William J. Barbera

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.
Brad L. Caswell

Brad focuses his practice on counseling hedge and private equity funds on operational, regulatory and compliance matters. He represents clients on a broad range of issues, including those related to the U.S. Investment Advisers Act, other federal, state and self-regulatory organization requirements and securities trading rules in the United States. Brad also provides guidance to clients with operations in Hong Kong, Japan and other markets throughout Asia and the United Kingdom with respect to regulatory, compliance, trading and operations. Prior to joining 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.
Brian T. Daly

Brian advises hedge, private equity and real estate fund managers on regulatory, compliance and operational matters. He has extensive experience designing and improving compliance processes and organizational systems and helps clients navigate their initial and ongoing regulatory compliance obligations under the rules and regulations of the 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.
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.
Melissa G.R. Goldstein

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.
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.
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.

---


\(^4\) 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 exposes” 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 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.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.


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.\(^9\)

---

\(^8\) Id.

\(^9\) See Investment Adviser Compliance Issues Related to the Cash Solicitation Rule, infra note 40.
D. Examination Process

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.

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*, 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.

---

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*. The original notice 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, 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.

---


(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, 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 positions 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.\textsuperscript{16} The rule classifies equity options as standardized, conventional or FLEX. Standardized and FLEX equity options are exchange-traded and conventional options trade OTC.\textsuperscript{17} FINRA Rule 2360(b)(3)(A) imposes a position limit on the number of equity options contracts in each class,\textsuperscript{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.\textsuperscript{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 effect an opening transaction on behalf of that entity or group without an exemption from the applicable position limit.

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

4. Position Limit Exemptions

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

(b) Examples of strategies and positions that affect position 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

\textsuperscript{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.”


\textsuperscript{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.

\textsuperscript{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), 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), 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. 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.

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.


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.


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.


(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.”

(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.

(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

(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

---


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

(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

(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.

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

(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.

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

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

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

(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;

32 Id. at 5.
33 Id.
35 Id.
(ii) How PII data is anonymized, and whether data that has been anonymized can still be used to identify 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


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”). 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:

(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 delegatee, 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. 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.

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).

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.

---

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

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.


(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


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

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.


(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

---


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. 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

---

52 See, e.g., Ginsburg v. ICC Holdings LLC, No. 3:16-cv-2311-d (N.D. Tex. Nov. 13, 2017) ("... where 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. 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.

---

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.”

   (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; (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); or (3) a plan which covers only partners and their spouses (often called a “partner-only” plan).

   (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

---

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) or (v); or

---

\(^{58}\) 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.

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).  

(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.

(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.)

(c) Furnishing of goods, services or facilities.

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

(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).

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.\textsuperscript{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.\textsuperscript{77} A similar penalty must be assessed against any non-fiduciary who knowingly participates in such a breach.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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,\textsuperscript{81} and the amount on which the tax is based may be the highest fair market value during the taxable period.\textsuperscript{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

\textsuperscript{76} ERISA § 409(a).
\textsuperscript{77} ERISA § 502(1).
\textsuperscript{78} ERISA § 502(1).
\textsuperscript{79} Internal Revenue Code § 4975(a) and (f)(4).
\textsuperscript{80} Internal Revenue Code § 4975(a), (f)(2) and (f)(5).
\textsuperscript{81} Internal Revenue Code § 4975(b).
\textsuperscript{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. 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.

---

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. 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. 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. 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”) 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.

---

93 ERISA § 412.
(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). 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. 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)(A) 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 2006-1697 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. 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 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

---

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

---

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”). 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” 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


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.