to phase in the applicability of the 2015 Regulations differently for transactions entered into each of: (i) calendar year 2017; and (ii) calendar year 2018 and subsequent calendar years.
4. On Jan. 19, 2017, the Treasury issued final and temporary regulations (the "Final Regulations" and "Temporary Regulations," respectively, and, together, the "2017 Regulations") that adopted, with some modifications, the 2015 Regulations.
5. On Aug. 4, 2017, the IRS released Notice 2017-42, which further extends the phase-in and delays the effective dates of certain provisions of the 2017 Regulations.
6. On Sept. 20, 2018, the IRS released Notice 2018-72, which further extends the phase-in and delays the effective dates of certain provisions of the 2017 Regulations.

B. Statutory Provision

1. Under Section 871(m) of the Code, a notional principal contract ("NPC") (generally, an equity swap) is a "Specified NPC" subject to withholding under Section 871(m) if the NPC provides for one or more amounts that may be contingent upon, or determined by reference to, U.S.-source dividends and at least one of the following four factors is present:
   (a) In connection with entering into the NPC, a long party to the NPC transfers the underlying security to a short party to the NPC (known as "crossing in");
   (b) In connection with the termination of the NPC, a short party to the NPC transfers the underlying security to a long party to the NPC (known as "crossing out");
   (c) The underlying security is not readily tradable on an established securities market; or
   (d) The underlying security is posted as collateral by a short party to the NPC with a long party to the NPC.
2. Section 871(m) of the Code authorizes the Treasury to specify other transactions as being "Specified NPCs" or otherwise substantially similar to a transaction yielding a dividend equivalent payment. The 2017 Regulations, as modified by IRS Notice 2018-72, expand the universe of transactions subject to Section 871(m) of the Code, if such transactions are entered into (or significantly modified) after 2016 or 2020, as applicable.

C. The 2017 Regulations

1. Transactions that Can Give Rise to "Dividend Equivalent Payments" ("Section 871(m) Transactions")
   (a) A "dividend equivalent" is any of:
      (i) A substitute dividend that references a U.S.-source dividend made pursuant to a securities lending or sale-repurchase transaction;
      (ii) A specified NPC;

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

(iv) Another substantially similar payment.

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

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

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

2. Miscellaneous Issues Regarding Dividend Equivalent Amounts

(a) Any gross amount that references the payment of a U.S.-source dividend, whether actual or estimated, explicit or implicit, is treated as a dividend equivalent to the extent of the amount determined under the 2017 Regulations.

For example, the 2017 Final Regulations treat a price return swap as a transaction that provides for the payment of a dividend equivalent because the anticipated dividend payments are presumed to be taken into account in determining the other terms of the NPC.

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

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

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

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

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

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

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

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

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

4. Determining Delta/Substantial Equivalence

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

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

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

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

5. Time of Withholding

Withholding is required at the later of:

(a) The time the amount of the dividend equivalent is determined, which is the later of: (i) the day prior to the ex-dividend date; and (ii) the record date; and

(b) The time a payment occurs. A payment is deemed to occur:

(i) If money or other property is paid to the long party, which includes the economic benefit to the long party of netted payments within the contract that would otherwise have been made at such time; or

(ii) The long party sells or disposes of the contract, including by virtue of termination of the contract, lapse of the contract, offsets or otherwise.

6. Baskets, Indices and Miscellaneous Situations

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

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

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

(ii) The 2017 Final Regulations do not provide for the netting of a taxpayer's long and short positions, though the preamble to the 2015 Final Regulations leaves open the possibility of more expansive rules in the future.

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

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

This affects swaps on "master limited partnerships." Fund managers should have upfront communications with their brokers to understand how they intend to apply this set of rules, including whether they may be over-withholding on a swap if they cannot get sufficient comfort that the particular master limited partnership referenced under the swap is not a covered partnership.

(d) Indices. Transactions that reference a qualified index are generally excepted from Section 871(m). The qualified index exception is designed to provide a safe harbor for widely used passive indices that reference a diversified portfolio of long positions, and is not intended to apply to any index that: (i) is customized or reflects a trading strategy; (ii) is not generally available (i.e., the exception does not apply to over-the-counter transactions); or (iii) targets dividends. Entering into a short position that references component security of a qualified index may invalidate a qualified index Section 871(m) transaction. There is a "de minimis" safe harbor for a short position that reduces the exposure to referenced components securities of a qualified index by five percent or less of the value of the long positions in component securities in the qualified index.

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

D. Notices 2016-76, 2017-42 and 2018-72

1. Transactions Entered into During Calendar Years 2017-2020

(a) "Delta One" Transactions

(i) The term "delta one" was not defined in any of the notices. However, the language of the notices supports that only simple contracts can be "delta one" transactions.

(ii) A transaction is a Section 871(m) Transaction if it has a delta of 1.0 on the date of issuance.

(b) Combined transactions (as described above) that have a delta of 1.0 are within the scope of the Notices. However, a broker acting as a short party will only need to combine over-the-counter transactions that are priced, marketed or sold in connection with each other. Long parties would still be responsible for the substantive tax for transactions that are combined under the 2017 Regulations, even if the short party is not responsible for withholding any tax.

(c) The IRS will apply a good faith standard to determine whether long and/or short parties applied the combination, withholding and other rules during 2017-2020.

(d) "Qualified derivatives dealers" ("QDDs") will not be subject to tax on dividends and dividend equivalents received in 2017-2020 in their equity derivatives dealer capacity or withholding on dividends (including deemed dividends). QDDs must use good faith efforts to comply with the 2017 Regulations through the end of 2020.

2. Transactions Entered into After 2020

(a) All other transactions entered into after 2020 (or significantly modified after 2020) that are considered Section 871(m) Transactions under the 2017 Regulations will be subject to the withholding and substantive tax provisions.

(b) The IRS will apply a good faith standard for actions taken by taxpayers during 2021 for Section 871(m) Transactions entered into during 2021 that are not "delta one" transactions, including whether taxpayers are properly applying the "substantial equivalence" test.

E. Possible Further Changes

1. A Treasury official announced publicly in November 2017 that the government is considering whether or not to implement the 2017 Regulations for transactions that are "non-delta one" transactions.

2. The Treasury and the IRS separately are evaluating the 2017 Regulations to "consider possible agency actions that may reduce unnecessary burdens imposed by the regulations" in accordance with Executive Order 13777.

III. Cryptocurrency

A. Characterization of Virtual Currency for U.S. Federal Tax Purposes

1. The IRS provided guidance in Notice 2014-21 that virtual currency (e.g., Bitcoin, Ether, Litecoin, Ripple, etc.) generally is treated as property for U.S. federal tax purposes and is not considered a "currency" that would trigger foreign currency gain or loss under Section 988 of the Code. As property, the character of gain or loss from the sale or exchange of virtual currency generally depends on whether or not the virtual currency is a capital asset in the hands of the taxpayer. Accordingly, taxpayers who hold virtual currency as a capital asset should recognize capital gain or loss on the disposition of such virtual currency.

2. Cash-settled Bitcoin futures currently trade on the CBoE and CME, and it has been announced that Ether futures and physically settled Bitcoin futures are also expected to trade on these exchanges. As a result, these futures contracts can qualify as "regulated futures contracts" and are subject to the mark-to-market rules under Section 1256 of the Code.

3. Despite the fact that the CFTC has decided to treat virtual currencies as commodities for regulatory purposes, the IRS has not clarified whether or not some or all virtual currencies can be characterized as commodities for any or all U.S. federal tax purposes.

B. Considerations for Investment Funds Investing in Virtual Currencies

1. *Publicly Traded Partnership Status.* The uncertainty around the tax characterization of virtual currency (e.g., whether or not they are commodities for these purposes) can present challenges to investment funds that want to rely on "qualifying income" within the meaning of Section 7704(c) of the Code in order to avoid being taxed as a corporation under the publicly traded partnership ("PTP") rules. Until greater clarity on the treatment of virtual currency for PTP purposes is offered, investment funds should either rely on the "100 partner" safe harbor or limit investors' liquidity to avoid PTP status.

2. *Wash Sales, Straddles, Short Sales and Mark-to-Market Elections.* The applicability of certain rules relating to wash sales, straddles, short sales and Section 475(f) mark-to-market elections is uncertain as applied to virtual currency. Some of these rules only apply to "stock and securities" or "commodities," while others apply to "actively traded personal property."

3. *Partnership Tax Allocations.* Many investment funds rely on "aggregation" for purposes of making "reverse Section 704(c) allocations" as permitted for "securities partnerships" under Treasury Regulations Section 1.704-3(e)(3). An investment fund is a securities partnership for these purposes if at least 90 percent of the investment fund's non-cash assets are considered "qualified financial assets" or personal property that is "actively traded" as determined for purposes of the straddle rules. Clarity from the IRS with respect to the applicability of the straddle rules to virtual currency should help determine if an investment fund that invests in virtual currency can use aggregation.

4. *Effectively Connected Income and the Trading Safe Harbors.* Non-U.S. investment funds generally rely on the Section 864(b)(2) safe harbors to avoid treating income and gain from trading in securities and commodities as effectively connected with a U.S. trade or business. Absent guidance from the IRS, it is unclear whether either of these safe harbors could apply to virtual currency. For purposes of the "securities" trading safe harbor, the Treasury Regulations define "securities" as either corporate stock or evidence of indebtedness. For purposes of the "commodities" trading safe harbor, applicable guidance provides that the term commodities should be interpreted in its ordinary financial sense, thereby creating greater flexibility that virtual currency might be able to be considered a commodity for these purposes. However, the safe harbor only applies to trading that involves both (i) commodities that are "of a kind customarily dealt in on an organized commodity exchange" and (ii) transactions that are "of a kind customarily consummated at such place." While not free from doubt, it is helpful for purposes of the safe harbor analysis that Bitcoin futures (and eventually Ether futures) are actively traded on organized commodity exchanges in transactions customarily effected on those exchanges. However, the ability to extrapolate from Bitcoin futures to other transactions in virtual currencies that are not traded on the CME or CBoE remains unclear.

5. *Virtual Currencies and ICOs as Deemed Equity Interests.* Virtual currencies that exhibit characteristics that resemble securities or otherwise function as other than a medium of exchange, such as certain Initial Coin Offerings ("ICOs"), may be characterized by the IRS as equity interests in an underlying constructive joint venture or association for U.S. federal tax purposes. An investment in such virtual currencies or ICOs that would be treated as constructive joint ventures or associations for U.S. federal tax purposes may cause non-U.S. investors or tax-exempt U.S. investors to earn effectively connected income or unrelated business taxable income, respectively. Even if not considered effectively connected income, if determined to be U.S. source, non-U.S. investors may be subject to FDAP withholding on distributions received (or deemed received) from such virtual currencies. Furthermore, if the constructive joint venture or association were regarded as a foreign corporation, U.S. investors may be subject to certain anti-deferral rules (e.g., PFIC, CFC, etc.) with respect to any income or deemed income of the constructive joint venture or association.

IV. Tax Reform

A. Carried Interest/Incentive Allocation

1. Federal Changes to Taxation of Carried Interest/Incentive Allocation

(a) If an "Applicable Partnership Interest" is held by a taxpayer, then the taxpayer's long-term capital gain with respect to such interest necessitates a holding period exceeding three years.

(b) An "Applicable Partnership Interest" is a partnership interest transferred to a taxpayer in connection with the performance of substantial services by the taxpayer (or a related person) in an "Applicable Trade or Business."

(c) An "Applicable Trade or Business" is an activity conducted on a regular, continuous and substantial basis which consists of: (i) raising or returning capital; and (ii) either investing, disposing, identifying or developing "Specified Assets."

(d) "Specified Assets" are securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to the foregoing, and an interest in a partnership to the extent of the proportionate interest in any of the foregoing.

(e) An Applicable Partnership Interest does not include: (i) an interest held by a corporation; or (ii) a capital interest which provides the taxpayer with a right to share in partnership capital commensurate with (x) the amount of capital contributed (determined at the time of receipt of such interest) or (y) the value of such interest subject to tax under Section 83 upon the receipt or vesting of such interest.

(f) Under a technical reading of Section 1061 of the Code, not only is carried interest subject to the three-year holding period requirement, but any future earnings on carried interest may also need to meet the three-year requirement in order to qualify for the long-term capital gains tax rate.

2. State Proposals

(a) Income from the Provision of Personal Services

(i) Certain states, including New York and New Jersey, have proposals to treat income from the provision of "investment management services" as generating state-sourced income that is taxable in such states. This would pick up carried interest, taxing it the same way management fees are taxed.

(ii) New Jersey's legislature approved A3088, which includes this concept, on July 1, 2018, and the New Jersey legislation was signed into law by Governor Murphy.

a. Caveat: The provision is not operative unless New York, Connecticut and Massachusetts enact legislation with a provision having an identical effect.

b. Governor Cuomo's proposed New York State budget for the 2019-2020 fiscal year, released on Jan. 15, 2019, includes changes that are substantially similar to New Jersey's statute, except that it also requires Pennsylvania to enact legislation with substantially the same effect, along with New Jersey, Connecticut and Massachusetts.

(iii) State tax credits may not be available for residents of states that do not view carried interest as generating service-based income.

(iv) For states with market-based sourcing, such as California, such a rule could have far-reaching consequences.

(b) Soak-up Tax

(i) Various states, including New York, New Jersey, Connecticut, Massachusetts, California and Illinois, have introduced proposals to subject carried interest income to an additional tax ranging from 17 percent to 24 percent, which, at a minimum, collects the difference between the federal long-term and short-term capital gains rates.

(ii) The proposals largely ignore the actual tax character of the underlying income, meaning that a short term capital gain or ordinary income item would also generate this additional tax.

(iii) New Jersey's legislature approved A3088, which includes the additional 17 percent tax, on July 1, 2018, and the New Jersey legislation was signed into law by Governor Murphy.

a. As drafted, the provision may also pick up incentive fees and management fees, even though such items are already subject to full federal and state taxation.

b. Caveat: The provision is not operative unless New York, Connecticut and Massachusetts enact legislation having an identical effect.

c. Governor Cuomo's proposed New York State budget for the 2019-2020 fiscal year, released on Jan. 15, 2019, includes a similar "carried interest fairness fee," but it also requires Pennsylvania to enact legislation with substantially the same effect, along with New Jersey, Connecticut and Massachusetts. A similar proposal introduced into the New York State Senate on Jan. 9, 2019 does not require Pennsylvania to enact similar rules and uses a 19 percent rate rather than 17 percent.

(iv) The California and Illinois proposals are not contingent on actions by other states.

3. Switching from an Incentive Allocation to an Incentive Fee

(a) Fund Tax Considerations

(i) Offshore fund generally is indifferent and may benefit in an intermediate fund structure if the intermediate fund entity is eliminated as a result.

(ii) Onshore fund appears to have only downside risk. If the fund is an "investor" or has investments that are treated as investment activities, rather than trading activities, non-corporate taxable investors would not be able to deduct the incentive fee.

(b) Benefits to Manager

(i) If the manager is a limited partnership, the manager's profits allocations to its active limited partners are currently not subject to the 3.8-percent Medicare tax or the 3.8-percent tax on net investment income (i.e., Obamacare tax). However, there is increased audit activity regarding the applicability of the Medicare tax on profit allocations to limited partners. An incentive allocation remains subject to the 3.8-percent net investment income tax.

(ii) Cash method managers may get a year of deferral since the fee is typically paid in the following January, while allocation reflects income realized as of Dec. 31.

(iii) If the manager earns carry based on annual outperformance of an index, there should be no tax-based limitations on paying the fee as it is earned.

(iv) For states with an unincorporated business tax, a fee might help with state and local tax deductions.

(c) Potential Problems for the Manager

(i) Side pockets and multi-year fees are generally subject to Section 457A of the Code, including potential additional taxes of 20 percent and premium interest, whereas incentive allocations are generally not subject to those rules.

(ii) Long-term capital gains treatment still exists for "qualified dividends" and 60 percent of the mark-to-market income on "Section 1256 contracts."

(iii) Fees are generally subject to state and local taxes, if any, where the manager is based (e.g., the New York City Unincorporated Business Tax).

(iv) For investments held for longer terms, the fee may accelerate taxation.

(v) In the case of an offshore fund, U.S. withholding tax may reduce the profits on which the incentive fee is based, whereas such tax may be recoverable by the manager earning an incentive allocation.

B. Sale of Partnership Interests by Foreign Partners

1. The IRS held in a 1991 Revenue Ruling[1] that gain on the sale of a partnership interest by a foreign partner was subject to tax in the U.S. to the extent of such partner's share of unrealized net gain in any "effectively connected income" assets held by the partnership.

2. In 2017, the Tax Court held in *Grecian Magnesite*[2] that a foreign partner was not subject to U.S. federal income tax on gain from the sale of a partnership interest in a partnership conducting business in the U.S., except for gain attributable to the partnership's United States real property interests. The IRS has appealed the decision of the Tax Court.

3. Section 864(c)(8) of the Code effectively reverses *Grecian Magnesite* by providing that gain or loss realized by a foreign partner from the sale or exchange of a partnership interest occurring on or after

[1] Rev. Rul. 91-32

[2] *Grecian Magnesite Mining* v. *Commissioner*, 149 T.C. No. 3 (July 13, 2017).

Nov. 27, 2017 is treated as effectively connected with a U.S. trade or business ("ECI") to the extent that the seller of such interest would have had effectively connected gain or loss had the partnership sold all of its assets for their fair market value as of the date of the sale or exchange.

4. Under Proposed Regulations issued on Dec. 27, 2018, Treasury provided that a gain realized by the transfer of partnership interests pursuant to a nonrecognition transaction will not generate ECI under this new rule. However, Treasury has stated that it is continuing to consider whether gain should be treated as recognized for certain nonrecognition transactions that reduce the scope of what may be subsequently taxed.

5. In addition, Code Section 1446(f) requires the buyer of a partnership interest to withhold 10 percent tax on the amount realized by the seller on the sale or exchange of a partnership interest occurring after Dec. 31, 2017 if any portion of the seller's gain on the sale of the interest would be effectively connected income under Code Section 864(c)(8), unless the seller certifies that the seller is non-foreign. In the event the buyer fails to withhold the correct amount of tax, the partnership shall deduct and withhold from distributions to the buyer an amount equal to the tax that the buyer failed to withhold from the seller.

6. The IRS issued Notice 2018-08 on Dec. 29, 2017, which suspends withholding under Code Section 1446(f) on the transfer of any interest in a PTP as defined in Code Section 7704(b) until regulations or other guidance has been issued under Code Section 1446(f).

7. On April 2, 2018, the IRS issued Notice 2018-29, providing interim guidance upon which taxpayers may rely (pending the issuance of regulations or other guidance).

   (a) The Notice outlines methods to certify that Section 1446(f) withholding is not necessary.

      (i) No Section 1446(f) withholding is required if the transferor certifies to its non-foreign status. Transferors may use a modified FIRPTA certificate or a Form W-9 (so long as such Form W-9 contains the name and taxpayer identification number of the transferor and is signed and dated under penalties of perjury). A transferee may rely on a previously obtained Form W-9.

      (ii) No Section 1446(f) withholding is required if the transferor provides a certification that the transfer will not result in gain.

      (iii) No Section 1446(f) withholding is required if, within 30 days prior to a transfer, the transferor provides a certification that transferor's allocable share of "effectively connected taxable income" in each of the three taxable years prior to such transfer was less than 25 percent of its entire distributive share of partnership income in each such year. It should be noted that this exception does not apply when the transferor is disposing of the interest to the partnership (e.g., through a withdrawal).

      (iv) No Section 1446(f) withholding is required if the partnership provides a certification that a hypothetical sale of all of its assets at fair market value would generate less than 25 percent effectively connected gain (including, for these purposes, FIRPTA gain).

   (b) The Notice suspends withholding under Section 1446(f) for nonrecognition transactions if the transferor provides a notification of a nonrecognition transaction to the transferee, signed under penalties of perjury, containing the transferor's name, TIN, address and a brief description of the transfer and an explanation of why gain or loss is not recognized in such transaction.

   (c) The Notice also suspends withholding in situations in which the partnership would be required to withhold under Section 1446(f) due to a transferee's failure to withhold as required.

C. Deductibility Issues

1. Limitation on Deductibility of Business Interest Expense

(a) Section 163(j) of the Code limits the deduction of business interest expense attributable to a trade or business generally to the sum of the taxpayer's (x) business interest income and (y) 30 percent of adjusted taxable income relating to a trade or business (unreduced by business interest expense and excluding business interest income). For these purposes, business interest expense and business interest income do not include "investment interest" or "investment income," respectively, within the meaning of Section 163(d) of the Code. For tax years beginning before January 2022, adjusted taxable income is generally equivalent to EBITDA. For tax years beginning on or after January 2022, adjusted taxable income is generally equivalent to EBIT.

(b) Generally, Section 163(j) applies after the application of provisions that subject interest expense to disallowance, deferral, capitalization or other limitation, but applies before the operation of the at-risk loss limitations, passive activity loss limitations and the limitation on excess business losses.[3]

(c) Any business interest expense not deductible pursuant to the foregoing limitation is treated as business interest expense of an eligible taxpayer that carries forward to succeeding taxable years, subject to the same limitation.

(d) The limitation on the deductibility of business interest expense does not apply to interest attributable to an electing real property trade or business and certain other businesses. Such activities, including the performance of services as an employee, are excluded from the meaning of trade or business for purposes of Section 163(j). Adjusted taxable income is computed without regard to income not properly allocable to a trade or business.

(e) Recently proposed regulations provide an expansive definition of "interest" and an anti-avoidance rule for amounts associated with the time value of money. This includes guaranteed payments for use of capital, a portion of the payments on swaps with significant nonperiodic payments, substitute interest payments on securities-lending transactions, income from hedging transactions in which the underlying security is an interest-bearing instrument, commitment fees, debt issuance costs and factoring income.

(f) Application to Partnerships.

  (i) In the case of a partnership, the limitation is determined at the partnership level. To the extent the limitation applies at the partnership level to reduce the business interest expense deductible for a year, such excess shall carry forward to succeeding years and, subject to certain limitations, may be deducted by an eligible partner to the extent the partnership has sufficient excess taxable income that was not offset by business interest expense in such year. Any amount not utilized will form part of the investor's adjusted basis in its interest in the partnership only at the time such investor disposes of its interest.

  (ii) Partner-level adjustments (e.g., Section 743 adjustments, remedial allocations, etc.) are not taken into account when determining the partnership's adjusted taxable income. Rather, they are taken into account at the partner level.

  (iii) As described above, 163(j) only applies to business interest expense and not to other types of interest expense such as investment interest expense. Notwithstanding the foregoing, the preamble to the proposed regulations indicates that for partnerships that are engaged in a trade or business, a partner that does not materially participate may be subject to the interest limitations under both Section 163(j) and Section 163(d).

  (iv) Business interest expense of a partnership disallowed as a deduction by the operation of Section 163(j) is allocated to the partners ("disallowed business interest"). Such amounts are carried forward and treated as paid in subsequent years, subject to certain limitations.

[3] Prop. Reg. § 1.163(j)-3(b)(3)

(v) Under recently proposed regulations, a partner may deduct its share of such disallowed business interest in a subsequent year to the extent of (a) its allocated excess business interest income from such partnership and (b) its allocated excess taxable income from such partnership (with the deduction of the amounts otherwise allowable under this clause (ii) capped at 30 percent of the sum of the partner's share of the excess taxable income from the partnership and adjusted taxable income from other sources). However, the Blue Book states that a partner can deduct its share of such disallowed business interest in a subsequent year only to the extent of its allocated excess business interest income and 30 percent of its share of the excess taxable income from the partnership).

(vi) If non-business interest expense of a partnership is allocated to a corporate partner, 163(j) limitations would apply at the corporate partner level because all interest expense and income of a corporation is treated as business interest expense and income.

(vii) Computation of a corporation's E&P does not take into account the application of 163(j). As a result, the limitations under 163(j) may not adversely impact investors in offshore feeder funds under certain circumstances.

(viii) Recently proposed regulations explicitly reserve on the application of 163(j) to tiered partnerships, partnership mergers and divisions and self-charged interest.

(g) Taxpayers may rely on recently proposed regulations before they are finalized, so long as the taxpayer consistently applies all the rules of such proposed regulations.

2. Limitation on Deductibility of Excess Business Losses; Changes to Rules on NOLs

(a) Under Section 461(l) of the Code, which applies to noncorporate taxpayers, if a trade or business activity generates losses in excess of a taxpayer's trade or business income, a maximum of $250,000 ($500,000 if filing a joint return) of the losses can be used to offset investment income for the year.

(i) Any excess business losses that are disallowed by this provision cannot be used to offset tax liability on investment income, but rather will be carried forward as net operating losses ("NOLs") that can be used in subsequent years.

(ii) This provision is not permanent; it applies only for taxable years beginning after Dec. 31, 2017 and before Jan. 1, 2026.

(b) For losses arising in taxable years beginning after Dec. 31, 2017, a deduction for NOLs is limited to 80 percent of taxable income.

(i) Any unused NOLs can be carried forward indefinitely.

(ii) NOLs can no longer be carried back (except for certain losses incurred in a farming trade or business).

(iii) NOLs carried forward from taxable years beginning before Jan. 1, 2018 are not subject to this new 80 percent limitation.

3. Suspension of Miscellaneous Itemized Deductions

Miscellaneous itemized deductions for individuals under Section 67 of the Code are suspended for any taxable year beginning after Dec. 31, 2017, and before Jan. 1, 2026.

4. Reduction in Corporate Tax Rate and Limitation on Deductibility of State and Local Taxes

(a) The corporate income tax rate is reduced from 35 percent to 21 percent for taxable years beginning after Dec. 31, 2017.

(b) For individual taxpayers, the amount of state and local taxes (including income and property taxes) permitted to be deducted is limited to $10,000 (aggregated).

The $10,000 aggregate limitation is scheduled to sunset in 2026; it applies only to tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026.

D. Deduction for Qualified Business Income of Pass-Through Entities

1. A deduction ("QBI Deduction") for taxpayers other than "C" corporations for certain qualified business income ("QBI") and certain other income is equal to the lesser of: (a) 20 percent of the taxpayer's QBI, plus 20 percent of the taxpayer's qualified REIT dividends and qualified PTP income and (b) 20 percent of the taxpayer's taxable income minus net capital gains. In no event may a taxpayer's QBI Deduction exceed 20 percent of the excess of the taxpayer's taxable income over such taxpayer's net capital gain for the relevant taxable year, thus ensuring that the QBI Deduction will not be applied to offset capital gain.

   (a) The QBI Deduction for taxpayers whose taxable income exceeds $157,500 ($315,000 in the case of a joint filer) (the "Threshold Amount") is subject to a wage/basis limitation equal to the greater of the taxpayer's allocable share of (x) 50 percent of the W-2 wages paid with respect to the qualified trade or business ("W-2 Wages") and (y) the sum of (i) 25 percent of W-2 Wages plus (ii) 2.5 percent of the "unadjusted basis immediately after acquisition" of all qualified property held by the trade or business ("UBIA").

   (b) The QBI Deduction is also available to offset income from qualified REIT dividends and qualified PTP income, without regard to the limitations described in (i) above.

2. Income earned with respect to a business that constitutes a "specified service trade or business" ("SSTB") is excluded from qualifying for the QBI Deduction (except for taxpayers that fall below the Threshold Amount).

   (a) On Jan. 18, 2018, final regulations were released to clarify certain of the provisions related to the QBI Deduction. Such regulations clarified that the determination of whether a business constitutes a SSTB is made at the entity level. Pass-through entities are required to report this determination to their owners. SSTBs include trades or businesses involving the performance of services in the investment management field.

   (b) Most investing funds are not "qualified trades or businesses." Funds whose trade or business does qualify (e.g., certain lending funds) generally do not pay W-2 wages. For most investment funds, the wage/basis limitation described will be $0.

3. Anti-Abuse Rules

   (a) The regulations provide that a SSTB includes any business that shares 50 percent common ownership (direct or indirect) with a SSTB. This provision prevents many structures that aim to segregate out certain activities in order to take advantage of the benefits of the QBI Deduction.

   (b) Amounts received for the performance of services as an employee are not eligible for the QBI Deduction. To prevent employees from changing employment status to take advantage of the new deduction, the regulations provide a rebuttable presumption that if an employee changes employment status but continues to provide substantially the same services to the former employer, the individual is presumed to be providing such services as an employee for three years following such change in status, and thus cannot offset any compensation income by the QBI Deduction.

   (c) The regulations exclude from treatment as a "qualified REIT dividend" eligible for the QBI Deduction any dividend received with respect to stock that has been held for 45 days or less, taking into account applicable rules under Section 246 that suspend holding periods for stock with respect to which the holder has a diminished risk of loss due to a hedge or straddle, during the 91-day period beginning on the date which is 45 days prior to the date on which the stock becomes ex-dividend. While the final regulations establish a holding period of 46 days, the Technical Corrections draft circulated on Jan. 2, 2019 indicates that this holding period is 60 days.

E. UBTI: Notice 2018-67

1. Section 512(a)(6) of the Code provides that UBTI must be calculated separately with respect to each separate trade or business with losses usable only against the same related trade or business and not against UBTI generally.

2. On Aug. 21, 2018, the IRS released Notice 2018-67 which noted that a tax-exempt organization may rely on a reasonable, good faith interpretation of Sections 511 through 514 of the Code, considering all of the facts and circumstances when determining whether an exempt organization has more than one unrelated trade or business.

   (a) A reasonable, good faith interpretation includes using the North American Industry Classification System six-digit codes.

   (b) Notice 2018-67 also provided interim and transition rules for partnership investments. Under such rules, an exempt organization may aggregate UBTI from its interest in a single partnership with multiple trades or businesses as long as the directly-held interest in the partnership meets the requirements of either the de minimis test or the control test (each, a "qualifying partnership interest"). An exempt organization may aggregate all qualifying partnership interests as a single trade or business for purposes of section 512(a)(6).

      (i) De Minimis Test: An exempt organization may aggregate UBTI from a single partnership so long as the entity holds no more than 2 percent of the profits interest and no more than 2 percent of the capital interest in the partnership. For purposes of this test, an exempt organization must combine the interests held by disqualified persons with respect to the exempt organization, a supporting organization or a controlled entity.

      (ii) Control Test: An exempt organization may aggregate UBTI from a single partnership so long as the organization holds no more than 20 percent of the capital interest and does not have control or influence over the partnership. For purposes of this test, an exempt organization must combine the interests held by disqualified persons with respect to the exempt organization, a supporting organization or a controlled entity. "Control or influence" will exist if an exempt organization may require the partnership to perform, or may prevent the partnership from performing, any act that significantly affects the operations of the partnership. An exempt organization also has control or influence over a partnership if any of the exempt organization's officers, directors, trustees or employees have rights to participate in the management of the partnership or conduct the partnership's business at any time, or if the exempt organization has the power to appoint or remove any of the partnership's officers, directors, trustees, or employees.

      (iii) Under an additional transition rule, an exempt organization may choose, for a partnership interest acquired prior to Aug. 21, 2018, to treat such partnership interest as a single trade or business.

V. Cayman Islands Economic Substance Requirements

A. The Cayman Islands has introduced legislation, effective Jan. 1, 2019, requiring certain entities resident in the Cayman Islands to demonstrate that they have appropriate economic substance in the jurisdiction.

B. Other commonly used fund and investment management jurisdictions, such as Jersey, Guernsey, the British Virgin Islands and Bermuda, either have or are expected to put in place similar legislation.

C. The introduction of these measures is intended to fulfil commitments made by these jurisdictions as members of the OECD in the context of the OECD's Base Erosion and Profit Shifting ("BEPS") initiative, and is also a response to their inclusion on the "grey list" of non-cooperative jurisdictions for tax purposes produced by the EU's Code of Conduct Group on Business Taxation.

D. Although the Cayman Islands has passed the relevant legislation effective Jan. 1, 2019, it is anticipated that the Cayman Islands will also issue regulations and guidance. It is hoped that the guidance, in particular, will clarify many matters related to the new legislation which are presently uncertain, especially in the context of outsourced activities, such as where a Cayman Islands manager delegates investment management and ancillary services to a sub-adviser in another jurisdiction (such as the U.K.).

E. The new Cayman Islands legislation is applicable to "Relevant Entities." Relevant Entities will include most Cayman limited companies, LLCs and LLPs, but not limited partnerships (although entities that are general partners of limited partnerships may be Relevant Entities).

F. Importantly, an "investment fund" is not a Relevant Entity (and so is not within the scope of the new legislation).

G. An "investment fund" is an entity whose principal business is the issuing of investment interests to raise funds or pool investor funds with the aim of enabling a holder of such an investment interest to benefit from the profits or gains from the entity's acquisition, holding, management or disposal of investments and includes any entity through which an investment fund directly or indirectly invests or operates. Most funds and their trading or subsidiary holding entities should therefore be outside the scope of the new rules.

H. Each Relevant Entity must make a report each year to the tax authority as to whether or not it is carrying on one or more "Relevant Activities." If it is, then it must meet an economic substance test in respect of such Relevant Activities and provide to the tax authority a detailed report describing the basis upon which it is meeting that economic substance test.

I. The "Relevant Activities" are:

   1. Fund management business
   2. Banking business
   3. Financing and leasing business
   4. Distribution and service center business
   5. Headquarters business
   6. Intellectual property business
   7. Shipping business
   8. Holding company business

   However, "investment fund business," meaning the business of operating as an investment fund, is excluded and is not a "Relevant Activity."

J. A Relevant Entity that carries on one or more Relevant Activities must satisfy the economic substance test. This requires the Relevant Entity to:

   1. Conduct Cayman Islands "core income generating activities" ("CIGA");
   2. Be "directed and managed" in an appropriate manner in the Cayman Islands;
   3. Having regard to the level of relevant income derived from a Relevant Activity:
      (a) Have an adequate amount of operating expenditure incurred in the Cayman Islands;
      (b) Have adequate physical presence (including maintaining a place of business or plant, property and equipment) in the Cayman Islands; and
      (c) Have an adequate number of full-time employees or other personnel with appropriate qualifications in the Cayman Islands.

K. CIGA are defined as those activities that are of central importance to the Relevant Entity in terms of generating activity and that are being carried out in the Cayman Islands. There are then further examples given of particular types of activity that may constitute CIGA for a Relevant Activity. For fund management, these examples include:

1. Taking decisions on holding and selling investments;
2. Calculating risks and reserves;
3. Taking decisions on currency or interest fluctuations and hedging positions; and
4. Preparing reports or returns to investors and the Cayman Islands Monetary Authority.

L. A Relevant Entity may still satisfy the CIGA requirements where its CIGA activities are conducted by another person on its behalf, provided that the Relevant Entity is able to monitor and control the carrying out of those activities.

M. In terms of the requirement that a Relevant Entity carrying on a Relevant Activity must be "directed and managed" in an appropriate manner in the Cayman Islands in order to meet the economic substance test, the legislation contains detailed provisions which require that:

1. The Relevant Entity's board of directors, as a whole, has the appropriate knowledge and expertise to discharge its duties;
2. That board meetings are held in the Cayman Islands with adequate frequency with a quorum of directors present in the Cayman Islands; and
3. That minutes of the board meetings record the strategic decisions taken and that such minutes and appropriate records are retained in the Cayman Islands.

N. Various penalties may be imposed on a Relevant Entity carrying on a Relevant Activity that fails to meet the economic substance test. In the first period of non-compliance, the Cayman Islands tax authorities may impose a $10,000 penalty and if the failure continues into subsequent periods, the penalty can be $100,000. There is also the possibility of criminal sanctions where any person (which might be a Relevant Entity or a director, manager, secretary of other officer of a Relevant Entity) knowingly or willfully supplies false or misleading information under these provisions or fails to provide information specifically requested by the tax authorities under these provisions.

O. Although the new law is effective as of Jan. 1, 2019, regulations and guidance are still awaited and there is much that remains unclear. Given that affected Cayman Islands entities have had little or no time to prepare, it is possible that regulations might defer the date upon which Relevant Entities carrying on a Relevant Activity are required to meet the economic substance test. Furthermore, the due date and form of the annual notification that a Relevant Entity must make to the tax authority that is potentially within the scope of the legislation has not yet been prescribed.

P. It is hoped that the promised guidance will clarify a number of the outstanding issues, such as the degree of economic substance required of a Relevant Entity that outsources activity, such as a Cayman Islands fund manager that delegates to an investment manager or sub-adviser in another jurisdiction (such as the U.K.). The Cayman Islands tax authority is required by the legislation to consult with the private sector prior to issuing its guidance and the industry will want to press its concerns as part of that consultation.

Q. Since the Cayman Islands is introducing these new rules with the intention of ensuring its removal from the EU's "gray list" of uncooperative tax jurisdictions, the EU is expected to review the legislation in early 2019 prior to its announcement of an updated "gray list." Depending upon the outcome of that review, it is possible that further changes will be made to the legislation.

VI. BEPS Implementation in the EU

A. Introduction

1. The EU has been an active participant in the BEPS initiative from the outset and has generally sought to enshrine BEPs-related measures into EU-wide law as a means of ensuring a smooth and cohesive implementation of these measures in all EU member states. In particular, the EU is introducing the Anti-Tax Avoidance Directive ("ATAD") and the DAC6 Directive amendments on mandatory disclosures of certain tax planning arrangement, and is actively supporting the adoption and ratification by EU member states of the Multi-Lateral Instrument and its measures aimed to prevent double tax treaty abuse.

B. The Multi-Lateral Instrument

1. Many countries, including all EU member states, have now adopted and ratified the OECD's Multi-Lateral Instrument ("MLI") to modify the application of their bilateral double tax treaties.
2. One of the key aims of the MLI is to implement the recommendations of Action 6 of BEPS on treaty abuse, which introduced minimum standards to prevent the granting of treaty benefits. Action 6 proposed that tax treaties should include either a principal purpose test ("PPT") alone or, if the jurisdictions in question choose it, both a PPT and a simplified limitation on benefits ("LOB") test.
3. The MLI presents the PPT as the default option and indeed it is the option that has been selected by most countries that have adopted the MLI.
4. The PPT denies a treaty benefit to an entity located in a treaty jurisdiction – most commonly, a reduced or zero rate of withholding tax on interest or dividend income paid by an entity in the other treaty jurisdiction – where it is reasonable to conclude, having regard to all the facts and circumstances, that obtaining the treaty benefit was one of the principal purposes of any arrangement that resulted directly or indirectly in that benefit.
5. There has been much discussion as to how the PPT should be interpreted and applied to funds and their investment-holding subsidiaries, particularly in the context of alternative investment funds (so-called non-CIVs). In January 2016, the OECD published a consultation document on non-CIV funds that includes three fact patterns where the OECD would regard the PPT as having been met. It is anticipated that this will be used as a guide to interpretation and application of the PPT by tax authorities and courts in many relevant jurisdictions.
6. The most useful of the three non-CIV examples describes a subsidiary established as a regional investment platform to invest across a wider economic area, such as the EU, and which earns dividends on its investments. This example concludes that the subsidiary is entitled to treaty benefits where it is set up for non-tax reasons and carries out material investment functions and other activities in the jurisdiction where it is established. Specified relevant functions include:
   (a) An experienced local management team which reviews investment recommendations;
   (b) Approval and monitoring of investments;
   (c) Treasury functions;
   (d) Maintenance of books and records and ensuring compliance with local regulatory requirements in investee jurisdictions;
   (e) A board of directors composed of a majority of locally resident directors with expertise in investment management; and
   (f) Payment of taxes and filing of tax returns in the jurisdiction.
7. It remains unclear how many of these functions need to be carried on, or to what extent, in order for the PPT to be satisfied. OECD Guidance is expected to continue to involve, as is the practice of investee jurisdictions in interpreting and applying the PPT that is now incorporated into their double tax treaties.

C. Anti-Tax Avoidance Directive ("ATAD")

1. The ATAD establishes a minimum standard that EU member states must meet in their domestic legislation in five key BEPS-related areas. ATAD requires EU member states to introduce:
   (a) Limitations on interest deductibility;
   (b) A general anti-abuse rule ("GAAR");
   (c) Controlled foreign company ("CFC") rules;
   (d) Hybrid mismatch rules; and
   (e) Exit taxation.
2. These measures generally need to be applied into domestic law with effect from Jan. 1, 2019, although there is a one-year delay permitted in relation to exit taxes and the rules on hybrid mismatches are not required until Jan. 1, 2020 (Jan. 1, 2022 in relation to reverse hybrid mismatches).

D. DAC6 — Mandatory Disclosure Rules

1. The DAC6 Directive amends a previous EU Directive with respect to the mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements. DAC6 in substance requires "intermediaries" such as tax advisers, accountants and lawyers that design and/or promote tax planning arrangements to report certain specified arrangements that are considered potentially abusive. If there is no such intermediary in relation to a specified arrangement, then the obligation shifts to the taxpayer. Following reporting, reported information is then automatically exchanged between EU member states.
2. The specified reportable arrangements are those that concern more than one EU member state, or an EU member state and a third country, and that have one or more "hallmarks." Although the hallmarks are intended to limit the reportable arrangements to potential tax-avoidance arrangements, a specific "main tax benefit" threshold test is not part of the regime.
3. The specific hallmarks include where an arrangement involves:
   (a) Confidentiality conditions
   (b) Standardized documentation
   (c) Success fees
   (d) Use or transfer of losses
   (e) Converting income into capital
   (f) Gifts or low/exempt income
   (g) Circular transactions
   (h) Transactions between related parties that include tax-exempt payers
   (i) Exempt or preferentially treated receipts
   (j) Taxpayers in non-cooperative jurisdictions
4. EU member states must implement DAC6 into their domestic law by no later than Dec. 31, 2019, so that the law applies from July 1, 2020 onwards. At present there is very little information available about how and when each EU member state will adopt these measures in their own domestic legislation. However, this raises a difficult issue since the Directive, once introduced and effective from July 1, 2020, will require disclosure in respect of any reportable arrangement where the first step in that reportable arrangement is implemented on or after June 25, 2018. DAC6 therefore has a retrospective effect, and intermediaries and taxpayers should be monitoring relevant transactions that they may have been

involved with since June 25, 2018 in case they may be required to make a report in respect of those transactions in August 2020.

VII. Qualified Opportunity Zones

A. Congress enacted, at the end of 2017, significant tax incentives for investments in Qualified Opportunity Zones ("QOZs"). The QOZ legislation was intended to spur investment in lower-income communities by allowing for the reinvestment of capital gain into a QOZ on a tax-favored basis, thus encouraging economic growth in such communities.

1. On Oct. 19, 2018, the Treasury Department issued Proposed Regulations under sections 1400Z-1 and 1400Z-2, a draft IRS Form with instructions, and Revenue Ruling 2018-29 (together, the "QOZ rules") to provide clarification on the legislation and to settle some open questions.

2. Additional guidance is expected in early 2019.

B. A QOZ is a low-income area that has been certified by the Secretary of the Treasury. As of this time, all QOZs have been certified. The QOZ designations expire on Dec. 31, 2028; however, for taxpayers with properly deferred gains generated prior to Dec. 31, 2026, the QOZ tax benefits remain available through Dec. 31, 2047.

C. Investment in a QOZ provides a taxpayer with three major benefits:

1. Deferral of tax on eligible capital gain until the earlier of the date the investor disposes of their interest in the QOZ investment or Dec. 31, 2026.

(a) If the investment is held through Dec. 31, 2026, there will be a tax on the deferred gain without corresponding cash available to pay the liability.

(b) Upon realization, the deferred gain will have the same tax attributes in the year of inclusion that it would have had if it had not been deferred under the QOZ rules.

2. A step-up in the basis of the QOZ investment in the amount of 10 percent of the amount of gain deferred if the interest is held for five years, and an additional 5 percent if held for seven years. Thus only 85 percent of the initial deferred amount will be subject to tax. Given that on Dec. 31, 2026 the deferred gain is realized, in order to obtain the step-up in basis, the five- and seven-year holding periods need to be met before such date.

3. The exclusion from taxation of any additional gain over the initial deferred amount upon the disposition of the investment interest if the interest is held for 10 years. Note that the interest in the QOF (as defined below) must be sold for the investor to realize this tax benefit.

D. An investor makes an investment in a QOZ by investing qualifying capital gain into a qualified opportunity fund ("QOF").

1. A QOF may be organized as a corporation or partnership for federal income tax purposes.

2. Only equity interests in a QOF are eligible, although a QOF equity interest may be pledged as collateral to obtain debt financing.

3. Deemed contributions due to allocations of partnership liabilities under Section 752 do not constitute investments in a QOF.

4. A QOF must hold 90 percent of its assets in "QOZ Property" as defined below (the "90-Percent Assets Test"). This is measured at the end of the first six months of the fund's taxable year and again at the end of each taxable year of the QOF.

(a) For purposes of the 90-Percent Assets Test, the value of the QOF's assets should generally be the book value reflected on the QOF's applicable financial statements. If the QOF has no such statements, the cost of the assets is used.

(b) Because the QOF interest must ultimately be disposed of after the 10-year holding period in order for the investor to enjoy tax-free gain on the investment, investors should consider setting up single-asset funds to facilitate disposition.

(c) If a QOF fails to satisfy the 90-Percent Assets Test for any month, the QOF will be subject to a penalty equal to the dollar amount by which it fails, multiplied by the then-effective IRS underpayment rate. The penalty calculation uses the yearly underpayment rate divided by 12.

5. A fund self-certifies as a QOF by filing a Form 8996 with its federal income tax return.

E. Any person that may recognize capital gain is eligible to invest in a QOF, including individuals, entities treated as partnerships, entities treated as corporations (including S corporations, regulated investment companies ("RICs") and real estate investment trusts ("REITs")), trusts and estates.

1. To qualify, capital gains must arise from a transaction with a person unrelated to the taxpayer.

2. Amounts other than qualifying capital gain may be invested, but the rules state that the investment will be bifurcated and such other amounts will not be subject to favorable tax treatment.

3. Capital gain recognized from Section 1256 contracts (e.g., regulated futures contracts, foreign currency contracts, non-equity options) is only eligible for the QOZ tax benefits to the extent of net gain from all of the investor's Section 1256 contracts.

4. Capital gain recognized from a position that is or ever has been part of an offsetting-positions transaction during the investor's holding period of the position is not eligible for the QOZ tax benefits under the QOZ rules.

(a) The QOZ rules suggest, however, that the net gain limitation applied to Section 1256 contracts, rather than a complete disallowance of the QOZ tax benefits, will apply to offsetting-positions transactions in which both positions are Section 1256 contracts.

(b) Straddles (as defined in Section 1092) are included in the definition, but the rule applies to the positions in a straddle whether or not the underlying property is actively traded.

(c) This rule may pose administrative burdens for pass-through entities that regularly hedge investments using offsetting-positions transactions.

F. Capital gain must be invested within 180 days of the date on which the investor would otherwise recognize the gain for federal income tax purposes.

1. In the case of a sale or exchange, this period begins on the date of the transaction.

2. In the case of a capital gain dividend received by a RIC or REIT shareholder, this period begins on the date the dividend is paid.

3. If a RIC or REIT shareholder is required under the Code to include an undistributed amount as capital gain, the shareholder's period begins on the last day of the RIC or REIT's taxable year.

4. If a partnership derives capital gain from a sale or exchange, the partnership may elect to defer the gain within 180 days of the transaction. If the partnership so elects, the gain will not be allocated to the partnership's partners. Instead, the gain will be allocated to the partners when the partnership recognizes it.

5. The partnership may instead allocate the gain to its partners, who then may choose to elect to defer the gain. In this instance, the partners' 180-day period begins on the last day of the partnership's taxable year.

6. Alternatively, partners may also invest their share of a partnership's gain within 180 days of the date the partnership realizes the gain, provided the partnership does not make the election.

(a) Gain that is allocated to a partner by a partnership is only eligible for deferral if the gain arose from a transaction with a person unrelated to both the partner and the partnership.

(b) The QOZ rules provide parallel treatment for other pass-through entities and their owners, including LLCs, S corporations, trusts and estates.

(c) Partnerships with partners who are interested in investing in QOFs may be asked for faster processing of Schedules K-1 and side letters or other agreements that the partnership will not elect to defer gain in a QOZ investment without the consent of the partners.

G. The assets that qualify for the 90-Percent Asset Test are QOZ stock, QOZ partnership interests and QOZ business property (together, “QOZ property”).

1. QOZ stock means any stock in a domestic corporation if:

(a) Such stock is acquired by the QOF after Dec. 31, 2017 at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash;

(b) At the time the stock was issued, the corporation qualified as a QOZ business (as defined below) or was formed for such purpose; and

(c) During substantially all of the QOF’s holding period for such stock, such corporation qualified as a QOZ business.

2. QOZ partnership interest means any capital or profits interest in a domestic partnership if:

(a) Such interest was acquired by the QOF after Dec. 31, 2017 from the partnership solely in exchange for cash;

(b) At the time the interest was acquired, the partnership qualified as a QOZ business or was formed for such purpose; and

(c) During substantially all of the QOF’s holding period for such interest, such partnership qualified as a QOZ business.

3. QOZ business property means tangible property used in a trade or business of the QOF if:

(a) Such property was acquired by the QOF by purchase from an unrelated person after Dec. 31, 2017;

(b) The original use of such property in the QOZ commences with the QOF or the QOF substantially improves the property (as defined below); and

(c) During all of the fund’s holding period for such property, substantially all of the use of such property was in a QOZ.

H. A QOZ business, as described above, means a business in which:

1. Substantially all of the tangible assets held by the business are QOZ business property. The proposed regulations state that the term “substantially all,” as used in this provision, means “70 percent or greater.”

2. At least 50 percent of the total gross income of the business is derived from the active conduct of a trade or business;

3. A substantial portion of any intangible property owned by the business must be used in the active conduct of a trade or business;

4. Less than 5 percent of the average of the aggregated unadjusted bases of the property in the business is attributable to “nonqualified financial property” (which includes debt, stock, partnership interests, derivatives, etc.); and

5. The underlying business is not a: private or commercial golf course; country club; massage parlor; hot tub facility; suntan facility; racetrack or other gambling facility; or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

I. Original Use or Substantial Improvement of QOZ business property

1. "Original use" is undefined in the QOZ rules. Given the permanence of land, the original use of land can never commence with a QOF in a QOZ and thus the QOZ rules do not require land to meet the original-use requirement.

2. Under the QOZ rules, property is considered to be substantially improved by a QOF if, during the 30-month period following the date on which the property is acquired, the QOF makes additions to the basis of the property equal to the acquisition cost of such property. In short, the QOF must double its basis in the property after purchasing it. If a QOF purchases a plot of land with an existing building on the land, the determination of whether a QOF has substantially improved land is made only with respect to the adjusted basis of the building (without regard to the basis allocable to the land) and separate improvements to the land are not required.

J. Realizing that developing businesses will have difficulty meeting some of the requirements under the QOZ rules, the rules provide a safe harbor for amounts deemed to be reasonable working capital.

1. The safe harbor applies to cash and other financial property held by a QOZ business if the QOZ business:

(a) Keeps written records that designate the use of the working capital for the acquisition, construction or improvement of QOZ business property;

(b) Provides a reasonable schedule for the use of the working capital in the QOZ business within 31 months of acquisition; and

(c) Actually uses the working capital in a manner that is substantially consistent with the written plan.

2. Several benefits apply to working capital that fits within the safe harbor:

(a) Working capital that meets the safe harbor can be set aside for use in acquiring, constructing and/or substantially improving tangible property that is expected to qualify as QOZ business property, and such property can thereby be considered QOZ business property, even if the working capital has not been fully invested, as long as the use of the capital is in accordance with the schedule required by the safe harbor;

(b) Income derived from safe-harbored working capital will be counted toward the requirement that 50 percent of the total gross income of the business be derived from the active conduct of a trade or business;

(c) Any intangible property of a business will be deemed used in the active conduct of a trade or business during the period of time that the business satisfies the three requirements in clause 1 above; and

(d) Property that is deemed to be safe-harbored working capital will be excepted from the requirement that less than 5 percent of the business property be attributable to nonqualified financial property.

Management Company Challenges in the Current Environment

I. Duty To Supervise

A. Supervisory Obligations Under the Securities Laws

1. Both the Securities and Exchange Commission and the Commodity Futures Trading Commission are keenly focused on the need for principals and senior personnel at investment managers to effectively supervise subordinate personnel.[1] The sources of authority for this focus differ for each regulator, but the regulatory impetus is similar in both regimes.

2. Section 203(e)(6) of the Investment Advisers Act of 1940 provides for the imposition of a sanction against an investment adviser who has failed reasonably to supervise, with a view to preventing violations of the securities laws, another person who commits such a violation, if such other person is subject to its supervision.

3. The statute continues with exculpatory language that states that "[n]o person shall be deemed to have failed reasonably to supervise any person, if [t]here have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person" and "[s]uch person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system[.]"

4. SEC Enforcement and Examination Focus

   (a) The SEC has brought several actions against private fund managers and their personnel for violations linked to a failure to supervise. These actions have been instituted in conjunction with incorrect valuations, misstated performance, and insider trading, among other substantive areas.[2]

   (b) In 2018, the SEC listed among its examination priorities an increased focus on internal controls at firms designed to supervise their representatives (although it then cited as particular areas of focus as being sales of products and services directed at senior investors and municipal adviser examinations).[3] There have, however, been numerous examples of "failure to supervise" settlements involving investment advisers over the past several years.

B. Supervisory Obligations under the Commodities and Futures Laws

1. CFTC Rule 166.3 requires that CFTC registrants "must diligently supervise the handling … of all commodity interest accounts carried, operated, advised or introduced by the registrant and all other activities of its partners, officers, employees and agents (or persons occupying a similar status or performing a similar function) relating to its business as a Commission registrant."

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[1] *See,* e.g., Securities and Exchange Commission, Office of Compliance Inspections and Examinations 2018 National Exam Program Examination Priorities (2018); Commodities Futures Trading Commission, 2018 Annual Report (Nov. 2018).

[2] *See,* e.g., SEC Press Release, Hedge Fund Firm Charged for Asset Mismarking and Insider Trading (May 8, 2018), available at www.sec.gov/news/press-release/2018-81; SEC Press Release, SEC Charges Hedge Fund Adviser With Deceiving Investors by Inflating Fund Performance (May 9, 2018), available at www.sec.gov/news/press-release/2018-83; and SEC Press Release, SEC Charges Morgan Stanley in Connection With Failure to Detect or Prevent Misappropriation of Client Funds (June 29, 2018), available at www.sec.gov/news/press-release/2018-124.

[3] SEC, 2018 Examination Priorities, *supra* at note 1.

2. Regulation 166.3 requires that a CFTC registrant establish and operate an adequate supervisory structure and compliance program.[4] One case has described this as a "duty to develop procedures for the 'detection and deterrence of [CEA violations.]'"[5]

3. Enforcement Focus

(a) In its annual report, the CFTC Division of Enforcement stated as one of its goals, "Promoting Individual Accountability" and detailed a broader strategy to achieve this goal by focusing on supervisors rather than just employees.[6] Marking the successes of this new strategy and new programs, the Division cited recent cases against companies and individuals, including supervisors. There were six actions filed regarding supervision during the 2018 fiscal year.

(b) Cases have cited violations that "should [have been] detected by a diligent system of supervision" and repeated violations, as evidence of a failure to supervise.[7]

C. In addition, managers with an affiliated broker-dealer may need to follow FINRA Rule 3010, which requires that its registrants "establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules."

II. Succession Planning

A. A 2015 study by Fidelity found that two-thirds of advisory firms would like to change ownership internally, but only a quarter of firms have successors in place, and less than half of firms have any kind of succession or continuity plan.[8] The study also showed that over one-third of advisers will leave the industry within the next 10 years.[9]

B. Succession Plans vs. Continuity Plans

1. A succession plan addresses a planned transition at the end of a manager's career, while a continuity plan is a contingency in the event of an unplanned departure, death or incapacitation of a key manager (or a "Departure Event").

2. A continuity plan is essential to ensuring investor's and employees' well-being in the event of an emergency. A succession plan is essential to ensuring a firm's continued prosperity following the retirement or scaling back of current management.

C. Continuity Plans May Soon Be Mandatory

1. In 2016, the SEC issued a rule proposal that would impose specific requirements with respect to succession planning.[10] The proposed rule would make it unlawful for an SEC-registered adviser to provide

[4] *In re Vision Financial Markets*, CFTC No. 13-36, 2013 WL 5376144, at *2 (Sept. 24, 2013); *In re GNP Commodities, Inc.*, CFTC No. 89-1, 1992 WL 201158, at *17-19 (Aug. 11, 1992), aff'd sub nom. *Monieson v. CFTC*, 996 F.2d 852 (7th Cir. 1993).

[5] *Samson Refining Co. v. Drexel Burnham Lambert, Inc.*, CFTC No. 82-R448, 1990 WL 282783, at * 11 (Feb. 16, 1990).

[6] CFTC, 2018 Annual Report, *supra* at note 1.

[7] *CFTC v. Sidoti*, 178 F.3d 1132, 1137 (11th Cir. 1999).

[8] "More than One in Three Firm Owners Are Planning To Exit the Business in the Next 10 Years," Fidelity (Dec. 17, 2015).

[9] *Id.*

[10] SEC Adviser Business Continuity and Transition Plans 17 C.F.R. § 275 (proposed Sept. 6, 2016) available at https://www.sec.gov/rules/proposed/2016/ia-4439.pdf.

investment advice unless the adviser adopts and implements written continuity and transition plans aimed at addressing potential Departure Events and reviews that plan at least annually. The proposed rule also requires maintaining records and copies of all written continuity and transition plans that are or were in effect at any time during the last five years.

2. The proposed rule would require an advisers' business continuity and transition plans to include policies and procedures on the maintenance of critical operations and systems, and the protection, backup and recovery of data, including client records. Such policies and procedures should be designed to minimize material service disruptions and any potential client harm from such disruptions.

3. While the proposed rule has not been adopted and has been removed from the SEC's regulatory agenda, the SEC staff has indicated that it expects advisers will have procedures in place that allow them to continue operations in the wake of an unexpected loss of access to key personnel.

D. Strategies for Continuity

1. Internal Continuity Plan

(a) This may involve giving authority over the firm and the funds to one or more individuals or to a committee in the event a Departure Event.

(b) Usually the authority is "springing" and is not granted until the emergency occurs (and will expire if the key manager returns (i.e., he or she recovers from an incapacity)).

(c) In most cases, the individual(s) or committee is granted authority to oversee the orderly wind-down of the business and the funds.

2. External Continuity Plan

(a) This involves a grant of authority by a key manager upon a Departure Event to a friend (usually someone who is also in the industry).

(b) Such friend is almost always granted authority to conduct the liquidation of the fund's investments, but such friend may also be tasked with overseeing the wind-down of the firm.

(c) This authority can be split between an external source (i.e., a third-party manager for investments) and an internal source (i.e., an internal person or team to manage the firm).

E. Strategies for Succession

1. Internal Succession:

(a) Internal succession can be a lengthy process which may include:

(i) Prolonged negotiations with the departing manager regarding their continued role, if any, and/or economics;

(ii) A lengthy ramp-up period to groom the successor; and/or

(iii) The need to inform investors and make sure they are comfortable with the successor and the succession plan.

(b) Internal succession can be accomplished in many ways, including:

(i) Promoting a successor from within the firm;

(ii) Hiring someone to become the successor; or

(iii) A buyout of departing management by the next generation.

2. Merger with another firm

(a) This strategy necessitates finding the right partner (e.g., managers should seek firms with cultures that complement their own, etc.).

(b) This strategy may involve a lengthy negotiation process.

3. Sale of firm to a third party

(a) This strategy requires at least 18 to 24 months to find a buyer, negotiate a deal and execute the transfer.

(b) This strategy can also be more disruptive to investors and employees.

F. Failure to have any sort of succession or continuity plan, or having an inadequate plan, is a red flag for investors and may cause investors to seek investment advice elsewhere.

G. Periodic Review of Continuity and Succession Plans

1. Regardless of what type of continuity or succession plan you have, you should review any plan periodically and update as necessary to reflect changes in circumstances (e.g., departure of the "heir apparent").

III. Restrictive Covenants

A. In today's era of technological advances, global expansion and rapidly moving information, employers are increasingly turning to restrictive covenants to protect their businesses, and the private investment industry is no exception.

B. Types of Restrictive Covenants

1. Confidentiality Agreements

(a) These covenants are ubiquitous in the hedge fund industry and are designed to protect an employer's trade secrets, confidential information and proprietary information. These types of covenants typically do not have any restrictions on duration.

(b) An employer must demonstrate the confidential information or trade secrets at risk and how their disclosure would negatively impact their business.[11] Confidentiality provisions are typically enforced for as long as the relevant information constitutes a secret. These provisions should not restrict the use and disclosure of information that becomes public through legal means.

[11] *See Int'l Bus. Mach. Corp. v. Visentin*, 2011 WL 672025 (S.D.N.Y. Feb. 16, 2011).

2. Non-Compete Clauses

   (a) The most common type of restrictive covenants are non-compete clauses, which are governed by state law. Generally speaking, these covenants restrict departing employees from competing against their former employer in an identical or similar line of business for a specified period.[12]

   (b) Non-compete provisions are more likely to be enforced when they are narrowly tailored to protect an employer's legitimate interests in trade secrets, confidential information or to protect unique client relationships.[13]

   (c) Courts will only enforce non-compete provisions when they are reasonable. Factors going to the reasonableness of a non-compete clause include the duration, geographic scope and compensation of the employee during the enforcement of the covenant. Courts can also consider whether either party has unclean hands.

   (d) Courts will generally recognize the right of contracting parties to select which states' laws will apply regarding non-compete provisions, however, some states require a "substantial relationship" between the controversy and the application of the proposed state's laws. Relevant factors include the place of contracting, the place of negotiation, the place of performance of the contract, and the location of the subject matter of the contract.

3. Non-Solicitation Agreements

   (a) These covenants prohibit a departing employee from poaching resources from their former employers by undermining relationships that their former employer has cultivated. These resources can be employees or investors.

   (b) To be enforceable, these covenants must be reasonable in scope and duration. Solicitation is unlikely to be found where an investor approaches a former employee at their new firm. Solicitation is often difficult to prove as an evidentiary matter because it can be difficult to discern whether the former employee approached the investor or current employee or vice versa.

4. Bad Boy Clauses

   (a) These are provisions that permit competition, but disincentive it by taking away compensation or benefits, such as unpaid deferred compensation or sunset payments, from employees who leave and join competitors. In most jurisdictions, including New York, these provisions need not be reasonable in scope or duration to be enforced provided they are applied when employees resign, and not when they are terminated without cause.

C. Recent Development: MASS. GEN. LAWS ch.149, § 24L (2018)

   1. Massachusetts codified the common law principle that non-competes be no broader than necessary to protect a legitimate business interest and that non-competes must be reasonable in duration (12 months maximum, absent certain circumstances), scope and geography.

D. Recent Development: *NuVasive, Inc. v. Miles*[14]

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[12] *See Reed, Roberts Assoc., Inc. v. Strauman*, 40 N.Y.2d 303 (N.Y. 1976); Ivy Mar Co. v. C.R. Seasons Ltd., 907 F. Supp. 547 (E.D.N.Y. 1995).

[13] *See BDO Seidman v. Hirshberg*, 93 N.Y.2d 382 (N.Y. 1999).

1. The Delaware Court of Chancery recently found in *NuVasive, Inc. v. Miles*, that California's policy against non-competes is not so fundamental when the employee is represented by counsel and knowingly bargains away such protections-seemingly opening the door for employers to enforce non-compete covenants against California employees.

2. In *NuVasive*, the plaintiff was a Delaware corporation doing business in California that tried to enforce a non-compete clause in a contract with an employee that also included a Delaware forum selection clause.

3. Cal. Labor Law 925 provides that while employers cannot generally require California-based employees to agree to an employment contract with a forum selection clause as a condition of employment, that prohibition does not apply if the employee is represented by counsel when negotiating the agreement.

[14] *NuVasive, Inc. v. Miles*, No. CV 2017-0720-SG, 2018 WL 4677607 (Del. Ch. Sept. 28, 2018).

Credit and Specialty Finance

I. Current State of the Credit Fund Markets

A. We have seen a material increase in the number credit and loan funds. One asset management firm predicts that the credit fund market will reach $1 trillion in assets under management by 2020.

1. The BlackRock survey of its institutional clients showed that the trend to private credit continues with 56 percent of their respondents planning to increase their allocations.

2. We have seen many new credit fund managers launch in 2018 and some existing private fund managers expanded their footprint.

3. Generally established credit fund managers have had increasingly successful fundraises.

4. There are a number of new credit fund managers, often led by well-established founders who are building their second or third business.

5. Some managers are launching credit funds in anticipation for growth in the Asian private credit markets, particularly China.

B. The “credit fund” marketplace contains a wide variety of strategies and investment programs.

1. Leveraged loan funds buy or originate bank loans and then lever the bank loan portfolio often on swap.

2. Special situations funds tend to have a broad focus and will buy a very wide range of “unique” fixed income opportunities.

   (a) Special situation funds often seek higher yields; often with “equity-like” returns.

3. Direct lending funds often originate loans rather than purchase loans in the secondary market.

   (a) Direct lending funds focus on senior secured loans with floating rate interest charges.

   (b) Lower yields are the norm for these types of funds.

   (c) Direct lending funds are often unlevered.

   (d) Often, loans are made to buyout fund borrowers as part of a leveraged buyout.

4. Multi-strategy credit funds are permitted to purchase assets in the private or public credit markets.

   (a) One trick to multi-strategy credit funds is designing the correct structure.

   (b) Investors are turning away from public assets and increasing their exposure to private assets, but the multi-strategy manager can handle both.

5. Distressed Debt Funds

   (a) For the past five years, industry experts have been waiting for the distressed credit market to arrive.

(b) Many fund managers launched distressed credit funds in 2015, 2016 and 2017, only to find capital was not put to work or put to work at lower returns than expected.

(c) Low covenant loan agreements may exacerbate this effect.

(d) 2018 saw few if any distressed credit fund launches, even though some market experts see a U.S. recession looming.

6. Specialty finance itself covers a wide range of strategies and deal types.

(a) Litigation finance funds saw increased attention in 2018 with several new launches. Investors appreciate the uncorrelated returns that these types of funds offer.

(b) Other esoteric asset classes are discussed below.

C. A variety of credit fund structures and terms are used.

1. Many credit fund managers use a closed-end or “private equity-style” structure.

(a) The benefits of this structure are:

(i) No admission or redemption rights, which relieves pressure from having to precisely value the portfolio of credit assets, which can be a complex task, especially in light of the shift to private assets which do not have market valuations.

(ii) No redemption rights by investors, so certainty of capital for the credit fund manager.

(iii) Capital call feature to reduce cash drag on the fund’s returns.

(b) The difficulties inherent with this structure:

(i) Needing to go to market with a new fund launch once capital has been called to a certain level.

(ii) Needing to liquidate all assets before the end of the term.

(iii) Compensation can be delayed. When using a back-ended waterfall (or “European-Style Waterfall”) for carried interest, the credit fund manager’s employees must wait years for carried interest distributions.

2. Many credit funds have also moved to “hybrid terms” that combine liquid and illiquid fund terms and tailor them to the characteristics of the fund’s assets. For example:

(a) Capital commitments added to an open-end fund.

(b) Withdrawal rights and investor-level gates after a long lockup.

(c) Slow pay funds are also much discussed among credit managers.

(i) These types of hybrid funds have built-in liquidating withdrawal accounts (the “slow pay” feature) which allow the credit fund manager to sell semi-liquid assets in the portfolio over a period of years – yet they are open-ended fund structures that rely on capital contributions, valuations, incentive allocations and mini-waterfalls for the slow-pay assets.

(d) The benefits of the hybrid structure are several, but the two key benefits are:

(i) For investors, there is some level of liquidity during the life of the fund; and

(ii) For the credit fund manager, there is one ongoing fund offering rather than rolling out new vintages to investors every few years and asking each investor to re-underwrite the fund offering.

3. Business development companies are a possible structure.

(a) Registered funds under the Investment Company Act.

(b) Investment Company Act of 1940 restrictions come into play when a manager invests private funds side-by-side with registered funds (e.g., BDCs).

D. Tax planning is critical for most credit funds.

1. Funds that lend or lead workouts may generate effectively connected income, which requires special structuring.

E. Resolving conflicts of interest with sister businesses and funds can be a significant issue and require thoughtful planning.

1. Credit fund managers must decide in advance in their compliance manual how they will allocate trades among their various funds.

2. They must also decide how to resolve conflicts when investing in different parts of the capital structure of a given portfolio company.

F. Valuation concerns come up for credit fund managers on a regular basis.

1. Managers must decide when to use in-house valuation or assign this task to third-party valuation firms and how often they will conduct the valuation of the portfolio.

2. Given recent SEC interest on this topic, managers are seeking outside valuation on a more frequent basis.

G. Terms and conditions for closed-end credit funds continue to evolve.

1. *Length of Investment Period*. The market is three years from the final closing date (or in some cases the initial investment date), but managers are starting to push for four-year investment periods.

2. *Terms*. The average term length we have seen is 6.5 years, and we have seen a push for even longer terms.

3. *Carried Interest Waterfall*. The market is still for a back-ended waterfall ("European-Style Waterfall"), however, some credit fund managers that seek higher returns (e.g., high teens) are asking if the market will accept a modified deal-by-deal waterfall ("American Waterfall").

(a) Note that with the American Waterfall, the credit fund manager must still recoup prior realized losses and permanent write-downs.

(b) In addition, investors who agree to an American Waterfall will often require the general partner to make interim clawbacks to ensure that too much capital doesn't leave the fund.

(c) The market for the carried interest rate varies from 15 percent to 20 percent. In general, the higher the expected return, the more likely it is that the manager will ask for and receive the higher carried interest rate.

4. *Preferred Return*. The market for higher-yielding credit funds is 8 percent, and the market for no leverage direct lending funds is either 6 percent or 7 percent. In general, the lower the yield of the credit fund, the easier it is to ask investors for lower preferred return.

5. *Management Fees*. The management fee rate and what the management fee is calculated on are hotly negotiated. We are seeing rates that range from 1 percent to 2 percent; however the 2 percent rate is often for smaller investors, and the institutions tend to pay closer to 1.25 percent.

(a) The base for the management fee continues to be invested capital (i.e., cost basis of the assets being managed), but managers are pushing the market to accept the management fee base being capital commitments or net asset value.

(b) Valuation becomes more of an issue should the credit fund manager urge investors to accept net asset value as the management fee base.

(c) Early bird discounts for investors who arrive for the first closing remain popular in the market, and we see discounts ranging from 25 to 50 basis points.

6. *Subscription Lines*. The subscription line issues market is more popular than ever. Managers should be adding the proper disclosure to their fund documents if use of subscription lines could alter internal rates of return. Cascading pledges may need to be used if your credit fund is hardwired for ERISA purposes because the feeder funds should not be borrowing under these types of structures.

7. *Fund-Level Leverage*. Some credit fund managers negotiate for the right to lever the portfolio at the fund level or at special purpose vehicles below the fund level. Fund-level debt ratios vary but market seems to be around 1 to 1 (debt to equity). Managers should remember to carve out subscription lines from their debt to equity ratios.

8. *Distribution of Current Income*. More investors in credit funds are insisting on some type of periodic distributions of cash. How much cash should be distributed, when it should be distributed and how it is defined varies widely in our experience. The manager should determine a definition of "free cash" that works for the fund and stick to that definition.

II. Bankruptcy Risks for Credit Strategies

A. Private funds seeking to provide liquidity, whether by taking advantage of short-term debt trading strategies or long-term strategies like loan to own, must be cognizant that the current liquidity crunch creates the very real risk of bankruptcy.

B. *Cram–Up*. "A cram-up" is when junior classes of creditors impose a cramdown on senior classes of creditors. In such circumstances, senior classes of creditors can be forced to accept the terms of a proposed restructuring, even if they are not as good as the original deal, including, for example, take back paper with a below market interest rate.

1. There are two primary cram-up methods: reinstatement and indubitable equivalent.

2. In a reinstatement cram-up, the maturity of debt is restored at the pre-bankruptcy level, collection on debt due as a result of defaults are decelerated, defaults are "cured" and lenders are compensated for damages, thereby continuing the terms of the pre-bankruptcy financing. Debtors may favor this approach in a market where interest rates have risen significantly (which current trends suggest may occur in 2019) or where debtors enjoy a favorable covenant package (as would be the case in many of the existing "covenant lite" financings).

3. In the alternative, debt can be crammed up by either providing the secured lender with deferred cash payments with a present value equal to the debt (assuming the lender is fully secured by its collateral package) or by providing the secured lender with the "indubitable equivalent" of its secured claim. Debtors may utilize this approach where the pre-bankruptcy maturity date is an issue or to compel lenders to involuntarily refinance using interest rates that may be lower than an existing facility.

   (a) Courts have applied two methodologies for determining the appropriate interest rate to calculate present value: the formula approach and the market approach. The "formula approach" starts with a risk-free base rate (such as the Treasury rate or prime rate) and is adjusted by the court to account for risks based on the circumstances of the case, the nature of the collateral, the terms of the take back paper and feasibility of the plan. The "market approach" refers to the prevailing rate of interest the debtor would be required to pay for the same financing in an efficient market.

C. Disallowance of OID: Original Issue Discount ("OID") is the difference between the value of the proceeds of a debt instrument at the time it is issued and the face amount of the same at its maturity. In addition to OID created at the time of issuance, OID can also arise in debt-for-debt exchanges (including face value exchanges and fair value exchanges).

1. OID is paid only when the debt matures and is amortized over the life of the debt from an accounting and tax perspective (like regular interest accrual). As such, bankruptcy courts have held that OID constitutes interest for purposes of treatment under the Bankruptcy Code.

2. In bankruptcy, the allowed amount of a creditor's claim is determined as of the date the bankruptcy case is commenced. Consistent with this rule, claims for unmatured interest, and unamortized OID, are disallowed.

D. *Lien Avoidance.* In bankruptcy, a debtor may seek to unwind certain transfers or obligations it believes were fraudulently made. An LBO transaction that goes bad can be a prime target for fraudulent conveyance claims because lenders, management and shareholders may benefit greatly, while the debt used to finance the deal can render the company insolvent.

1. In general, an LBO or functionally similar transaction involves substituting debt for equity. Often, loan proceeds are obtained by the acquiring entity, secured by the target entity's assets and used by the acquiring entity to buy-out the existing equity holders of the target entity. With respect to lender risks, parties may initiate fraudulent transfer litigation to avoid the liens granted to the third-party lenders that financed the LBO.

2. There are two types of fraud for purposes of fraudulent transfers: actual fraud and constructive fraud. Actual fraud exists where a transfer was made with actual intent to hinder, delay or defraud investors. Because direct evidence of fraudulent intent is often unavailable, courts rarely find actual fraud in the case of an LBO. Constructive fraud does not require fraudulent intent but instead deals with transfers that were not in the best interests of the transferor.

3. In order to avoid the liens under a theory of constructive fraud, the debtor must have been (1) insolvent or (2) undercapitalized at the time of (or as a result of) the transaction. This is a fact-intensive inquiry and often requires expert analysis, but courts frequently look to three data points as a start:

   (a) *Equity Market Cap*. With respect to solvency, courts prefer market evidence and have frequently relied on a public company's positive equity capitalization as dispositive proof of solvency in the absence of fraud.

   (b) *Balance Sheet*. Another solvency data point, albeit not dispositive, is the balance sheet. If the assets of the company exceed liabilities by a meaningful cushion after the LBO transaction, courts may consider that to be evidence of solvency.

   (c) *Adequate Capital*. If solvency is a snap-shot at a particular point in time, determinations of "adequate capitalization" is forward-looking based on projections. If the company's projections show a sufficient operating income to deal with its operating liabilities based on reasonable assumptions, courts may consider that to be evidence of adequate capitalization.

4. *Risk Mitigants*. Lenders should be cognizant that a failed LBO will likely be subject to litigation. To mitigate risks, lenders should be prepared to conduct a thorough, independent solvency analysis of the potential borrower at time of transaction (both on an individual and post-LBO consolidated basis). When performing a solvency analysis and valuation, lenders should expect that courts will "collapse" the transaction and look at the net value received by the borrower, rather than consideration exchanged in any individual/incremental transaction. Lenders may also require a third-party solvency opinion and representations in the loan agreement (and transaction agreement) and an officers' certificate on solvency.

   (a) These steps would *not eliminate* the fraudulent transfer risk but would be helpful to mitigate them in the event of a future bankruptcy filing.

III. Certain Material Provisions of a Typical Credit Agreement

A. Credit Facility

1. *Mechanics*. The facility section of the credit agreement sets forth the mechanics of making a loan, the payment of the principal of, and interest on, each loan, and the maximum amounts, sublimits, borrowing bases and other basic terms that relate to the facility.

2. Interest Rate

   (a) Loan pricing may be divided into two categories: interest rates based on (x) an all-inclusive calculation of the bank's costs in extending credit, such as the bank's prime rate, and (y) the bank's "cost of funds." In each case, the lender may add a margin or spread to the foregoing base interest rates, based upon the lender's perceived risk of the credit. The most common cost of funds rate is LIBOR. Note that the Financial Conduct Authority of the United Kingdom plans to phase out LIBOR by the end of 2021. Discussions are underway to determine the new benchmark rate to replace LIBOR.

   (b) Most states have laws that limit the rate of interest a lender may charge on a loan. Most of these limitations do not apply to large commercial loans. For example, in New York, commercial loans in excess of $2,500,000 are not subject to usury restrictions. Some states, however, still have usury laws that are of concern to commercial lenders. Note that fees and equity kickers may be included as interest when calculating the interest rate for determining whether a loan is usurious.

3. *Incremental Facilities*. Credit agreements may have provisions that allow for (i) incremental facilities to increase the existing loans on same terms or different terms, and/or (ii) side-car loan facilities that permit additional loans on same terms or different terms. The terms of the incremental facilities, the amounts, the economics and rights of existing lenders to participate or provide such facilities are all negotiated on a deal-by-deal basis.

B. Letters of Credit

1. A letter of credit facility is usually part of the revolving facility (i.e., reduces the amount available under the revolving facility) with a sublimit on the letter of credit facility.

C. Application of Payments

1. Waterfall – Governs how the proceeds from collateral or other payments are allocated among the lenders after the occurrence of an event of default.

D. Conditions Precedent

1. Conditions precedent establish the conditions to the lender's obligation to extend credit to the borrower.

2. Many credit agreements entered into in connection with an acquisition financing require "SunGard" closing conditions. SunGard provisions replace the customary conditions precedent to initial funding that require the perfection of security interest on the collateral and that all representations and warranties are true and correct, in each case, as of the closing date. The purpose of SunGard provisions is to reduce the number and scope of conditions precedent so there is more certainty for the seller that the financing will be available and the acquisition will close as expected.

E. Representations and Warranties

1. The representations and warranties of a credit agreement, together with the disclosure schedules that are attached to the credit agreement, provide a "snapshot" of the borrower at a particular point in time, and, if there is a gap between signing and closing of any funding, the representations and warranties are "brought down" (i.e., re-made) on the closing date and each funding date.

2. There are two broad categories of representations and warranties. The first category deals with standard issues, such as the borrower's due organization and compliance with laws. The second category deals with issues specific to the particular credit and borrower. These include such items as compliance with specific regulations applicable to the borrower's business and ownership of assets by the borrower.

F. Covenants

1. Through the covenants of a credit agreement, the lender seeks to maintain the "snapshot" of the borrower. If a covenant is violated, a lender may reevaluate the credit and declare an event of default. There are many types of covenants found in credit agreements. Covenants are generally divided into affirmative covenants (setting forth actions the borrower should affirmatively take), negative covenants (setting forth prohibitions on certain actions by the borrower) and financial covenants.

2. Examples of affirmative covenants: financial reporting, compliance with laws, maintenance of existence, maintenance of insurance, inspections/lender calls, maintenance of books and records and further assurances.

3. Examples of negative covenants: limitations on debt, liens, investments, dispositions, fundamental changes, dividends/distributions, change in the nature of business, payment on other debt and transactions with affiliates.

   (a) These covenants typically include certain exceptions and thresholds. Borrowers will often push to expand the threshold baskets by (x) setting the basket as the "greater of a fixed amount and a certain percentage of EBITDA" as opposed to a fixed amount and (y) using the "Available Amount/Builder Basket." All of the covenant baskets should be reviewed collectively – especially given the prevalence of EBITDA grower baskets and available amount baskets.

   (b) The "Limited Condition Acquisition" concept is fairly prevalent in large cap and upper middle-market transactions. Limited Condition Acquisition provisions were originally introduced so that a buyer in an acquisition could bolster its position by stating its offer to purchase is not conditional on obtaining third-party debt. Credit agreements that permit Limited Condition Acquisitions will allow a borrower to elect to test availability under debt incurrence baskets and/or conditions such as "no default or event of default" on the date of the execution of the acquisition documents rather than at its completion.

   (c) Some credit agreements also differentiate between "Restricted Subsidiaries" and "Unrestricted Subsidiaries." Restricted Subsidiaries are subject to the representations and warranties and the covenants of the credit agreement. Unrestricted Subsidiaries would not be subject to such provisions. If a credit agreement permits the borrower to have Unrestricted Subsidiaries, it is important to review all of the negative covenants for any potential issues.

   (d) Credit agreements should reflect the assumptions used to underwrite the deal. Credit agreements should prohibit transfers of assets that are material to the business of the borrower, and if certain baskets are expected to be utilized solely with cash (e.g., cash investments and cash restricted payments), the credit agreement should be drafted clearly to state such expectations.

4. Financial Covenants

   (a) Weakening of financial covenants – "covenant-lite" approach, speculative EBITDA addbacks and increased cushion to sponsor models – all may affect recovery prospects for lenders.

   (b) Financial covenants should be tight enough to detect a financial problem in advance of a default. If the financial covenants are sufficiently sensitive and the credit is being monitored properly, the lenders should be able to exercise rights and remedies before a payment default occurs.

G. Events of Default and Remedies

1. Events of default are the triggers that allow the lender to exercise its rights and remedies, including acceleration of the loans and termination of commitments.

2. May include an equity cure provision to permit the borrower to cure its financial covenant defaults.

IV. Specialty Finance, Esoteric Deals and Yields Uncorrelated to Capital Markets

A. With volatility in capital markets, these types of deals and similar products continue to be in high demand.

B. During the great recession barely 10 years ago, when commoditized deals backed by consumer debt fell off a cliff, "esoteric" deals continued to move forward.

C. *Specialty Finance*. This includes all areas that traditional banks can't fund.

1. *Consumer Credit*. Debt incurred by consumers when purchasing goods or services. Examples include rent-to-own and motorcycle leases.

2. *Commercial Credit*. Examples include merchant cash advances and insurance-related receivables.

3. *Life Settlements*. The sale of a life insurance policy for less than the policy's face value. The buyer will receive the full policy amount when the insured dies.

    (a) A generally uncorrelated asset class: Benefits include the ability to build a performing portfolio; the challenge risk has significantly declined and noise has subsided.

    (b) Risk factors include longevity, insufficient reserves for premiums, inconsistent cash flows during ramp-up, insurable interest, fraud in the application and cost of insurance.

    (c) Regulation: 45 states, Washington, DC and Puerto Rico regulate life settlements. Three states regulate viatical transactions only. Five states do not have any life settlement related regulation.

D. "Esoteric" Deals

1. *Litigation Finance*. In our specialty finance practice, litigation funding has been one of the fastest growing asset classes over the last 24 months.

    (a) *Uncorrelated and Illiquid*. Litigation outcomes are generally not impacted by volatility in capital markets. Some consider this asset class to be recession proof.

    (b) *High Potential Returns*. ROI in some cases can be based on interest rates and in other cases on a MOIC metric.

    (c) Counterparties can be law firms and corporations, as well as individuals, such as in class action payout fundings.

    (d) There are a variety of options for investors. Deals can be large or small.

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