Regulatory Compliance 2020

Schulte Roth & Zabel

29TH ANNUAL

PRIVATE INVESTMENT FUNDS SEMINAR

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Brad L. Caswell 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 his B.A., *magna cum laude*, from Georgetown University.

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David M. Cohen focuses his practice on matters related to fiduciary responsibility, ERISA and qualified plans. Prior to joining SRZ, David held positions in both the private sector (as vice president and assistant general counsel of a major investment firm) and government service (with the Department of Labor Employee Benefits Security Administration's Divisions of Regulatory Coordination and Exemptions). He speaks and writes widely on ERISA and benefit fund-related issues, including authoring ERISA compliance guides for broker-dealers for the Practising Law Institute and presenting on "Handling ERISA Issues When Managing a Plan Asset Look-Through Fund" for a Financial Research Associates Hedge Fund Tax, Accounting and Administration Master Class and on "Fund Formation Issues," "Current Topics in Private Equity and Alternative Investments" and "Current Fiduciary Issues" for recent Practising Law Institute Pension Plan Investments and ERISA Plans in the Financial Markets conferences.

In recognition of his accomplishments, David was selected for inclusion in *New York Super Lawyers*, a listing of outstanding attorneys in the New York metro area, *Chambers USA* and *The Best Lawyers in America*. David received his J.D. from The George Washington University Law School and his B.A. from Columbia University.

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Brian T. Daly

Brian T. Daly advises hedge, private equity and real estate fund managers on regulatory, compliance and operational matters. He has extensive experience designing compliance policies and processes and regularly represents clients in enforcement actions, examinations and informal inquiries from the U.S. Securities and Exchange Commission, the Commodity Futures Trading Commission, the National Futures Association, and numerous futures exchanges and SEFs. Brian is also well known for representing Asian-based managers with U.S. jurisdictional ties. 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 managers.

Brian is a recognized leader in advising alternative investment fund managers on regulatory and compliance matters and is highly regarded 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. He received his J.D., with distinction, from Stanford Law School.

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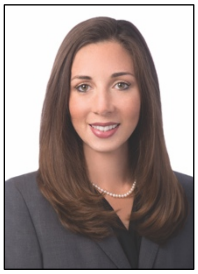
Marc E. Elovitz

Marc E. Elovitz is co-managing partner of the firm. He serves as chair of the Investment Management Regulatory & Compliance Group and as a member of the firm's Executive Committee. Marc advises private fund managers on running their businesses consistent with the Investment Advisers Act of 1940 and all other applicable laws, regulations and legal requirements. Marc provides guidance to clients on SEC registration, examination and enforcement matters. He also regularly leads training sessions for investment professionals 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 NYU School of Law and his B.A., with honors, from Wesleyan University.



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Melissa G.R. Goldstein

Melissa G.R. Goldstein advises banks, broker-dealers, investment advisers, funds, insurance companies and money services businesses, including those involved in global e-commerce and virtual currency, on anti-money laundering and sanctions regulations, rules and related issues governing their investment and business activities. She has particular expertise with issues arising out of the USA PATRIOT Act, as amended by 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 anti-money laundering regulations and guidance, and served as counsel on enforcement actions involving issues such as failure to implement and maintain an adequate anti-money laundering compliance program, failure to register as a money services business, and failure to maintain confidentiality of 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." Melissa received her J.D. from Fordham University School of Law and her B.S., with honors, from Cornell University.

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Kelly Koscuiszka advises on securities enforcement and regulatory matters as well as privacy and data security issues for broker-dealers, private funds, financial institutions, companies and individuals. Kelly also defends individuals and entities under investigation for or charged with securities fraud, mail/wire fraud, accounting fraud and insider trading. She advises clients on securities trading matters and, when necessary, represents them in regulatory investigations and enforcement actions by the SEC, DOJ, FINRA, and other self-regulatory organizations and state regulators. Kelly also leads training sessions for clients on complying with insider trading laws and best practices for electronic communications and related firm policies. Kelly also represents clients in civil litigation matters involving breach of contract, alter ego liability, fraud and cross-border disputes. Kelly received her J.D. from Georgetown University Law Center and her B.A. from Rutgers University.

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Ian L. Levin

Ian L. Levin concentrates on executive compensation and employee benefits, including the fiduciary and plan asset requirements of ERISA. Ian regularly advises clients regarding 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's practice also focuses on the employee benefit aspects of mergers and acquisitions, representing both executives and companies with respect to the negotiation and drafting of executive employment agreements and advising companies on the design, establishment and operation 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.

Ian has been recognized as a leading employment and employee benefits attorney by *Chambers USA*, *The Legal 500 US*, *New York Super Lawyers* and *Best Lawyers*. *The Legal 500 US* noted that he "operates at a very high level across many areas, but brings a particularly unique set of skills to ERISA Title I matters in his representation of private investment funds." 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 received his LL.M. from NYU School of Law, his J.D. from Emory University School of Law and his B.A. from Union College.

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Edward H. Sadtler is head of the Intellectual Property, Sourcing & Technology Group. He represents clients in a wide variety of transactions and other matters involving intellectual property and technology. Edward also advises clients on data security and privacy matters. Working closely with cross-practice teams, Edward has advised on the intellectual property, technology, privacy and data security aspects of mergers and acquisitions, private equity investments, carve-outs, financings, securitizations, public offerings and restructurings. Specifically, he has counseled clients in negotiating licenses, intellectual property transfers, IT service agreements, joint ventures and strategic alliances, consulting and publicity rights contracts, and manufacturing, distribution and supply arrangements, as well is in trademark prosecution matters. His experience covers many industries, including financial services, health care, software, cybersecurity, apparel and accessories, travel, hospitality, media, entertainment, energy, logistics and communications.

Edward is recognized by *The Legal 500* as a leading lawyer in the category of Media, Technology and Telecoms: Technology: Transactions. He received his J.D. from the University of Virginia School of Law and his B.A., *cum laude*, with departmental honors, from Columbia University.

Regulatory Compliance 2020

I. Proposed Amendments to SEC Advertising Rule and Cash Solicitation Rule

A. Advertising Rule Overview

1. On Nov. 4, 2019, the U.S. Securities and Exchange Commission issued proposed amendments to the "Advertising Rule" under the Investment Advisers Act of 1940 ("Advisers Act"),[1] which shift the model of regulating advertisements from a prescriptive to a principles-based approach.

2. The SEC is soliciting comments on a wide range of items relating to the proposed rule, with all comment letters due by Feb. 10, 2020.[2]

B. Distinguishing Between Retail and Non-Retail Advertisements

1. The proposed rule creates a new category of "Non-Retail Advertisements," which would permit greater latitude in content and presentation, but the dissemination of which would be limited to "qualified purchasers" and "knowledgeable employees."[3]

2. Non-Retail Advertisements are also exempt from new performance reporting requirements that would require advisers to:

   (a) Show performance over specified time periods; and

   (b) Affirmatively provide certain disclosures accompanying hypothetical performance relating to the risks and limitations of such performance.[4]

C. Case Studies

1. The proposed rule incorporates a "fair and balanced" principle to evaluate the use of case studies and other past specific recommendations.[5]

2. The SEC notes that while the guidance from several staff no-action letters can be useful in applying the "fair and balanced" standard, the standard exists independently and advisers would not be obligated to follow the requirements of those letters.[6]

3. "Cherry-picking" and other presentations of specific investment advice and related performance that are misleading would be prohibited under the "fair and balanced" standard.[7]

D. Hypothetical Performance

1. The proposed rule permits the use of hypothetical performance where advisers:

   (a) Provide sufficient information to enable the recipient to understand the criteria and assumptions underlying the performance; and

   (b) Provide (or, if a Non-Retail Advertisement offers to provide) similar information addressing the risks and limitations of the use of hypothetical performance in making investment decisions.[8]

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[1] Investment Adviser Advertisements; Compensation for Solicitations, Advisers Act Release No. IA-5407 (Nov. 4, 2019) (hereinafter "Advertising Rule Proposal"), available at https://www.sec.gov/rules/proposed/2019/ia-5407.pdf.
[2] https://www.govinfo.gov/content/pkg/FR-2019-12-10/pdf/2019-24651.pdf
[3] Advertising Rule Proposal *supra* note 1, 108. For example, advisers would be permitted to show gross performance without accompanying net performance in Non-Retail Advertisements; provided that the advertisement contains or offers to promptly furnish a schedule of specific fees and expenses.
[4] *Id.* at 109.
[5] *Id*. at 63.
[6] *Id*. at 65-66. In connection with any adoption of the Advertising Rule Proposal, the SEC staff is considering withdrawing certain staff no-action letters addressing the Advertising Rule. *Id.* at 296.
[7] *Id.* at 58-59.
[8] *Id.* at 158-160.

E. Extracted Performance

1. Under the proposed rule, advisers would be permitted to provide extracted performance in advertisements; provided that such advertisements contain or offer to promptly furnish the performance results of all investments in the portfolio from which the performance was extracted.[9]

F. Related Portfolios

1. The proposed rule would prohibit advertisements that show the performance of a "related portfolio" (which are those portfolios with substantially similar investment policies, objectives and strategies as those of the services being offered or promoted) unless the advertisement shows the performance of all related portfolios.

2. Advisers would be able to exclude the performance of a related portfolio only when the performance shown would be no higher than if the performance of all related portfolios were included.[10]

G. Compliance

1. The proposed rule would generally require review and pre-approval of advertisements by a designated employee.[11]

2. This review and approval requirement also applies to updates to previously-reviewed advertisements.[12]

3. The proposed rule would also require advisers to adopt policies and procedures with respect to the use of Non-Retail Advertisements and hypothetical performance.[13]

H. Testimonials

1. The proposed rule would generally permit the use of testimonials, endorsements and third-party ratings in advertisements, provided that they are accompanied by certain disclosures.

2. Disclosures include whether compensation has been provided by or on behalf of the adviser to the person providing the testimonial or endorsement, or whether that person is a client.

I. Definition of "Advertisement"

1. The proposed rule fundamentally reworks the definition of an advertisement to cover "any communication, disseminated by any means, by or on behalf of an investment adviser, that offers or promotes the investment adviser's advisory services or that seeks to obtain or retain one or more investment advisory clients or investors in any pooled investment vehicle advised by the investment adviser," subject to certain enumerated exceptions.[14]

2. The proposed rule would make it clear that communications with existing clients and investors that "offer or promote" advisory services, which could, in certain circumstances, include the adviser's market commentary and discussions of the adviser's investing thesis, are considered advertisements.[15]

J. Additional General Prohibitions

1. The proposed rule expands on the general prohibitions currently included in the Advertising Rule.

2. Advisers would be prohibited from disseminating advertisements that:

   (a) Contain any material claim or statement that is not substantiated[16];

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[9] *Id.* at 352.
[10] *Id.* at 145.
[11] *Id.* at 190.
[12] *Id.*
[13] *Id.* at 108.
[14] *Id.* at 19-20.
[15] *Id.* at 24-25.
[16] *Id.* at 56.

(b) Contain untrue or misleading implications about material facts relating to the adviser, or that are reasonably likely to cause an untrue or misleading inference to be drawn concerning any material facts[17];

(c) Discuss or imply any potential benefits connected with or resulting from the adviser's services or methods of operation that do not also "clearly and prominently" disclose associated material risks or other limitations[18];

(d) Include or exclude performance results, or contain presentations of performance time periods, in a manner that is not fair and balanced[19]; and

(e) Are otherwise materially misleading.[20]

K. Transition Period and Existing No-Action Letters

1. The SEC is proposing a one-year transition period from the effective date of the proposed rule to formal implementation.

2. Advisers would be permitted to rely on the final rules during the period after the effective date but before the compliance date.

L. Cash Solicitation Rule Proposal

1. The SEC also proposed amendments to the "Cash Solicitation Rule" (Rule 206(4)-3) to expand the types of activities and compensation covered by that Rule and update certain compliance obligations under the Advisers Act.[21]

2. The proposed rule would expand the applicability of the Cash Solicitation Rule to include solicitors of private fund investors (currently the Rule only covers solicitors of "clients," not of "investors" in funds that are clients).[22]

3. An adviser's officers, directors, partners and employees would continue to remain exempt from the written agreement, compliance and oversight provisions of the Cash Solicitation Rule; provided that the affiliation is disclosed to clients or private fund investors.[23]

4. The SEC proposed expanding the applicability of the Cash Solicitation Rule to cover all forms of compensation, including non-cash compensation such as awards, prizes, free or discounted services, or directed brokerage.[24]

5. The proposed rule would eliminate the requirement that a solicitor deliver the adviser's brochure to clients and obtain from each client acknowledgements of receipt of the solicitation disclosures.[25]

6. Transition Period and Existing No-Action Letters

(a) The SEC is proposing a one-year transition period from the effective date of the proposed rule to formal implementation.

(b) Advisers would be permitted to rely on the amended rules during the period after the effective date but before the compliance date.

(c) The proposing release contains a list of no-action letters under the Advertising Rule that the staff is reviewing for potential withdrawal in connection with the adoption of final rules.

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[17] *Id*. at 57.
[18] *Id*. at 59.
[19] *Id*. at 68.
[20] *Id*. at 72.
[21] *Id*. at 200.
[22] *Id*. at 201-202.
[23] *Id*. at 245-246.
[24] *Id*. at 205.
[25] *Id*. at 18.

II. Standard of Conduct for Investment Advisers

A. On June 5, 2019, the SEC published four items of guidance related to the standard of conduct required of investment advisers and broker-dealers under the federal securities laws:

1. Commission Interpretation Regarding the Standard of Conduct for Investment Advisers ("Fiduciary Interpretation")[26];

2. Form CRS Relationship Summary; Amendments to Form ADV ("Form CRS Release")[27];

3. Regulation Best Interest[28]; and

4. Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser ("Solely Incidental Interpretation").[29]

B. Fiduciary Interpretation

1. The Fiduciary Interpretation is the SEC's first holistic statement regarding an adviser's federal fiduciary duties.

2. Federal Fiduciary Duty

(a) The SEC cites U.S. Supreme Court decisions (and its own precedent) stating that the Investment Advisers Act unambiguously establishes a federal fiduciary duty for investment advisers.[30]

(b) The Fiduciary Interpretation emphasizes that this fiduciary duty exists, that it exists for all categories of clients and that it cannot be categorically waived.

3. Conflicts of Interest Waivers

(a) With respect to the efficacy of disclosure in curing conflicts of interest, the SEC clarified in the Final Interpretation that "[w]e believe that while full and fair disclosure of all material facts relating to the advisory relationship or of conflicts of interest and a client's informed consent prevent the presence of those material facts or conflicts themselves from violating the adviser's fiduciary duty, such disclosure and consent do not themselves satisfy the adviser's duty to act in the client's best interest."[31]

(b) The Fiduciary Interpretation provides that an adviser must "eliminate or make full and fair disclosure of all conflicts of interest which might incline an investment adviser — consciously or unconsciously — to render advice which is not disinterested such that a client can provide informed consent to the conflict."[32]

(c) The SEC, in the Fiduciary Interpretation:

(i) Acknowledges that advisers are not required to "seek to avoid" all conflicts of interests; rather, an adviser may utilize disclosure in lieu of eliminating a conflict[33]; and

(ii) Validates an "informed consent" concept for conflict of interest disclosures by an adviser.[34]

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[26] Commission Interpretation Regarding the Standard of Conduct for Investment Advisers, Advisers Act Release No. IA-5248 (July 12, 2019) (hereinafter "Fiduciary Interpretation"), available at https://www.sec.gov/rules/interp/2019/ia-5248.pdf.
[27] Form CRS Relationship Summary; Amendments to Form ADV, Advisers Act Release No. IA-5247 (June 5, 2019) (hereinafter "Form CRS Release"), available at https://www.sec.gov/rules/final/2019/34-86032.pdf.
[28] Regulation Best Interest: The Broker-Dealer Standard of Conduct, Release No. 34-86031 (June 5, 2019) (hereinafter "Regulation Best Interest"), available at https://www.sec.gov/rules/final/2019/34-86031.pdf.
[29] Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser, Advisers Act Release No. IA-5249 (June 5, 2019) (hereinafter "Solely Incidental Interpretation"), available at https://www.sec.gov/rules/interp/2019/ia-5249.pdf.
[30] Fiduciary Interpretation *supra* note 26, at 6.
[31] *Id*. at 23.
[32] *Id*.at 8.
[33] *Id*. at 23, n. 57.
[34] *Id*. at 9.

4. Contractual Limits

   (a) The Fiduciary Interpretation expressly acknowledges that retail and institutional investors are differently positioned in their ability to assess conflicts, stating that "institutional clients generally have a greater capacity and more resources than retail clients to analyze and understand complex conflicts and their ramifications."[35]

   (b) The SEC made clear that this "greater capacity and more resources" point only goes so far, noting that "while the application of the investment adviser's fiduciary duty will vary with the scope of the relationship, the relationship in all cases remains that of a fiduciary to the client."[36]

   (c) The Fiduciary Interpretation specifically noted that overbroad waivers, such as the following, will not be permitted:

      (i) A contractual provision purporting to waive the adviser's federal fiduciary duty generally;

      (ii) A statement that the adviser will not act as a fiduciary;

      (iii) A blanket waiver of all conflicts of interest; or

      (iv) A waiver of a specific obligation under the Investment Advisers Act.[37]

5. Guidance on the Duty of Care

   (a) The SEC stated that an advisers' fiduciary duties encompass a duty of care as well as a duty of loyalty[38]

   (b) Obligations with respect to the duty of care run to:

      (i) Suitability (and a duty of inquiry to support a reasonable belief that advice is in the best interests of a given client);

      (ii) An obligation to seek best execution; and

      (iii) A requirement to monitor performance over the course of a relationship.[39]

6. Use of Contingent Language in Disclosures

   (a) An adviser may not state that it "may" have a conflict when:

      (i) The adviser, in fact, has a particular conflict; or

      (ii) Has such a conflict with respect to some, but not all, of the adviser's clients.[40]

   (b) The SEC clarified that the use of "may" in disclosures of potential conflicts is appropriate when a conflict does not currently exist, but might reasonably present itself in the future.[41]

7. Specific Guidance on Allocation Policies

   (a) The SEC specifically addressed investment allocation policies, which have been a focus in many examinations.

   (b) The Fiduciary Interpretation stressed that "when allocating investment opportunities, an adviser is permitted to consider the nature and objectives of the client and the scope of the relationship. An adviser need not have pro rata allocation policies, or any particular method of allocation, but, as with

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[35] *Id.* at 28, n. 70.
[36] *Id.* at 10.
[37] *Id.* at 10-11.
[38] *Id.* at 2.
[39] *Id.* at 12.
[40] *Id.* at 25.
[41] *Id.*

other conflicts and material facts, the adviser's allocation practices must not prevent it from providing advice that is in the best interest of its clients."[42]

C. Form CRS Release

1. The Form CRS Release requires registered investment advisers that provide advisory services to "retail investor" clients to complete, file and deliver new Part 3 of Form ADV, also known as a Form CRS Relationship Summary.

2. The Form CRS Release confirmed that "[i]f a firm does not have retail investor clients … and is not required to deliver a relationship summary to any clients … , the firm will not be required to prepare or file a relationship summary."[43] As the D.C. Circuit held in *Goldstein v. SEC,*[44] in the private fund context, the private fund itself is an adviser's client and, absent a separate relationship, investors in such private fund are not advisory clients.[45]

3. For those advisers with separately managed accounts, it is important to note that "retail investor" is defined as "a natural person, or the legal representative of such natural person, who seeks or receives services primarily for personal, family or household purposes," which the SEC interprets broadly as any services provided to a natural person for his or her own account.[46] In other words, wealthy and sophisticated individuals who have separately managed accounts are "retail investors" who must receive the new mandated disclosure in Form CRS.

4. Firms that are required to complete Part 3 of Form ADV must file their initial relationship summary with the SEC between May 1, 2020 and June 30, 2020.[47]

D. Regulation Best Interest and the "Solely Incidental" Interpretation

1. Regulation Best Interest and the Solely Incidental Interpretation apply only to broker-dealers and not to investment advisers.

2. Regulation Best Interest establishes a heightened standard of conduct for broker-dealers and their associated persons.

   (a) Specifically, the heightened standard of conduct requires broker-dealers to:

      (i) Act in the best interest of retail customers when recommending a securities transaction or an investment program involving securities; and

      (ii) Establish policies and procedures reasonably designed to identify and disclose conflicts of interest and, when necessary, mitigate or, in certain circumstances, eliminate such conflicts.[48]

   (b) The Solely Incidental Interpretation provides that investment advice is "solely incidental" to broker-dealer activity (and therefore a broker-dealer is not classified as an investment adviser under the

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[42] *Id*. at 26.
[43] Form CRS Release *supra* note 27, at 234.
[44] 451 F.3d 873 (D.C. Cir. 2006).
[45] The Division of Investment Management confirmed this approach in a recent FAQ on Form CRS:

> Q: My firm is an investment adviser to pooled investment vehicles, such as a hedge funds, private equity funds and venture capital funds. The investors in these funds include natural persons who may be "retail investors" as defined in Form CRS. Am I required to deliver a relationship summary to these funds?
>
> A: An investment adviser must initially deliver a relationship summary to each retail investor before or at the time the adviser enters into an investment advisory contract with the retail investor. "Retail investor" is defined as "a natural person, or the legal representative of such natural person, who seeks to receive or receives services primarily for personal, family or household purposes." In the staff's view, the types of pooled investment vehicles described above would not meet this definition and a relationship summary would not be required to be delivered.

Frequently Asked Questions on Form CRS, (Nov. 26, 2019), available at https://www.sec.gov/investment/form-crs-faq.
[46] 17 CFR § 275.204-5(d)(2).
[47] Form CRS Release *supra* note 27, at 239.
[48] Regulation Best Interest *supra* note 28, at 1.

Advisers Act) when it "is provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions."[49]

(c) The Solely Incidental Interpretation reinforces that giving advice as to the value and characteristics of securities should not be the primary business of a firm relying on the broker-dealer exclusion from the definition of investment adviser under the Advisers Act, and it also provided guidance regarding the application of the "solely incidental" prong in the context of:

(i) Exercising investment discretion over customer accounts, stating that "there are situations where a broker-dealer may exercise temporary or limited discretion in a way that is not indicative of a relationship that is primarily advisory in nature," but "unlimited discretion would not be solely incidental to the business of a broker-dealer"[50]; and

(ii) Account monitoring, providing that the SEC "disagree[s] with commenters who suggested that any monitoring of customer accounts would not be consistent with the solely incidental prong."[51]

III. Proxy Voting Rule Guidance

A. On Nov. 5, 2019 the SEC issued guidance that detailed several issues that investment advisers should address in their proxy voting policies ("Proxy Guidance").[52]

1. The Fiduciary Interpretation[53] specified that voting decisions fall within the (fiduciary) duties of care and loyalty owed to clients by investment advisers.

2. Rule 206(4)-6 under the Investment Advisers Act specifically requires registered investment advisers that seek "to exercise voting authority with respect to client securities" to adopt and implement written policies and procedures that are reasonably designed to ensure that the investment adviser votes proxies in the best interest of its clients.

B. Annual Reviews

1. The Proxy Guidance makes it clear that the SEC expects an investment adviser to review and document, "no less frequently than annually," the overall adequacy of its proxy voting program.[54]

2. The SEC noted that such a review allows the adviser to confirm that its voting policies and procedures have been reasonably formulated (both in the abstract and in actual operation) and effectively implemented.

C. Compliance Confirmations

1. The SEC stated that a registered investment adviser "should consider reasonable measures to determine that it is casting votes on behalf of its clients consistently with its voting policies and procedures."[55]

2. The Proxy Guidance suggests that reviewing a sampling of voting decisions, presumably by a compliance officer, is a viable way for an adviser to evaluate its compliance with Rule 206(4)-6 and confirm compliance with the manager's policies and procedures.[56]

D. Multiple Clients

1. The Proxy Guidance also focuses on how the actions of an investment adviser should change when the adviser has multiple clients.

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[49] Solely Incidental Interpretation *supra* note 29, at 12.
[50] *Id*. at 16.
[51] *Id*. at 19.
[52] Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Advisers Act Release No. IA-5325 (Sep. 10, 2019) (hereinafter "Proxy Guidance"), available at https://www.sec.gov/rules/interp/2019/ia-5325.pdf.
[53] Fiduciary Interpretation *supra* note 26, at 12, n. 32.
[54] Proxy Guidance *supra* note 52, at 16.
[55] *Id*. at 15.
[56] *Id*.

2. The SEC questioned whether a single policy for all of the adviser's clients would be in the best interest of each of its clients, and in a footnote said "nothing in [Rule 206(4)-6] prevents an investment adviser from having different policies and procedures for different clients or different categories of clients."[57]

E. Managers That Make Specific Voting Decisions

1. The Proxy Guidance expressly states that advisers exercising voting authority must "conduct a reasonable investigation into matters on which the adviser votes and to vote in the best interest of the client."[58]

2. The SEC noted that any conflict of interest the adviser has in connection with a proxy vote must be carefully addressed.

3. The SEC also indicated that a "reasonable investigation" should consider whether particular votes request a more detailed analysis (e.g., mergers and acquisitions).[59]

F. Managers that Abstain from Voting

1. The Proxy Guidance confirms that an investment adviser is not required to cast votes on behalf of its clients, but this ability to abstain is limited only to two situations[60]:

(a) Where an investment adviser and the client have agreed in advance to limit the conditions under which the investment adviser would exercise voting authority; or

(b) When an investment adviser has determined that refraining from voting is in the best interest of that client (such as where the adviser determined that the cost to the client of voting the proxy exceeds the expected benefit to the client).

2. The SEC cautioned that when abstaining under a "best interests" analysis the adviser is still subject to the undertakings it made to its clients and, more broadly, to its duty of care

G. Managers That Employ a Proxy Advisory Firm

1. The primary focus of the Proxy Guidance is on advisers' use of proxy advisory firms

2. The guidance applies not only to firms that empower proxy advisory firms to formulate positions and cast ballots on behalf of an adviser's clients, but also to advisers that utilize proxy firms for research and recommendations while retaining the ultimate decisions for itself

3. The Proxy Guidance recommends that advisers employing a proxy advisory firm[61] consider:

(a) Additional steps to evaluate whether the investment adviser's voting determinations are consistent with its voting policies and procedures;

(b) In the client's best interest; and

(c) Before the votes are cast.

4. Examples of "additional steps" to evaluate whether the investment adviser's voting determinations are consistent with its voting policies and procedures proposed in the Proxy Guidance include[62]:

(a) Reviews of the proposed voting slates; and

(b) Additional substantive analysis of proposed votes on matters that are contested or controversial, that are not subject to any specific guidance in the manager's policies, or that may have been recommended prior to new information coming into the market.

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57 *Id*. at 15, n. 40.
58 *Id*. at 13.
59 *Id*. at 14.
60 *Id*. at 10-11.
61 *Id*. at 15.
62 *Id*. at 15-16.

5. Capacity and Competence Assessment

    (a) The SEC also has suggested that an adviser, as a condition of continued engagement, should evaluate the "capacity and competence" of any proxy advisory firm, suggesting a focus on "the proxy advisory firm's staffing, personnel, and/or technology."[63]

    (b) The Proxy Guidance further recommends that the adviser "should also consider whether the proxy advisory firm has an effective process for seeking timely input from issuers and proxy advisory firm clients"[64] in formulating its recommendations; in other words, the adviser's investment staff should understand:

        (i) How the proxy adviser formulates its recommendations;

        (ii) How it deals with conflicts of interests (examples of several kinds of conflicts are included in the Proxy Guidance); and

        (iii) How it utilizes technology in disclosing conflicts.

6. Effectiveness

    (a) The Proxy Guidance states that an investment adviser should consider the "effectiveness" of the proxy advisory firm's process for obtaining "current and accurate information" related to matters on which is makes voting recommendations.[65]

    (b) The SEC guidance suggests that advisers consider matters such as:

        (i) How a proxy advisory firm engages with issuers and ensures that it has complete and accurate information;

        (ii) How the firm tries to identify and correct deficiencies in its analysis;

        (iii) The quality of the proxy advisory firm's disclosure of these matters to the adviser; and

        (iv) Whether and how the adviser employs factors specific to a given issuer or proposal.[66]

7. Investigating Errors

    (a) Situations where an adviser becomes aware of potential factual or methodological errors in a proxy advisory firm's work were also raised

    (b) The SEC suggested that an adviser "should conduct a reasonable investigation into the matter" and, more generally, review its own policies and procedures to ensure that they have been "reasonably designed to ensure that its voting determinations are not based on materially inaccurate or incomplete information."[67]

IV. CFTC Amendments to Registration and Compliance Rules

A. On Nov. 25, 2019, the Commodity Futures Trading Commission ("CFTC") approved amendments[68] that impact several registration and reporting exemptions that may be relevant to many private fund managers.

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[63] *Id*. at 17.
[64] *Id*.
[65] *Id*. at 21.
[66] *Id*. at 21-22.
[67] *Id*. at 21.
[68] Registration and Compliance Requirements for Commodity Pool Operators (CPOs) and Commodity Trading Advisors: Family Offices and Exempt CPOs, RIN 3038-AE76 (Nov. 25, 2019), 84 Fed. Reg. 67355 (Dec. 10, 2019) (hereinafter "CFTC Exemptions Release"), available at https://www.govinfo.gov/content/pkg/FR-2019-12-10/pdf/2019-26162.pdf; Registration and Compliance Requirements for Commodity Pool Operators and Commodity Trading Advisors: Registered Investment Companies, Business Development Companies, and Definition of Reporting Person, RIN 3038-AE-76-P (Nov. 25, 2019); 84 Fed. Reg. 67343 (Dec. 10, 2019) (hereinafter "CFTC Reporting Release"), available at https://www.govinfo.gov/content/pkg/FR-2019-12-10/pdf/2019-26161.pdf.

1. These amendments are generally designed to streamline administrative processes or harmonize CFTC rules with those of other regulators or with actual market practice.

2. Private fund managers relying on CFTC exemptions should review the details of these changes.

B. Rule 4.13 "Qualified Eligible Person" and "Non-United States Person" Updates

1. Many private fund managers rely on the Regulation 4.13(a)(3) "de minimis" exemption from CFTC registration as a commodity pool operator ("CPO").[69]

2. Among other requirements, Rule 4.13(a)(3) requires that each participant in a qualifying pool fall into one of the following categories:

(a) An "accredited investor" as defined in Rule 501 under the Securities Act of 1933 (or a trust that was formed by an accredited investor for the benefit of a family member);

(b) A "knowledgeable employee" as defined in Rule 3c-5 under the Investment Company Act of 1940; or

(c) Certain categories of "qualified eligible persons" listed in CFTC Rule 4.7(a)(2)(viii)(A).[70]

3. The November 2019 amendment expanded the qualified eligible person prong to include *any* qualified eligible person (and not just those listed in clause (a)(2)(viii)(A) or Rule 4.7).[71]

4. The amendment also clarified that Rule 4.7's definition of "non-United States person"[72] should be used for this purpose. The definition includes:

(a) A natural person who is not a resident of the United States;

(b) Estates and trusts outside of U.S. income tax jurisdiction;

(c) Business associations organized for passive investments located outside of the United States;

(d) Passive investment vehicles that have under 10% U.S. ownership; and

(e) Non-U.S. pension plans.

C. Family Office Exemption Claims

1. Family offices that engage in commodity interest trading have historically been able to rely on two CFTC no-action letters, 12-37 and 14-143,[73] to avoid registration with the CFTC and the National Futures Association ("NFA") as CPOs or Commodity Trading Advisors ("CTAs").

2. New Rule 4.13(a)(6)[74] and new Rule 4.14(a)(11)[75] substantially codify the CFTC's older CPO and CTA no-action relief but, notably, neither of the new exemptions require any filings with the NFA or CFTC (which was the case with no-action letters).[76]

3. New Regulation 4.13(a)(6) provides an exemption from CPO registration for a person with respect to a qualifying commodity pool if[77]:

(a) Interests in the pool are exempt from registration under the Securities Act, and such interests are sold only to "family clients" (as defined in Securities Act Rule 202);

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[69] 17 CFR § 4.13(a)(3).
[70] 17 CFR § 4.7(a)(2)(viii)(A).
[71] CFTC Exemptions Release *supra* note 68, at 67362.
[72] 17 CFR § 4.7(a)(1)(iv).
[73] Family Offices, CFTC No-Action Letter No. 12-37 (Nov. 29, 2012), available at https://www.cftc.gov/csl/12-37/download; No-Action Relief from Registration as Commodity Trading Advisors for Family Office, CFTC No-Action Letter No. 14-143 (Nov. 5, 2014), available at https://www.cftc.gov/csl/14-143/download.
[74] 17 CFR § 4.13(a)(6).
[75] 17 CFR § 4.14(a)(11).
[76] CFTC Exemptions Release *supra* note 68, at 67358.
[77] *Id*. at 67357.

(b) The commodity pool qualifies as a "family office" (also as defined in Securities Act Rule 202); and

(c) The person reasonably believes, at the time of investment, that each person who participates in the pool is a "family client" of the "family office."

4. New Regulation 4.14(a)(11) provides an exemption from CTA registration to a person who directs commodity trading advice solely to (and for the sole use of) "family clients."[78]

5. Regulation 4.13(a)(6) and 4.14(a)(11) will supersede No Action Letters 12-37 and 14-143 (although not prior staff letters determining that a particular entity is "not a pool").[79]

6. All managers that are registered with the CFTC will also need to plan on reviewing and revising their NFA Bylaw 1101 questionnaires to reflect the CFTC's new rules and documentation requirements for family offices.

D. General Solicitation Under § 506(c)

1. The CFTC's November amendments[80] also harmonized Rule 4.13(a)(3) and Rule 4.7 pool investments with offerings conducted under Rule 506(c),[81] which allows:

(a) Certain general solicitation activities for unregistered securities;

(b) Provided that accredited investor verification efforts are undertaken.

2. The November 2019 Amendment clarifies that:

(a) Rule 4.7's prohibition on marketing to the public does not apply to a registered CPO that offers or sells participations in a pool offered pursuant to Rule 506(c);[82]

(b) The relief under Rule 4.7(b) is available to otherwise eligible pools, even if participations in such pools are resold under Rule 144A[83]; and

(c) The marketing and advertising of interests in Rule 4.13(a)(3) (de minimis) pools to the public is permissible if done in compliance with Rule 506(c) or Rule 144A.[84]

3. No further action is required for firms that have already filed the notice required by CFTC No-Action Letter 14-116.[85]

4. CPOs using general solicitation with respect to future pools that qualify for Regulation 4.7 or 4.13(a)(3) will need to furnish the standard NFA notices required by those exemptions.[86]

E. Form CPO-PQR and CTA-PR Exclusions for Reporting Persons

1. The CFTC's November amendments[87] substantively codify its prior no-action letters:

(a) Letter 14-115: Providing relief from reporting on Form CPO-PQR for CPOs that exclusively operate Regulation 4.13(a)(3) pools or pools subject to a definitional exclusion under Regulation 4.5[88]; and

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[78] *Id.*
[79] *Id.* at 67360.
[80] *Id.*
[81] *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 77 Fed. Reg. 54464 (Sept. 5, 2012) and 78 FR 44771 (July 24, 2013), available at https://www.sec.gov/rules/final/2013/33-9415.pdf.
[82] CFTC Exemptions Release *supra* note 68, at 67361.
[83] *Id.*
[84] *Id.*
[85] *Id.*
[86] *Id.*
[87] CFTC Reporting Release *supra* note 68, at 67347.
[88] Exemptive Relief from CFTC Regulation 4.27(c) with Respect to Certain Registered Commodity Pool Operators, CFTC No-Action Letter No. 14-115 (Sep. 8, 2014).

(b) Letter 15-47: Providing relief from reporting on Form CTA-PR for CTAs that are registered, but are not yet directing client accounts.[89]

2. Additionally, the CFTC amendments to Regulation 4.27(b) extend Form CTA-PR reporting relief to registered CTAs that nonetheless comply with the CTA registration exemptions in Regulation 4.14(a)(4) (where the CTA is already registered as a CPO) and Regulation 4.14(a)(5) (where the CTA is exempt from CPO registration).[90]

3. No Notice Filing Requirement.[91]

V. New Supervision and Cybersecurity Obligations for NFA Registrants

A. The Internal Control Systems Interpretive Notice

1. On Jan. 31, 2019, the NFA announced it had adopted a new interpretive notice, "Compliance rule 2-9: CPO Internal Control System" ("Internal Control Notice"),[92] which is directed at CPOs with control over customer funds.

2. Background

(a) NFA Compliance Rule 2-9 imposes a general requirement for NFA members (including CFTC-registered private fund managers) to "diligently supervise" their personnel.[93]

(b) The NFA interprets that general rule as requiring a "strong control environment" with internal controls that are designed to[94]:

(i) Deter fraud and errors in order to safeguard customer funds;

(ii) Reliably produce accurate and timely financial reports; and

(iii) Cause compliance with all regulations addressing the control of customer funds.

(c) The Internal Control Notice is intended to supplement Compliance Rule 2-9[95] and provide CPOs with guidance on the design of an adequate financial controls system as well as to set forth certain "minimum components" of such a system.

3. Strong Control Environment

(a) The Internal Control Notice expressly requires the adoption and implementation of two different sets of written compliance polices.

(i) Policies and procedures reasonably designed to ensure that a CPO's operations are in compliance with all applicable NFA rules and CFTC regulations [96]; and

(ii) Policies and procedures that fully explain a CPO's internal controls framework and describe the CPO's supervisory system, "which should be reasonably designed to ensure that [they] are diligently followed by all employees."[97]

(b) The NFA also made clear in the Internal Controls Notice that the behavior of senior personnel is an integral element of a strong control environment.[98]

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[89] Exemptive Relief from CFTC Regulation 4.27(c) with Respect to Certain Registered Commodity Trading Advisors, CFTC No-Action Letter No. 15-476 (July 21, 2015).
[90] CFTC Reporting Release *supra* note 68, at 67347.
[91] *Id.* at 67349.
[92] NFA Interpretive Notice 9074, NFA Compliance Rule 2-9: CPO Internal Controls System, (Jan. 31, 2019), available at https://www.nfa.futures.org/rulebook/rules.aspx?Section=9&RuleID=9074.
[93] *Id.*
[94] *Id.*
[95] NFA Compliance Rule 2-9: Supervision, available at https://www.nfa.futures.org/rulebook/rules.aspx?Section=4&RuleID=RULE%202-9
[96] *Id.*
[97] *Id.*
[98] *Id.*

(c) The non-circumvention concept is also expressed in a requirement that the firm have an "escalation policy" that[99]:

(i) Provides a mechanism for reporting attempts to improperly override a firm's internal controls system "in any respect"; and

(ii) Addresses "whether and when a matter should be reported to the firm's regulator."

4. Separation of Duties

(a) The Internal Controls Notice also advises that, to the extent possible, persons who perform day-to-day functions in the following areas should be different from the persons who supervise those functions[100]:

(i) Handling funds;

(ii) Trade execution activities;

(iii) Financial records; and

(iv) Risk management.

5. Controls over Investment Activity and Financial Transactions

(a) The Internal Controls Notice also highlighted two common areas of risk[101]:

(i) Financial transactions between pools and their investors; and

(ii) Investment decision-making.

(b) The Internal Controls Notice suggested specific steps that would "form the basis of" adequate internal controls in these areas.[102]

(c) The Internal Controls Notice proposes that, to reduce the financial and operational risks associated with pool subscriptions, redemptions and transfers (and to protect participant and pool assets), a CPO should[103]:

(i) Verify that pool investments are held in accounts properly titled with the pool's name and are not commingled with the assets of any other person;

(ii) Periodically reconcile transactions between the pool's general ledger, banks and other third-party depositories;

(iii) Include authorization of redemptions as a process subject to explicit verification and confirmation checks (check that the request is made by a participant; that adequate funds are available; that the NAV calculation is correct; that funds are actually released and timely rendered to the correct party, etc.); and

(iv) Verify that transactions involving pool funds do not violate NFA Compliance Rule 2-45, prohibiting direct or indirect loans from a pool to a member CPO or affiliates.

(d) The NFA also regards investment activity and valuation process as common high-risk areas for CPOs and expects that a CPO will[104]:

(i) Include approvals of investments within its control framework (for example, ensuring that each type of investment is authorized and consistent with the pool's strategy);

[99] *Id.*
[100] *Id.*
[101] *Id.*
[102] *Id.*
[103] *Id.*
[104] *Id.*

(ii) Verify that investments are valued in accordance with its valuation policies;

(iii) Perform ongoing due diligence of counterparties and other third-party depositories (including reviewing reputation, trading strategy, past performance and regulators' actions);

(iv) Monitor risks associated with investments held at third parties on an ongoing basis, including market and credit risk; and

(v) Continually monitor pool liquidity to ensure its capacity to meet financial obligations such as redemption requests and margin calls.

(e) When implementing such controls, the NFA advises that business and trading principals play a direct and primary in monitoring and assessing risks within their areas of responsibility.[105]

B. Cybersecurity Amendments

1. On Jan. 7, 2019, the NFA announced that it had issued an amendment ("Cybersecurity Notice Amendment")[106] to its 2016 interpretive notice entitled "Compliance Rules 2-9, 2-36 and 2-49: Information Systems Security Programs" ("2016 Interpretive Notice").[107]

2. The 2016 Interpretive Notice[108]:

(a) Prescribed that members create a written framework of supervisory practices to address unauthorized access risks and established general requirements relating to such programs, while leaving the exact form of the information systems security program up to each member; and

(b) Required covered entities to create an incident response plan that addresses how, in the event of a cybersecurity incident, the member will communicate externally with customers, counterparties, financial industry regulators, self-regulatory organizations; and law enforcement, however it did not explicitly require members to notify the NFA in connection with such an incident

3. New NFA Notification Requirement

(a) The Cybersecurity Notice Amendment requires CPOs to maintain policies and procedures to promptly notify the NFA of a cybersecurity breach or similar incident that results in[109]:

(i) Any loss of customer or counterparty funds;

(ii) Any loss of a member's own capital; or

(iii) The member providing notice to customers or counterparties under state or federal law.

(b) When notifying the NFA, the member must provide a written summary of the incident unless the member provides a notice to customers or counterparties, in which case it may provide a copy of the notice to the NFA instead of a written summary.[110]

4. ISSP Approval

(a) The Cybersecurity Notice Amendment also requires that a CPO's Information Systems Security Program ("ISSP") must be approved by the CEO, another senior level official with primary responsibility for

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[105] *Id.*
[106] NFA Interpretive Notice I-19-01, NFA Amends Interpretive Notice Regarding Information Systems Security Programs—Cybersecurity (Jan. 7, 2019), available at https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5085.
[107] NFA Interpretive Notice 9070, NFA Compliance Rules 2-9, 2-36 and 2-49: Information Systems Security Programs (effective March 1, 2016), available at https://www.nfa.futures.org/news/PDF/CFTC/InterpNotc_CR2-9_2-36_2-49_InfoSystemsSecurityPrograms_Aug_2015.pdf.
[108] *Id.*
[109] NFA Interpretive Notice 9070, NFA Compliance Rules 2-9, 2-36 and 2-49: Information Systems Security Programs (effective Sept. 30, 2019), available at https://www.nfa.futures.org/rulebook/rules.aspx?Section=9&RuleID=9070.
[110] *Id.*

information technology security (such as a CTO or CISO), or a senior official who is listed as a principal and has authority to supervise the NFA member's execution of the ISSP.[111]

(b) Approval requirements vary depending upon whether a committee approves an ISSP or where there are approvals at different levels in a multi-entity organization.[112]

5. Other Regulatory Regimes

(a) The Cybersecurity Notice Amendment adds that a covered CPO should be familiar with notice requirements contained in applicable data security and privacy laws of the United States and other jurisdictions.[113]

6. The Cybersecurity Notice Amendment clarifies that information security training should be provided both at hiring; and at least annually thereafter, with more frequent training as circumstances warrant. Descriptions of such training contents should be included in the ISSP.[114]

VI. California Consumer Privacy Act

A. The California Consumer Privacy Act ("CCPA"), the country's first comprehensive privacy law, became effective on Jan. 1, 2020.

B. Entities and Individuals Required to Comply

1. The Act defines a "consumer" as any "natural person who is a California resident."[115]

2. The law applies to any business with at least $25 million in gross annual revenue[116] that collects personal information from "consumers," which in the private fund context could be an investor, prospective investor, employee, job applicant, independent contractor or potentially even a business contact who resides in California.[117]

3. A business that does not meet the threshold may still be subject to the CCPA if it controls, or is controlled by, a business that meets the criteria and shares common branding.[118]

4. This expansive covered business concept means that, in the private fund context, managers will need to assess the potential coverage of the CCPA at both the adviser or sponsor level as well as for the funds themselves

5. The definition of "personal information" receives broad treatment, being defined as information that "identifies, relates to, describes, is reasonably capable of being associated with, or could reasonably be linked, directly or indirectly, with a particular consumer or household."[119]

(a) This is much broader than other privacy laws and expressly includes items such as email addresses, internet protocol addresses and biometric information.[120]

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[111] *Id.*
[112] *Id.*
[113] *Id.*
[114] *Id.*
[115] California Consumer Privacy Act, CAL. CIV. CODE § 1798.140(g).
[116] *Id.* § 1798.140(c)(1)(A). The statute does not specify whether the $25-million gross annual revenue threshold is based on gross revenue in California, the United States or worldwide. For the time being, fund managers are advised to assume it is worldwide revenue.
[117] *Id.* § 1798.145(a)(6). For a company without a physical presence or affiliate in California, the statute provides a narrow exemption if the "commercial conduct takes place wholly outside of" and it is not otherwise "doing business" in California. This requires not having a single investor, prospective investor, employee or independent contractor in California.
[118] *Id.* § 1798.140(c)(2). Two other criteria less likely to apply to private funds are businesses that (i) annually buy, sell, receive or share, for commercial purposes, personal information of 50,000 or more consumers, households or devices; or (ii) derive 50% or more of annual revenue from selling consumer's personal information. *Id.* § 1798.140(c)(1)(B)-(C).
[119] *Id.* § 1798.140(o)(1).
[120] *Id.* § 1798.140(o)(1)(A).

C. Overview: The CCPA requires covered businesses that collect personal information about California residents to:

1. Make certain disclosures concerning the collection and use of personal information, including the purposes for which the personal information is used and the categories of third parties with whom the personal information is shared;

2. Inform individuals of their rights to request detailed information about how their personal information is used or to request deletion of their personal information, and implement policies to comply with such requests;

3. Provide "conspicuous" notice and a means for individuals to opt out of the sale[121] of their personal information; and

4. Be accountable for data breaches that result from a failure to maintain reasonable security practices.

D. Compliance and Enforcement Timing

1. The California Attorney General, who is primarily tasked with enforcement, is still in the process of finalizing regulations.

2. The CCPA precludes the commencement of any enforcement actions prior to July 1, 2020.[122]

3. Actions brought after July 1, however, may relate to conduct between Jan. 1 and July 1, 2020. The California Attorney General may assess civil penalties of up to $2,500 per unintentional violation and $7,500 per intentional violation. A business is not liable if it cures any noncompliance "within 30 days after being notified of alleged noncompliance,"[123] although the California Attorney General has stated some violations may not be capable of being cured after the fact.

E. Private Right of Action in the CCPA

1. Limited solely to consumers whose personal information (defined more narrowly for these purposes)[124] has been subject to unauthorized access or disclosure as a result of the covered business' failure to maintain reasonable security procedures.[125]

2. A consumer must give the business 30 days' written notice and an opportunity to cure (if a cure is possible) prior to bringing any action.[126]

3. A consumer may seek statutory damages in an amount of not less than $100 and not greater than $750 per consumer per incident, or actual damages, whichever is greater, as well as an injunction or any relief a court deems proper.[127]

F. Private Fund Manager Implications

1. Personal information that private fund managers collect from existing investors who are individuals (i.e., natural persons) typically will be exempt from the CCPA, but other categories of information are covered:

(a) Existing Individual Investors

(i) The most pertinent CCPA provision for private fund managers is the exemption for any information collected "pursuant to" the Gramm-Leach-Bliley Act ("GLBA").[128]

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[121] "Sale" is defined broadly to include any disclosure or dissemination of personal information "for monetary or other valuable consideration." *Id.* § 1798.140(t).
[122] *Id.* § 1798.185(c).
[123] *Id.* § 1798.155(b).
[124] For purposes of the private right of action, the definition of "personal information" is defined as an individual's unencrypted and non-redacted first name or initial and/or last name combined with certain other types of personal information, such as social security number, account number or credit card number. *Id.* § 1798.150(a)(1)
[125] *Id.* § 1798.150(a)(1).
[126] *Id.* § 1798.150(b).
[127] *Id.* § 1798.150(a)(1).
[128] *Id.* § 1798.145(e). The CCPA contains exemptions in relation to certain other statutes, including the California Information Privacy Act, but the GLBA exemption is the most relevant to fund managers.

(ii) The GLBA regulates information privacy practices of financial institutions and covers personal information that is collected in the specific context of providing an individual with a financial product or service.

(iii) The exemption for information collected under the GLBA effectively covers all information that funds collect about their existing investors.

(iv) For example, name, contact information, social security or other tax identification number and bank routing information collected in the context of a subscription agreement is covered by the GLBA and therefore CCPA exempt.

(b) Prospective Individual Investors

(i) Because the GLBA does not reach prospective investors, personal information collected from prospective individual (natural person) investors in California will be subject to the CCPA, requiring CCPA disclosures at the point of collection.

(ii) The method of making these disclosures will depend on the context in which the personal information is collected.

(1) A fund manager that makes substantive information available to prospective investors via its website might add CCPA disclosures to an existing online privacy policy.

(2) A manager may also add a CCPA disclosure along with other disclosures in pitch books or other marketing materials, or as a notice at the bottom of investor relation emails.

(c) B2B Contacts

(i) Unlike most privacy laws, the CCPA's expansive definition of "personal information" encompasses information that identifies an individual person exchanged in a purely business-to-business context, such as the email address of a California resident acting on behalf of an institutional investor or service provider.

(ii) The California legislature has placed a one-year moratorium on the statute's coverage for personal information obtained by a business from a California resident acting for another entity occurring "solely within the context of the business conducting due diligence regarding, or providing or receiving a product or service to or from" the other entity.[129]

(iii) The moratorium delays enforcement for things like the professional email address of a California resident working on behalf of an institutional investor or service provider but does not appear to apply to information obtained from a third party, such as a list provider.

G. Human Resources Related Information

1. The CCPA requires disclosures to be made to employees, job applicants and independent contractors in California about the categories of personal information collected and the purposes for which the personal information will be used. This can be accomplished by adding notices in job applications, employee handbooks and independent contractor agreements.

2. For persons already engaged by a fund manager, disclosure can be made through circulating an email with a link to the disclosures.

3. In this context, there is a one-year moratorium during which the disclosure requirements are limited to a description of the categories of information being collected and the purpose for which the categories of information will be used.

[129] *Id.* § 1798.140(o) (as amended by AB-1355). The moratorium does not apply to the private right of action or the right to opt out of selling for these type of business contacts.

4. Absent an extension to the moratorium or amendment, the CCPA's more extensive disclosure requirements will apply commencing Jan. 1, 2021[130]

H. Alternative Data

1. Data in which personal information has been "deidentified" or "aggregated" is excluded from the CCPA.[131]

I. Sharing Personal Information with Service Providers

1. A business must disclose to consumers the purposes for which it shares personal information.[132] This can be accomplished by adding language in an online privacy policy or similar disclosure.

2. The CCPA contains certain more burdensome obligations with respect to the "sale" or use for a "commercial purpose"[133] of consumer information, such as providing the ability to "opt out," providing consumers the right to request deletion of their information or responding to other individual information requests.[134]

3. Transferring a consumer's personal information to a service provider for a "business purpose" is generally an exception to what constitutes a "sale" under the CCPA.[135]

4. Most of the purposes for which fund managers share information with service providers will fall into one of the CCPA's seven categories of "business purposes," which are, in short:

(a) Auditing interactions with consumers;

(b) Detecting security incidents and protecting against illegal activity;

(c) Debugging to repair errors;

(d) Short-term "transient" uses;

(e) Performing services on behalf of the business that collected the information;

(f) Internal research for technological development; and

(g) Maintaining and verifying quality and safety.[136]

5. The CCPA requires businesses to contractually prohibit its service providers from retaining, using or disclosing the consumer's personal information for any purpose other than performing the services specified in the contract.[137]

J. CCPA and GDPR Compliance

1. GDPR compliance does not ensure CCPA compliance because there are significant differences in requirements, definitions and scope.[138]

2. Data inventorying and mapping that many firms have already undertaken for purposes of GDPR compliance can be leveraged to assess the categories of information collected and how such information is used for purposes of CCPA compliance.

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[130] *Id.* § 1798.145(h).
[131] *See*, e.g., *Id.* §§ 1798.140(o)(2); 1798.145(a)(5).
[132] *Id.* § 1798.100(b), 1798.140(t)(2)(C)(i).
[133] "Commercial purposes" means to advance a person's commercial or economic interests, such as by inducing another person to buy, rent, lease, join, subscribe to, provide, or exchange products, goods, property, information, or services, or enabling or effecting, directly or indirectly, a commercial transaction. *Id.* § 1798.140(f).
[134] *Id.* § 1798.140(t)(2)(C); 1798.140(v).
[135] *Id.* § 1798.140(t)(2).
[136] *Id.* § 1798.140(d).
[137] *Id.* § 1798.140(v).
[138] The California Attorney General has in fact specifically rejected a safe harbor exemption for GDPR-compliant businesses. See OFFICE OF THE ATTORNEY GEN., STATE OF CAL. DEP'T OF JUSTICE, INITIAL STATEMENT OF REASONS (ISOR) (2019), available here.

VII. Framework for OFAC Compliance

A. On May 2, 2019, the U.S. Department of the Treasury's Office of Foreign Assets Control ("OFAC") published "A Framework for OFAC Compliance Commitments" ("Framework") outlining five critical components of a risk-based sanctions compliance program.[139]

1. Along with the Framework, OFAC also released a list of compliance program deficiencies most commonly identified as root causes of apparent violations of OFAC regulations.[140]

2. Several of these deficiencies have, in fact, been identified by OFAC in its latest settlements and findings, which reflect an aggressive approach to sanctions enforcement, including multimillion-dollar settlements for activity that was primarily conducted abroad by foreign affiliates of U.S. companies.[141]

B. The Framework

1. OFAC regulations do not require companies to maintain a sanctions compliance program, or "SCP" for short.[142]

2. Nonetheless, OFAC encourages firms subject to U.S. jurisdiction to adopt a formal SCP, including foreign entities that conduct business in or with[143]:

   (a) The United States;

   (b) U.S. persons; or

   (c) Using U.S.-origin goods or services.

3. The Framework is intended to assist such firms in developing, implementing and updating their respective SCPs.

4. It also outlines how OFAC may evaluate apparent violations and resolve investigations resulting in settlement.

   (a) More specifically, if, after determining that a civil monetary penalty is the appropriate administrative action in response to an apparent violation, OFAC will evaluate a firm's SCP and will consider favorably the existence of an effective SCP at the time of an apparent violation.[144]

5. While each firm's risk-based SCP will depend on a variety of factors, including the company's size and sophistication, products and services, customers and counterparties and geographic locations, each SCP should incorporate five essential components of compliance[145]:

   (a) Management commitment;

   (b) Risk assessment;

   (c) Internal controls;

   (d) Testing and auditing; and

   (e) Training.

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[139] U.S. Department of the Treasury, "A Framework for OFAC Compliance Commitments" (May 2, 2019) (hereinafter "OFAC Framework"), available at https://www.treasury.gov/resource-center/sanctions/Documents/framework_ofac_cc.pdf.
[140] *Id.* at 9-12.
[141] *See*, e.g., U.S. Department of Treasury, Enforcement Information for March 27, 2019 (Stanley Black & Decker, Inc.), available at https://www.treasury.gov/resource-center/sanctions/CivPen/Documents/20190327_decker.pdf; U.S. Department of Treasury, Settlement Agreement (Stanley Black & Decker, Inc.), available at https://www.treasury.gov/resource-center/sanctions/CivPen/Documents/20190327_decker_settlement.pdf.
[142] OFAC Framework *supra* note 139, at 9.
[143] *Id.* at 1.
[144] *Id.*
[145] *Id.*

6. Management Commitment

(a) OFAC has stated that senior management's commitment to, and support of, a firm's SCP is one of the most important factors in determining the success of the SCP.[146]

(b) Such support is essential in ensuring that:

(i) The firm's compliance unit receives adequate resources, including in terms of[147]:

(1) Human capital;

(2) Expertise; and

(3) Information technology; and

(ii) Compliance personnel are delegated sufficient authority and autonomy to deploy policies and procedures in a manner that effectively controls risk.[148]

(c) To this end, senior management should:

(i) Review and approve a firm's SCP[149];

(ii) Recognize the seriousness of sanctions rules[150]; and

(iii) Promote a culture of compliance throughout the organization — including by[151]:

(1) Discouraging misconduct;

(2) Highlighting the potential repercussions of non-compliance; and

(3) Addressing the root causes of past violations.

7. Risk Assessments

(a) Firms should[152]:

(i) Conduct routine, if not ongoing, risk assessments to identify potential OFAC issues;

(ii) Address the particular risks identified; and

(iii) Tailor policies, procedures, internal controls and training to mitigate such risks.

(b) The risk assessment should:

(i) Holistically review the firm from top to bottom[153]; and

(ii) Assess all touchpoints to the outside world, including, where applicable[154]:

(1) Customers;

(2) Supply Chains;

(3) Intermediaries;

(4) Counterparties;

(5) Products and Services;

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[146] *Id.* at 2.
[147] *Id.* at 2-3.
[148] *Id.* at 2.
[149] *Id.*
[150] *Id.* at 3.
[151] *Id.*
[152] *Id.*
[153] *Id.*
[154] *Id.*

(6) Transactions; and

(7) Geographic locations.

(c) The risk assessment should be updated to reflect the root causes of any apparent violations or systemic deficiencies identified either during the routine course of business or through a testing or audit function.[155]

(d) The risk assessment should also inform the extent of due diligence conducted at customer on-boarding, as well as in the context of mergers and acquisitions.[156]

8. Internal Controls

(a) Effective SCPs should include internal controls.[157]

(b) Firms should design and implement written policies and procedures outlining the SCP, including:

(i) How to identify, interdict, escalate, report and keep records regarding activity that may be prohibited by OFAC.[158]

9. Testing and Auditing

(a) Firms should have a comprehensive and objective testing or audit function to identify SCP weaknesses and deficiencies and take immediate and effective action to remediate any gaps.[159]

10. Training

(a) Firms should provide OFAC-related training with a scope and frequency tailored to the firm's risk profile.[160]

C. Root Causes of OFAC Violations

1. OFAC also issued a non-exhaustive list of root causes associated with apparent violations of OFAC regulations.[161]

2. The aim of this list is to assist firms in designing, updating and amending their SCPs to avoid breakdowns.

3. The root causes identified in the list include:

(a) Lack of a formal OFAC SCP[162];

(b) Misinterpreting, or failing to understand the applicability of, OFAC's regulations[163];

(c) Facilitating transactions by non-U.S. persons (including through or by overseas subsidiaries or affiliates)[164];

(d) Exporting or re-exporting U.S.-origin goods, technology, or services to OFAC-sanctioned persons or countries[165];

(e) Utilizing the U.S. financial system, or processing payments to or through U.S. financial institutions, for commercial transactions involving OFAC-sanctioned persons or countries[166];

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[155] *Id.* at 4.
[156] *Id.*
[157] *Id.* at 5.
[158] *Id.* at 5-6.
[159] *Id.* at 6-7.
[160] *Id.* at 7-8.
[161] *Id.* at 9-12.
[162] *Id.* at 9.
[163] *Id.*
[164] *Id.* at 9-10.
[165] *Id.* at 10.
[166] *Id.* at 10.

(f) Sanctions screening software or filter faults[167];

(g) Improper due diligence on customers/clients (e.g., ownership, business dealings, etc.)[168];

(h) De-centralized compliance functions and inconsistent application of an SCP[169];

(i) Utilizing non-standard payment or commercial practices[170]; and

(j) Individual liability.[171]

VIII. OFAC Reporting Obligations

A. In June 2019, OFAC issued an interim final rule ("Interim Final Rule") amending the Reporting, Procedures and Penalties Regulations ("RPPR").[172]

1. The Interim Final Rule, which became effective on June 21, 2019, imposes new requirements relating to who must file reports on rejected transactions with OFAC and what transactions must be reported.[173]

2. At its symposium on Nov. 12, 2019, OFAC emphasized the importance of these new requirements.

B. Expanding Reporting Requirements

1. The Interim Final Rule significantly broadens the reporting requirements under 31 CFR § 501.604 by expanding both[174]:

(a) The transactions that qualify for reporting; and

(b) The category of persons required to report on rejected transactions.

2. The Interim Final Rule requires reporting of all "rejected transactions,"[175] which are defined broadly to include any transaction rejected because it would violate sanctions, including:

(a) Transactions "related to wire transfers, trade finance, securities, checks, foreign exchange, and goods or services."[176]

3. The Interim Final Rule requires reporting by all U.S. persons and persons subject to United States jurisdiction.[177] Previously, only "financial institutions" ("FIs") were subject to that requirement.

4. In FAQ Number 36, OFAC has advised that transactions should be rejected where the underlying transaction may be prohibited, but there is no blockable interest in the transaction.[178]

(a) There is a lack of clarity in how this concept applies to the broader category of persons required to file rejected transaction reports under the Interim Final Rule.

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[167] *Id.* at 11.
[168] *Id.*
[169] *Id.*
[170] *Id.*
[171] *Id.*
[172] 31 CFR § 501; Reporting, Procedures and Penalties Regulations, 84 Fed. Reg. 29055 (June 21, 2019) (hereinafter "Interim Final Rule"), available at https://www.govinfo.gov/content/pkg/FR-2019-06-21/pdf/2019-13163.pdf.
[173] *Id.*
[174] *Id.* at 29055-56.
[175] *Id.* at 29056.
[176] 31 C.F.R. § 501.604(a)(3).
[177] 31 C.F.R. § 501.604(a)(1).
[178] "Blocking and Rejecting Transactions," OFAC Frequently Asked Questions ("FAQ") no. 36, available at https://www.treasury.gov/resource-center/faqs/Sanctions/Pages/faq_compliance.aspx#block.

C. Other Changes to the RPPR

1. In addition to expanding the scope of the reporting requirements, the Interim Final Rule expands the scope of the information required to be reported on initial and annual reports of blocked property, as well as in reports on rejected transactions, adding a list of new information to be included on each report.[179]

2. OFAC also added a new requirement that goes into effect in 2020 for those U.S. persons who maintain blocked funds in omnibus accounts[180] and submit annual reports.

   (a) The new regulation requires that annual reports contain a disaggregated list showing each blocked asset contained within an omnibus account.[181]

3. The Interim Final Rule also amends 31 CFR § 501.801 to require that applications for specific licenses to engage in transactions otherwise prohibited under 31 C.F.R. Chapter V, or sanctions programs administered by OFAC, be filed through OFAC's Reporting and License Application Forms page or by mail.[182]

4. The Interim Final Rule further clarifies that reports of blocked, unblocked and rejected transactions are subject to release under the Freedom of Information Act ("FOIA") upon receipt of a valid FOIA request, unless they are exempt from disclosure pursuant to an applicable FOIA exemption.[183]

5. The Interim Final Rule expands OFAC's subpoena power to clarify that OFAC can request or obtain[184]:

   (a) "Electronic documents," such as videos or sound recordings;

   (b) The testimony of witnesses; and

   (c) The production of any books, contracts, letters, papers and other hard copy documents relating to any matter under investigation.

6. OFAC also revised 31 CFR § 501.701 to accurately describe the penalties imposed for willful violations of the Trading with the Enemy Act ("TWEA") to reflect the increases to the maximum term of imprisonment from 10 to 20 years under TWEA, as imposed under Section 107(a)(4) of the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010.[185]

IX. ERISA Considerations When 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."

[179] Interim Final Rule *supra* note 172, at 29056.
[180] Omnibus accounts are not defined in the regulation.
[181] 31 C.F.R. § 501.603.
[182] Interim Final Rule *supra* note 172, at 29057.
[183] *Id.* at 29056-57.
[184] *Id.* at 29058; 31 C.F.R. § 501.602(a).
[185] Interim Final Rule *supra* note 172, at 29057.

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."[186]

(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[187]; (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)[188]; or (3) a plan which covers only partners and their spouses (often called a "partner-only" plan).[189]

(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).

(i) 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 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.

2. 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.[190]

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

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186 ERISA § 401(a); 3(3).
187 Labor Reg. § 2510.3-2(d).
188 Labor Reg. § 2510.3-3(b).
189 Labor Regs. § 2510.3-3(b) and § 2510.3-3(c)..
190 ERISA § 3(21)(A); Internal Revenue Code § 4975(e)(3).

3. 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% or more interest in an entity described in (3) or (4);

(vi) A relative of an individual described in (1), (2), (3) or (5). "Relative" includes a spouse, ancestor, lineal descendant or spouse of a lineal descendant[191];

(vii) An entity 50% or more of which is controlled, directly or indirectly, by individuals or entities described in (1), (2), (3), (4), or (5);

(viii) An employee, officer, director or a person directly or indirectly controlling 10% or more of an individual or entity described in (2), (3), (4), (5), or (7); or

(ix) A person who is a 10% or more partner or joint venturer in an individual or entity described in (2), (3), (4), (5), or (7).[192]

4. 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.[193]

(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.[194]

(iii) Duty to diversify plan investments so as to minimize the risk of large losses (with certain very limited exceptions).[195]

(iv) Duty to act in accordance with the documents governing the investing plans to the extent that such documents are consistent with ERISA.[196]

(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.[197] A DOL regulation allows certain persons to maintain assets outside the United States under limited circumstances.[198] Under

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[191] ERISA § 3(15); Internal Revenue Code § 4975(e)(6).
[192] ERISA § 3(14); Internal Revenue Code § 4975(e)(2).
[193] ERISA § 404(a)(1)(A); Internal Revenue Code § 401(a).
[194] 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.
[195] ERISA § 404(a)(1)(C).
[196] ERISA § 404(a)(1)(D).
[197] ERISA § 404(b).
[198] Labor Reg. § 2550.404b-l.

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 the:

(1) 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) Fiduciary is a registered investment adviser (or a bank or insurance company) with $50,000,000 under management and either: (1) over $750,000 in shareholders' or partners' equity; or (2) 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.

(vi) Must not cause a plan to invest in employer securities or employer real property in excess of certain specified limitations.[199]

(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.

5. 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).[200]

(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).[201] (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 receives a fee

[199] ERISA § 406(a)(2).
[200] ERISA § 406(b)(1); Internal Revenue Code § 4975(c)(1)(E).
[201] ERISA § 406(b)(2).

or other thing of value from an unaffiliated broker in return for the manager selecting that broker to execute trades for the fund).[202]

(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.

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

(a) A sale, exchange, or lease of property.[203]

(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.)[204]

(c) Furnishing of goods, services, or facilities.[205]

(d) Transfers to, or use by a party in interest of, any fund assets.[206]

(e) Subject to certain exceptions, acquisition by a party in interest, on behalf of the fund, of any employer security or employer real property.[207] (ERISA only.)

7. 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 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.[208]

(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% 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.[209] A similar penalty must be assessed against any non-fiduciary who knowingly participates in such a breach.[210] 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% of the greater of the fair market value of the consideration given

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[202] 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.
[203] ERISA § 406(a)(1)(A); Internal Revenue Code § 4975(c)(1)(A).
[204] ERISA § 406(a)(1)(B); Internal Revenue Code § 4975(c)(1)(B).
[205] ERISA § 406(a)(1)(C); Internal Revenue Code § 4975(c)(1)(C).
[206] 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.
[207] ERISA § 406(a)(1)(E).
[208] ERISA § 409(a).
[209] ERISA § 502(1).
[210] ERISA §502(1).

or the fair market value of the consideration received in the transaction.[211] However, if the prohibited transaction involves the receipt of excess compensation for the performance of services, the initial tax is 15% 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; or

(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.[212]

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% of the consideration given or received or the consideration in excess of reasonable compensation, whichever is applicable,[213] and the amount on which the tax is based may be the highest fair market value during the taxable period.[214] 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 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.[215]

(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.[216]

(2) If more than one person is liable for the tax, the tax is the joint and several liability of all such persons.[217] 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.[218]

(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.[219]

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[211] Internal Revenue Code § 4975(a) and (f)(4).
[212] Internal Revenue Code § 4975(a), (f)(2) and (f)(5).
[213] Internal Revenue Code § 4975(b).
[214] Internal Revenue Code § 4975(f)(4)(B).
[215] Internal Revenue Code § 4975(f)(5) and (f)(11).
[216] Internal Revenue Code § 4975(a) and (b).
[217] Internal Revenue Code § 4975(f)(1).
[218] Internal Revenue Code § 4975(a) and (b).
[219] ERISA § 405(a).

(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,"[220] describe when the underlying assets of an entity in which "benefit plan investors", as defined in Section 3(42) of ERISA and 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% 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

[220] Labor Reg. § 2510.3-101.

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.

(i) "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 to an ERISA-Covered Plan of 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.[221] 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.[222]

(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.[223] 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.

(1) ERISA defines an investment manager to include a bank, an insurance company and, most significantly, a registered investment adviser.[224] 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-

[221] ERISA § 403(a)(1).
[222] ERISA § 403(a)(2).
[223] ERISA § 404(d)(1).
[224] ERISA § 3(38).

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.

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% of the funds handled by such fiduciaries or $500,000.[225] 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.

[225] ERISA § 412.

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")[226] 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.

(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% 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,

[226] 49 Fed. Reg. 9494 (March 13, 1984).

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% 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:

(1) Assume that Plan X is a 50% investor in the First Fund and also a 4% investor in the Second Fund. The First Fund purchases a 30% 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).[227] 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.[228] 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

[227] By executing the securities transactions of a plan asset fund, the broker-dealer becomes a party in interest (as a service provider) to each benefit plan investor in the hedge fund. Because the broker-dealer is a service provider, the extension of credit violates Section 406(a)(1)(B) of ERISA.
[228] 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.

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 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 2006-16229 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.[230] 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[231] provides a statutory exemption that permits a fiduciary with respect to a plan to cause the plan to enter into an otherwise prohibited: (1) sale, exchange or lease of property; (2) loans including a margin loan; or (3) 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 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

[229] 71 Fed. Reg. 63786 (Oct. 21, 2006).
[230] 71 Fed. Reg. 63786, 63792 (Oct. 21, 2006).
[231] ERISA § 408(b)(17) and Internal Revenue Code § 4975(d)(20).

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,[232] 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% 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

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

(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% 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").[233] 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"[234] if the value of the qualifying employer securities (when combined with "qualifying

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

[234] A "qualifying employer security" includes both stock and marketable obligations of the benefit plan investor's sponsoring employer, provided that no more than 25% of the outstanding stock or marketable obligations at the time of acquisition is held by the benefit plan investor, at least 50% of the outstanding stock or marketable obligations is held by persons independent of the sponsoring employer, and, in the case of marketable obligations,

employer real property") held by the Benefit Plan Investor does not exceed 10% 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% of its assets directly in XYZ stock and acquires 5% 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% of its assets in the XYZ stock (i.e., 8% directly and 2% 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 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% 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.

immediately following the acquisition, no more than 25% of the benefit plan investor's assets are invested in marketable obligations of the sponsoring employer.

(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% 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% 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% 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% limit as long as the master fund is kept under 25% 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% 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.

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