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29TH ANNUAL

PRIVATE INVESTMENT FUNDS SEMINAR

JANUARY 21, 2020

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Regulatory Compliance 2020

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Brad L. Caswell

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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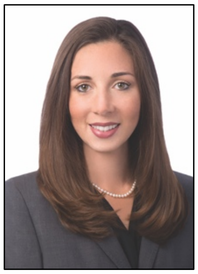
Marc E. Elovitz

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

[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);

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[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;

[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."

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[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

[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

[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

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[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.

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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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Tax

I. Qualified Opportunity Zones

A. Congress enacted, at the end of 2017, significant tax incentives for investments in Qualified Opportunity Zones ("QOZs"). The QOZ legislation was intended to spur investment in lower-income communities by allowing for the reinvestment of capital gain into a QOZ on a tax-favored basis, thus encouraging economic growth in such communities.

1. On Dec. 19, 2019, the U.S. Treasury Department issued Final Regulations under sections 1400Z-1 and 1400Z-2 to provide clarification on the legislation and to settle open questions.

B. A QOZ is a low-income area that has been certified by the Secretary of the Treasury. As of this time, all QOZs have been certified. The QOZ designations expire on Dec. 31, 2028. However, for taxpayers with properly deferred gains generated prior to Dec. 31, 2026, the QOZ tax benefits remain available through Dec. 31, 2047.

C. Investment in a QOZ provides a taxpayer with three major benefits.

1. Deferral of tax on eligible capital gain until the earlier of the date the investor disposes of their interest in the QOZ investment, experiences an inclusion event or Dec. 31, 2026.

(a) If the investment is held through Dec. 31, 2026 or the investor experiences certain inclusion events, there will be a tax on the deferred gain without corresponding cash available to pay the liability.

(b) Upon realization, the deferred gain will generally have the same tax attributes in the year of inclusion that it would have had if it had not been deferred under the QOZ rules.

2. A step-up in the basis of the QOZ investment in the amount of 10% of the amount of gain deferred if the interest is held for five years, and an additional 5% if held for seven years. Thus, only 85% of the initial deferred amount will be subject to tax.

(a) Given that the deferred gain will be realized, at the latest, on Dec. 31, 2026, in order to obtain the step-up in basis, the five- and seven-year holding periods need to be met before such date.

3. If the QOF interest is held for 10 years or more, the exclusion from taxation of any additional gain over the initial deferred amount upon (i) the disposition of a QOF (as defined below) interest, (ii) the disposition of qualified opportunity zone property (QOZ stock, QOZ partnership interests or QOZ business property, each as defined below) or (iii) for QOFs that are pass-through entities, the disposition of an underlying asset (other than inventory).

D. An investor makes an investment in a QOZ by investing qualifying capital gain into a qualified opportunity fund ("QOF").

1. A QOF may be organized as a corporation or partnership for federal income tax purposes, and may be an existing entity.

2. Only equity interests in a QOF are eligible, although a QOF equity interest may be pledged as collateral to obtain debt financing.

3. Deemed contributions due to allocations of partnership liabilities under Section 752 do not constitute investments in a QOF.

4. A QOF must hold 90% of its assets in "QOZ Property" as defined below ("90-Percent Assets Test"). This is measured at the end of the first six months of the fund's taxable year and semiannually thereafter.

(a) For purposes of the 90-Percent Assets Test, the value of the QOF's assets should generally be the value reflected on the QOF's applicable financial statements. If the QOF has no such statements, alternative valuation methods described in the final regulations may be used.

(b) If a QOF fails to satisfy the 90-Percent Assets Test for any month, (subject to a cure period), the QOF will be subject to a penalty equal to the dollar amount by which it fails multiplied by the then-effective IRS underpayment rate. The penalty calculation uses the yearly underpayment rate divided by 12.

5. A fund self-certifies as a QOF by filing a Form 8996 with its federal income tax return.

E. Any person that may recognize capital gain is eligible to invest in a QOF, including individuals, entities treated as partnerships, entities treated as corporations (including S corporations, regulated investment companies (“RICs”) and real estate investment trusts (“REITs”)), trusts and estates.

1. To qualify, capital gains must arise from a transaction with a person unrelated to the taxpayer.

2. Amounts other than qualifying capital gain may be invested, but the rules state that the investment will be bifurcated and such other amounts will not be subject to favorable tax treatment.

3. Capital gain recognized from Section 1256 contracts (e.g., regulated futures contracts, foreign currency contracts, non-equity options) is only eligible for the QOZ tax benefits to the extent of net gain from all of the investor’s Section 1256 contracts.

4. Capital gain recognized from a position that is or has been part of a “straddle” (within the meaning of section 1092, applying only to actively-traded property) during (i) the current taxable year or (ii) a prior taxable year in the event losses arising from such arrangement have been carried over to the current taxable year is not eligible for the QOZ tax benefits under the QOZ rules (special rules apply to identified straddles).

F. Capital gain must be invested within 180 days of the date on which the investor would otherwise recognize the gain for federal income tax purposes.

1. In the case of a sale or exchange, this period generally begins on the date of the transaction.

2. In the case of a capital gain dividend received by a RIC or REIT shareholder, this period begins on the date the dividend is received, even if the RIC or REIT does not designate the dividend as a capital gain dividend until later. Alternatively, a shareholder may elect to begin its 180-day investment period on the last day of such shareholder’s taxable year.

3. If a RIC or REIT shareholder is required under the Code to include an undistributed amount as capital gain, the shareholder’s period begins, at the shareholder’s election, on the last day of the RIC or REIT’s taxable year or the last day of the shareholder’s taxable year in which the amount would otherwise be recognized as long-term capital gain by the shareholder.

4. If a partnership derives capital gain from a sale or exchange, the partnership may elect to defer the gain within 180 days of the transaction. If the partnership so elects, the gain will not be allocated to the partnership’s partners. Instead, the gain will be allocated to the partners when the partnership recognizes it.

5. The partnership may instead allocate the gain to its partners, who then may choose to elect to defer the gain. In this instance, the partners’ 180-day period begins on one of three dates: (i) the date on which the gain is realized, (ii) the last day of the partnership’s taxable year in which the gain is realized or (iii) the due date (without extensions) of the partnership’s tax return for the year in which the gain is realized.

(a) Gain that is allocated to a partner by a partnership is only eligible for deferral if the gain arose from a transaction with a person unrelated to both the partner and the partnership.

(b) The QOZ rules provide parallel treatment for other pass-through entities and their owners, including LLCs, S corporations, trusts and estates.

(c) Partnerships with partners who are interested in investing in QOFs may be asked for faster processing of Schedules K-1 and side letters or other agreements that the partnership will not elect to defer gain in a QOZ investment without the consent of the partners.

G. The assets that qualify for the 90-Percent Asset Test are QOZ stock, QOZ partnership interests and QOZ business property (together, “QOZ property”).

1. QOZ stock means any stock in a domestic corporation if:

   (a) Such stock is acquired by the QOF after Dec. 31, 2017 at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash;

   (b) At the time the stock was issued, the corporation qualified as a QOZ business (as defined below) or was formed for such purpose; and

   (c) During substantially all of the QOF's holding period for such stock, such corporation qualified as a QOZ business.

2. QOZ partnership interest means any capital or profits interest in a domestic partnership if:

   (a) Such interest was acquired by the QOF after Dec. 31, 2017 from the partnership solely in exchange for cash;

   (b) At the time the interest was acquired, the partnership qualified as a QOZ business or was formed for such purpose; and

   (c) During substantially all of the QOF's holding period for such interest, such partnership qualified as a QOZ business.

3. QOZ business property means tangible property used in a trade or business of the QOF if:

   (a) Such property was acquired by the QOF by purchase from an unrelated person after Dec. 31, 2017;

   (b) The original use of such property in the QOZ commences with the QOF or the QOF substantially improves the property (as defined below); and

   (c) During all of the fund's holding period for such property, substantially all of the use of such property was in a QOZ.

H. A QOZ business, as described above, means a business in which:

   1. Substantially all of the tangible assets held by the business are QOZ business property;

   2. At least 50% of the total gross income of the business is derived from the active conduct of a trade or business;

   3. A substantial portion of any intangible property owned by the business must be used in the active conduct of a trade or business;

   4. Less than 5% of the average of the aggregated unadjusted bases of the property in the business is attributable to "nonqualified financial property" (which includes debt, stock, partnership interests, derivatives, etc.); and

   5. The underlying business is not a: private or commercial golf course; country club; massage parlor; hot tub facility; suntan facility; racetrack or other gambling facility; or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

I. Original Use or Substantial Improvement of QOZ Business Property

   1. "Original use" is defined differently for different types of property, but generally provides that property must first be used in the QOZ or may be previously used if vacant for a period of time. Given the permanence of land, the original use of land can never commence with a QOF in a QOZ and, thus, the QOZ rules do not require land to meet the original use requirement.

   2. Under the QOZ rules, property is considered to be substantially improved by a QOF if, during the 30-month period following the date the property is acquired, the QOF makes additions to the basis of the property equal to the acquisition cost of such property. In short, the QOF must double its basis in the property after purchasing it. If a QOF purchases a plot of land with an existing building on the land, the determination of whether a QOF has substantially improved land is made only with respect to the adjusted basis of the building (without regard to the basis allocable to the land) and separate improvements to the land are not required.

(a) The QOZ rules provide for the aggregation of capital expended to improve property for purposes of determining whether this requirement has been met.

J. Realizing that developing businesses will have difficulty meeting some of the requirements under the QOZ rules, the rules provide a safe harbor for amounts deemed to be reasonable working capital.

1. The safe harbor applies to cash and other financial property held by a QOZ business if the QOZ business:

(a) Keeps written records that designate the use of the working capital for development of a trade or business in a QOZ (including the acquisition, construction or improvement of QOZ business property in the QOZ);

(b) Provides a reasonable schedule consistent with the ordinary startup of a trade or business for the use of the working capital in the QOZ business within 31 months; and

(c) Actually uses the working capital in a manner that is substantially consistent with the written plan.

(i) The 31-month period for the use of working capital may generally be extended by an additional 31 months with respect to each item of tangible property. The second 31-month period must be pursuant to a plan and schedule that is compliant with the above requirements.

2. Several benefits apply to the use of working capital that fits within the safe harbor:

(a) Tangible property that is purchased, leased or improved pursuant to the working capital plan and schedule is treated as QOZ business property for purposes of meeting the requirement that a QOZ business hold substantially all of its assets as QOZ business property;

(b) Income derived from safe-harbored working capital will be counted toward the requirement that 50% of the total gross income of the business be derived from the active conduct of a trade or business;

(c) Intangible property purchased or licensed by a business pursuant to the reasonable written plan with a written schedule for the expenditure of the working capital will be deemed to be used in the active conduct of a trade or business during the period of time that the business satisfies the three requirements in clause 1 above; and

(d) Property that is deemed to be safe-harbored working capital will be excepted from the requirement that less than 5% of the business property be attributable to nonqualified financial property.

II. Section 752

A. In October 2019, Treasury issued final regulations under Section 752 of the Code providing guidance, among other things, on when a partnership's liabilities should be treated as recourse for purposes of being included in a partner's outside tax basis in its partnership interest.

B. Generally, recourse liabilities are apportioned to the partners, if any, that bear the economic risk of loss with respect to such liabilities (i.e., the obligation to repay the partnership's liabilities if the partnership becomes worthless).

C. The final regulations change the analysis for determining this risk of loss ("Changes"). The Changes apply to liabilities assumed or incurred by a partnership on or after Oct. 9, 2019, other than those assumed or incurred pursuant to a binding written contract entered into prior to Oct. 9, 2019.

D. For transactions grandfathered from the Changes, generally, the partners' actual ability to repay the liabilities is disregarded (i.e., there was a presumption that, barring a plan to avoid the obligation to repay, partners would fulfill their obligations).

E. Responsibility for repaying the partnership's recourse liabilities (e.g., short sales) will generally fall exclusively to the general partner regardless of the general partner's external financial status, except where another partner has assumed such liabilities. Historically, the general partner would receive an increase in its outside tax basis corresponding to most (if not all) of such liabilities.

F. Under the Changes, a partnership must determine whether there exists a commercially reasonable expectation that the partner(s) with the risk of loss for a liability will have the ability to repay such liability under the terms of the obligation if the obligation becomes due. The Changes further explain that among the facts and circumstances considered in making such determination are the factors a third-party creditor would take into account in deciding whether to extend credit to the partner.

G. Additionally, the Changes include an anti-abuse mechanism that considers whether the facts and circumstances surrounding allocations indicate a principal purpose of eliminating partners' economic risk of loss or creating the appearance of an applicable economic risk of loss when the substance of the arrangement indicates otherwise.

H. Additionally, the Changes may operate to limit the recourse liabilities under what can be termed as a "cliff effect" (i.e., if a liability in its entirety cannot be supported by the net worth of a partner, even if a portion of such liability can be supported by the net worth of the partner, the liability will not be considered recourse to the partner at all). There is some uncertainty as to how the cliff effect will apply when there are multiple liabilities.

I. Liabilities for which no partner bears the economic risk of loss under the Changes will be treated as nonrecourse. Regulations Section 1.752-3 apportions basis from nonrecourse liabilities in the following order: (i) according to the partners' shares of partnership minimum gain; (ii) according to the amount of any taxable gain that would be allocated to the partners under Section 704(c) of the Code and the principles of reverse 704(c); and (iii) in a manner consistent with allocations of partnership profits or allocations on amounts related to a significant item of income or gain.

J. It is important to note that the Changes do not distinguish between new liabilities and those assumed or incurred prior to Oct. 9, 2019 that are replaced with new ones on or after Oct. 9, 2019 (e.g., an existing liability extinguished under a facility entered into prior to Oct. 9, 2019 and a new liability taken out in the same amount under the same facility on or after Oct. 9, 2019).

III. Limitation on Deductibility of Business Interest Expense

A. Section 163(j) of the Code limits the deduction of business interest expense attributable to a trade or business generally to the sum of the taxpayer's (x) business interest income and (y) 30% of adjusted taxable income relating to a trade or business (unreduced by business interest expense and excluding business interest income). For these purposes, business interest expense and business interest income do not include "investment interest" or "investment income," respectively, within the meaning of Section 163(d) of the Code. For tax years beginning before January 2022, adjusted taxable income is generally equivalent to EBITDA. For tax years beginning on or after January 2022, adjusted taxable income is generally equivalent to EBIT.

B. Generally, Section 163(j) applies after the application of provisions that subject interest expense to disallowance, deferral, capitalization or other limitation but applies before the operation of the at-risk loss limitations, passive activity loss limitations and the limitation on excess business losses.[1]

C. Any business interest expense not deductible pursuant to the foregoing limitation is treated as business interest expense of an eligible taxpayer that carries forward to succeeding taxable years, subject to the same limitation.

D. The limitation on the deductibility of business interest expense does not apply to interest attributable to an electing real property trade or business and certain other businesses. Such activities, including the performance of services as an employee, are excluded from the meaning of trade or business for purposes of Section 163(j). Adjusted taxable income is computed without regard to income not properly allocable to a trade or business.

E. Proposed regulations released in November 2018 ("November 2018 Proposed Regulations") provide an expansive definition of "interest" and an anti-avoidance rule for amounts associated with the time value of money. This includes guaranteed payments for use of capital, a portion of the payments on swaps with significant nonperiodic payments, substitute interest payments on securities lending transactions, income from hedging transactions in which the underlying security is an interest-bearing instrument, commitment fees, debt issuance costs and factoring income.

[1] *See* Prop. Reg. § 1.163(j)-3(b)(3).

F. Application to Partnerships

1. In the case of a partnership, the limitation is determined at the partnership level. To the extent the limitation applies at the partnership level to reduce the business interest expense deductible for a year, such excess shall carry forward to succeeding years and, subject to certain limitations, may be deducted by an eligible partner to the extent the partnership has sufficient excess taxable income that was not offset by business interest expense in such year. Any amount not utilized will form part of the investor's adjusted basis in its interest in the partnership only at the time such investor disposes of its interest.

2. Partner-level adjustments (e.g., Section 743 adjustments, remedial allocations, etc.) are not taken into account when determining the partnership's adjusted taxable income. Rather, they are taken into account at the partner level.

3. As described above, Section 163(j) only applies to business interest expense and not to other types of interest expense such as investment interest expense. Notwithstanding the foregoing, the preamble to the November 2018 Proposed Regulations indicates that for partnerships that are engaged in a trade or business, a partner that does not materially participate may be subject to the interest limitations under both Section 163(j) and 163(d).

4. Business interest expense of a partnership disallowed as a deduction by the operation of Section 163(j) is allocated to the partners ("disallowed business interest"). Such amounts are carried forward and treated as paid in subsequent years, subject to certain limitations.

5. Under the November 2018 Proposed Regulations, a partner may deduct its share of such disallowed business interest in a subsequent year to the extent of:

   (a) Its allocated excess business interest income from such partnership and

   (b) Its allocated excess taxable income from such partnership (with the deduction of the amounts otherwise allowable under this clause (b) capped at 30% of the sum of the partner's share of the excess taxable income from the partnership and adjusted taxable income from other sources). However, the Blue Book states that a partner can deduct its share of such disallowed business interest in a subsequent year only to the extent of its allocated excess business interest income and 30% of its share of the excess taxable income from the partnership).

6. If non-business interest expense of a partnership is allocated to a corporate partner, 163(j) limitations would apply at the corporate partner level because all interest expense and income of a corporation is treated as business interest expense and income.

7. Computation of a corporation's E&P does not take into account the application of 163(j). As a result, the limitations under 163(j) may not adversely impact investors in offshore feeder funds under certain circumstances.

8. The November 2018 Proposed Regulations explicitly reserve on the application of 163(j) to tiered partnerships, partnership mergers and divisions and self-charged interest.

G. Taxpayers may rely on the November 2018 Proposed Regulations before they are finalized so long as the taxpayer consistently applies all the rules of such proposed regulations.

IV. Sale of Partnership Interests by Foreign Partners

A. The IRS held in a 1991 Revenue Ruling[2] that gain on the sale of a partnership interest by a foreign partner was subject to tax in the U.S. to the extent of such partner's share of unrealized net gain in any "effectively connected income" assets held by the partnership.

B. In 2017, the Tax Court held in Grecian Magnesite[3] that a foreign partner was not subject to U.S. federal income tax on gain from the sale of a partnership interest in a partnership conducting business in the U.S., except for gain

[2] *See* Rev. Rul. 91-32.
[3] *See Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (July 13, 2017).

attributable to the partnership's United States real property interests. The IRS has appealed the decision of the Tax Court.

C. Section 864(c)(8) of the Code effectively reverses Grecian Magnesite by providing that gain or loss realized by a foreign partner from the sale or exchange of a partnership interest occurring on or after Nov. 27, 2017 is treated as effectively connected with a U.S. trade or business to the extent that the seller of such interest would have had effectively connected gain or loss had the partnership sold all of its assets for their fair market value as of the date of the sale or exchange.

D. In addition, Code Section 1446(f) requires the buyer of a partnership interest to withhold 10% tax on the amount realized by the seller on the sale or exchange of a partnership interest occurring after Dec. 31, 2017 if any portion of the seller's gain on the sale of the interest would be effectively connected income under Code Section 864(c)(8), unless the seller certifies that the seller is non-foreign. In the event the buyer fails to withhold the correct amount of tax, the partnership shall deduct and withhold from distributions to the buyer an amount equal to the tax that the buyer failed to withhold from the seller.

E. The IRS issued Notice 2018-08 on Dec. 29, 2017, which suspends withholding under Code Section 1446(f) on the transfer of any interest in a PTP as defined in Code Section 7704(b) until regulations or other guidance has been issued under Code Section 1446(f).

F. On April 2, 2018, the IRS issued Notice 2018-29, providing interim guidance upon which taxpayers may rely (pending the issuance of regulations or other guidance).

1. The Notice outlines methods to certify that Section 1446(f) withholding is not necessary.

   (a) No Section 1446(f) withholding is required if the transferor certifies to its non-foreign status. Transferors may use a modified FIRPTA certificate or a Form W-9 (so long as such Form W-9 contains the name and taxpayer identification number of the transferor, and is signed and dated under penalties of perjury). A transferee may rely on a previously obtained Form W-9.

   (b) No Section 1446(f) withholding is required if the transferor provides a certification that the transfer will not result in gain.

   (c) No Section 1446(f) withholding is required if, within 30 days prior to a transfer, the transferor provides a certification that transferor's allocable share of "effectively connected taxable income" ("ECTI") in each of the three taxable years prior to such transfer was less than 25% of its entire distributive share of partnership income in each such year. It should be noted that this exception does not apply when the transferor is disposing of the interest to the partnership (e.g., through a withdrawal).

   (d) No Section 1446(f) withholding is required if the partnership provides a certification that a hypothetical sale of all of its assets at fair market value would generate less than 25% effectively connected gain (including, for these purposes, FIRPTA gain).

2. The Notice suspends withholding under Section 1446(f) for nonrecognition transactions if the transferor provides a notification of a nonrecognition transaction to the transferee, signed under penalties of perjury, containing the transferor's name, TIN, address, a brief description of the transfer and an explanation of why gain or loss is not recognized in such transaction.

3. The Notice also suspends withholding in situations in which the partnership would be required to withhold under Section 1446(f) due to a transferee's failure to withhold as required.

G. On May 7, 2019, the IRS released proposed regulations providing guidance on Section 1446(f), adding to and modifying some of the exceptions to withholding provided in Notice 2018-29.

1. The proposed regulations require the transferee to report and pay any tax withheld by the 20th day after the date of the transfer.

2. The proposed regulations provide six exceptions to withholding that a transferee can rely on, unless the transferee has actual knowledge that the certifications are incorrect or unreliable:

   (a) The transferor can certify non-foreign status with a Form W-9.

        (i) The proposed regulations also clarify that a Form W-9 may be used to establish non-foreign status of a transferor for purposes of Section 1445 (FIRPTA withholding).

    (b) The transferor can certify that there will be no gain realized by the transferor. Unlike Notice 2018-29, the proposed regulations clarify that this certification must take into account any ordinary income arising from application of Section 751(a) and the regulations thereunder (e.g., income from unrealized receivables). Therefore, a transferor may not provide such certification if Section 751(a) and the regulations thereunder would require the transferor to realize ordinary income, even if the transferor would realize an overall loss on the transfer.

    (c) No withholding is required if the transferee receives a certification from the partnership that, in a hypothetical sale of all of the partnership's assets at fair market value, the amount of net effectively connected gain resulting from the deemed sale would be less than 10% of the total net gain, instead of the 25% threshold in Notice 2018-29.

    (d) Consistent with Notice 2018-29, no withholding is required if the transferor certifies that its distributive share of ECTI during the previous three years was below a certain threshold; however, the proposed regulations reduce the 25% threshold provided in the Notice to 10%. The transferor must certify that it was a partner in the partnership at all times during the immediately prior taxable year and the two years preceding it, and that its (and certain related parties') allocable share of ECTI for each of those taxable years was less than 10% of the transferor's total distributive share of the partnership's net income for that year. In addition, the transferor must certify that, in such taxable years, the transferor's allocable share of ECTI was less than $1 million.

        (i) The proposed regulations expand this exception beyond Notice 2018-29, by allowing a partnership to use this exception when the transferor is disposing of the interest to the partnership (e.g., through a withdrawal).

    (e) The transferee may rely on a certification from the transferor that a nonrecognition provision of the Code applies to the transfer, consistent with Notice 2018-29.

        (i) If only a portion of the gain realized on the transfer would be subject to the nonrecognition provision, an adjustment to the amount required to be withheld may be permitted.

    (f) An additional exception to withholding, which is not contained in Notice 2018-29, exists if the transferor certifies that it is not subject to tax on any gain based on a claim of treaty benefits. The certification must include a valid Form W-8BEN or Form W-8BEN-E that contains the information required to support the claim of treaty benefits, and the transferee must mail a copy, along with certain additional information, to the IRS by the 30th day after the transfer date in order to rely on it.

        (i) This exception does not apply to a transferor that is a flow-through entity (e.g., a partnership), even if all of its partners qualify for an exemption under a treaty.

    (g) The exceptions described above apply to transfers that occur on or after the date that is 60 days after the date these proposed regulations are finalized. For transfers that occur before such 60th day, taxpayers may apply the rules described in either Notice 2018-29 or the proposed regulations' exceptions described above.

3. Under Section 1446(f)(4), if a transferee fails to withhold any amount required to be withheld under section 1446(f)(1), the partnership must deduct and withhold from distributions to such transferee a tax equal to the amount the transferee failed to withhold, plus interest.

    (a) To prevent such secondary withholding obligation, a transferee must furnish, within 10 days of the transfer, a certification to the partnership that includes, among other things, underlying certifications that the transferee relies on to claim an exception or adjustment to the withholding.

    (b) These rules apply to transfers that occur 60 days after the date of the finalization of these proposed regulations.

    (c) If the partnership does not receive a certification that the proper amount was withheld or that there was an exception to withholding, it must begin to withhold on distributions made to the transferee on the later of the date that is 30 days after the transfer or 15 days after the partnership acquires actual knowledge of the transfer.

V. Dividend Equivalent Payments: Section 871(m)

A. Introduction

1. In 2010, Section 871(m) of the Code was enacted to treat as U.S. source dividends for U.S. withholding tax purposes:

   (a) "Dividend equivalent payments" on "specified notional principal contracts" that are based on a four-factor statutory definition; and

   (b) Substitute dividend payments on securities lending or sale-repurchase transactions.

2. On Sept. 17, 2015, the Treasury issued final and temporary regulations ("2015 Final Regulations" and "2015 Temporary Regulations," respectively, and, together, the "2015 Regulations") implementing Section 871(m) of the Code.

3. On Dec. 2, 2016, the IRS released Notice 2016-76, which indicated the Treasury's intent to phase in the applicability of the 2015 Regulations differently for transactions entered into each of: (i) calendar year 2017; and (ii) calendar year 2018 and subsequent calendar years.

4. On Jan. 19, 2017, the Treasury issued final and temporary regulations ("Final Regulations" and "Temporary Regulations," respectively, and, together, the "2017 Regulations") that adopted, with some modifications, the 2015 Regulations.

5. On Aug. 4, 2017, the IRS released Notice 2017-42, which further extends the phase in and delays the effective dates of certain provisions of the 2017 Regulations.

6. On Sept. 20, 2018, the IRS released Notice 2018-72, which further extends the phase in and delays the effective dates of certain provisions of the 2017 Regulations.

7. On Dec. 16, 2019, the IRS (i) finalized certain proposed regulations ("2019 Regulations") and (ii) released Notice 2020-2, which further extends the phase-in and delays the effective dates of certain provisions of the 2017 Regulations.

B. Statutory Provision

1. Under Section 871(m) of the Code, a notional principal contract ("NPC") (generally, an equity swap) is a "Specified NPC" subject to withholding under Section 871(m) if the NPC provides for one or more amounts that may be contingent upon, or determined by reference to, U.S.-source dividends and at least one of the following four factors is present:

   (a) In connection with entering into the NPC, a long party to the NPC transfers the underlying security to a short party to the NPC (known as "crossing in");

   (b) In connection with the termination of the NPC, a short party to the NPC transfers the underlying security to a long party to the NPC (known as "crossing out");

   (c) The underlying security is not readily tradable on an established securities market; or

   (d) The underlying security is posted as collateral by a short party to the NPC with a long party to the NPC.

2. Section 871(m) of the Code authorizes the Treasury to specify other transactions as being "Specified NPCs" or otherwise substantially similar to a transaction yielding a dividend equivalent payment. The 2017 Regulations, as modified by IRS Notice 2018-72, expand the universe of transactions subject to Section 871(m) of the Code, if such transactions are entered into (or significantly modified) after 2016 or 2020, as applicable.

C. The 2017 Regulations

1. Transactions that Can Give Rise to "Dividend Equivalent Payments" ("Section 871(m) Transactions")

   (a) A "dividend equivalent" is any of:

(i) A substitute dividend that references a U.S.-source dividend made pursuant to a securities lending or sale-repurchase transaction;

(ii) A specified NPC;

(iii) A payment that references a U.S.-source dividend made pursuant to a specified equity-linked instrument ("specified ELI"); or

(iv) Another substantially similar payment.

(b) An NPC for purposes of Section 871(m) generally means an equity swap.

(c) An equity-linked instrument ("ELI") for purposes of Section 871(m) generally means any financial transaction that references the value of one or more underlying equity securities, potentially including: forward contracts, futures contracts, swaps, options, convertible preferred stock, convertible debt instruments and debt instruments linked to underlying equity securities.

The "portfolio interest" exception to interest withholding will not apply to any dividend equivalent payment under a debt instrument.

2. Miscellaneous Issues Regarding Dividend Equivalent Amounts

(a) Any gross amount that references the payment of a U.S.-source dividend, whether actual or estimated, explicit or implicit, is treated as a dividend equivalent to the extent of the amount determined under the 2017 Regulations.

For example, the 2017 Final Regulations treat a price return swap as a transaction that provides for the payment of a dividend equivalent because the anticipated dividend payments are presumed to be taken into account in determining the other terms of the NPC.

(b) A dividend equivalent with respect to a Section 871(m) transaction is reduced by the amount of any deemed dividend arising from adjustments of convertible debt instruments and other ELIs under Section 305 of the Code, such as a change to the conversion ratio or conversion price of a convertible debt instrument. Such a deemed dividend may still be subject to withholding under other Code sections.

(c) A payment referencing a distribution on an underlying security is not a dividend equivalent subject to Section 871(m) to the extent that the distribution would not be subject to U.S. withholding if the long party owned the underlying security directly.

3. The "Delta" and "Substantial Equivalence" Tests

(a) An NPC or an ELI is a specified NPC or specified ELI subject to Section 871(m) if the instrument has a "delta" of 0.8 or greater in the case of a "simple contract," or if a "substantial equivalence" test is satisfied in the case of a "complex contract," which is in each case determined at the time of the instrument's "issuance."

(i) A "simple contract" is a contract that: (i) references a fixed number of shares (that is known when the contract is issued) of one or more issuers to determine the payments under the contract; and (ii) has a single maturity or exercise date on which all amounts are required to be calculated.

(ii) A contract can still be a simple contract if it has a range of potential exercise dates (such as an option) as long as amounts due under the contract are determined by reference to a single, fixed number of shares on the exercise date.

(iii) A "complex contract" is any contract that is not a simple contract (e.g., if the number of shares of stock referenced by the contract is not fixed, but, rather, varies based on the payoff amount, time of payout or some other factor).

(b) The "delta" of a simple contract is generally a measure of how sensitive the fair market value of an instrument is to changes in the fair market value of the underlying security, generally ranging from one (completely dependent on the value of the underlying security) to zero (completely independent of the value of the underlying security).

(c) For a complex contract, "substantial equivalence" generally measures the correlation between the value of the contract and the value of the shares used to hedge the contract at various testing prices. If this correlation is greater than the equivalent calculations performed for a simple contract specified ELI or a specified NPC, then the complex contract is a specified ELI or a specified NPC, as applicable. The Treasury has invited comments to the "substantial equivalence" test.

4. Determining Delta/Substantial Equivalence

(a) The determination of whether an instrument is a specified ELI or a specified NPC is made only on the date the instrument is "issued."

An instrument is treated as issued when it is issued, entered into, purchased or otherwise acquired at its inception or original issuance, including an issuance that results from a deemed exchange pursuant to Section 1001 of the Code.

(b) If one of the parties to a transaction subject to Section 871(m) is a broker or dealer, that party is required to determine whether a potential Section 871(m) transaction is a Section 871(m) transaction and report the timing and amount of any dividend equivalent to the other party.

(c) If neither or both parties are dealers or brokers, then the short party must make such determination and provide such reporting.

5. Time of Withholding

Withholding is required at the later of:

(a) The time the amount of the dividend equivalent is determined, which is the later of: (i) the day prior to the ex-dividend date; and (ii) the record date; and

(b) The time a payment occurs. A payment is deemed to occur:

(i) If money or other property is paid to the long party, which includes the economic benefit to the long party of netted payments within the contract that would otherwise have been made at such time; or

(ii) The long party sells or disposes of the contract, including by virtue of termination of the contract, lapse of the contract, offsets or otherwise.

6. Baskets, Indices and Miscellaneous Situations

(a) *Baskets*. If a short party issues a contract that references a basket of 10 or more underlying securities and hedges the contract with an exchange-traded security that references substantially the same underlying securities, then the short party may use the hedge security to determine the delta of the contract it is issuing.

(b) *Combined Transactions*. If a long party (or a related person) enters into two or more transactions that reference the same underlying security and the transactions were entered into in connection with each other, then the transactions are combined and treated as a single transaction for purposes of Section 871(m).

(i) If a broker does not have actual knowledge that multiple transactions were entered into in connection with each other, the broker may generally presume the transactions were not entered in connection with each other if either: (i) the transactions were entered into two or more business days apart; or (ii) the transactions are held in different accounts.

(ii) The 2017 Final Regulations do not provide for the netting of a taxpayer's long and short positions, though the preamble to the 2015 Final Regulations leaves open the possibility of more expansive rules in the future.

(c) *Transactions Referenced to Partnership Interests*. Section 871(m) only applies to payments on an NPC or ELI that references a payment on a partnership interest when the partnership: (i) is a trader or dealer in securities; (ii) holds significant investments in securities; or (iii) holds an interest in a lower-tier partnership described in (i) or (ii).

A partnership is considered to hold significant investments in securities if either 25% or more of the value of the partnership's assets consist of underlying securities or potential Section 871(m) transactions, or the value of the underlying securities or potential Section 871(m) transactions equals or exceeds $25 million. In this case, dividend equivalent payments are determined by looking through to such partnership's underlying assets.

This affects swaps on "master limited partnerships." Fund managers should have upfront communications with their brokers to understand how they intend to apply this set of rules, including whether they may be over-withholding on a swap if they cannot get sufficient comfort that the particular master limited partnership referenced under the swap is not a covered partnership.

(d) *Indices*. Transactions that reference a qualified index are generally excepted from Section 871(m). The qualified index exception is designed to provide a safe harbor for widely used passive indices that reference a diversified portfolio of long positions, and is not intended to apply to any index that: (i) is customized or reflects a trading strategy; (ii) is not generally available (i.e., the exception does not apply to over-the-counter transactions); or (iii) targets dividends. Entering into a short position that references component security of a qualified index may invalidate a qualified index Section 871(m) transaction. There is a "*de minimis*" safe harbor for a short position that reduces the exposure to referenced components securities of a qualified index by 5% or less of the value of the long positions in component securities in the qualified index.

(e) *Anti-Abuse Rule*. The IRS Commissioner may treat any payment on a transaction as a dividend equivalent if the taxpayer entered into or acquired the transaction with a principal purpose of avoiding Section 871(m). The IRS may also avail itself of general common law and statutory rules in order to challenge transactions that are designed to avoid the application of Section 871(m).

D. Notices 2016-76, 2017-42, 2018-72 and 2020-2

1. Transactions Entered into During Calendar Years 2017-2022

(a) "Delta One" Transactions

(i) The term "delta one" was not defined in any of the notices. However, the language of the notices supports that only simple contracts can be "delta one" transactions.

(ii) A transaction is a Section 871(m) Transaction if it has a delta of 1.0 on the date of issuance.

(b) Combined transactions (as described above) that have a delta of 1.0 are within the scope of the Notices. However, a broker acting as a short party will only need to combine over-the-counter transactions that are priced, marketed or sold in connection with each other. Long parties would still be responsible for the substantive tax for transactions that are combined under the 2017 Regulations, even if the short party is not responsible for withholding any tax.

(c) The IRS will apply a good faith standard to determine whether long and/or short parties applied the combination, withholding and other rules during 2017-2022.

(d) "Qualified derivatives dealers" ("QDDs") will not be subject to tax on dividends and dividend equivalents received in 2017-2022 in their equity derivatives dealer capacity or withholding on dividends (including deemed dividends). QDDs must use good faith efforts to comply with the 2017 Regulations through the end of 2022.

2. Transactions Entered into After 2022

(a) All other transactions entered into after 2022 (or significantly modified after 2022) that are considered Section 871(m) Transactions under the 2017 Regulations will be subject to the withholding and substantive tax provisions.

(b) The IRS will apply a good faith standard for actions taken by taxpayers during 2023 for Section 871(m) Transactions entered into during 2023 that are not "delta one" transactions, including whether taxpayers are properly applying the "substantial equivalence" test.

E. Possible Further Changes

1. A Treasury official announced publicly in November 2017 that the government is considering whether or not to implement the 2017 Regulations for transactions that are “non-delta one” transactions.

2. The Treasury and the IRS announced on Dec. 16, 2019 (the same date as Notice 2020-2 was issued) that they are continuing to evaluate the 2017 Regulations to “consider possible agency actions that may reduce unnecessary burdens imposed by the regulations” in accordance with Executive Order 13777.

ESG

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Christopher Hilditch is co-head and co-founding partner of the firm's London office. With 25 years of experience advising many of the highest profile hedge funds, Chris focuses his practice on entrepreneurial and institutional investment managers, other financial services firms and investment funds, especially hedge funds, hybrid funds, co-investment funds and distressed funds. He provides practical and strategic advice on the structuring and operation of funds and investment managers, including fundraising, investor issues, investment transactions and financing as well as regulatory and compliance matters.

Chris has been described by interviewees in *Chambers UK* as "fantastic — practical, commercial and knows his stuff" and as a "go to lawyer for dealing with a complicated hedge fund" and in *The Legal 500 UK* as "excellent" and "knows the industry inside out." He received an "Outstanding Contribution" award for his services to the hedge fund industry (*The Hedge Fund Journal* Awards) and was one of only two hedge fund lawyers listed as a leading individual by *The Legal 500 UK* in 2015, which also included him as an elite leading lawyer in investment funds in 2014. Clients praise his "very strong technical knowledge and commercial awareness" as well as his "deep knowledge and experience in the fund industry." Chris has also been named as a leading funds lawyer in *Chambers UK, Chambers Europe*, *Expert Guide to the Best of the Best* (which named him as one of the top 25 funds lawyers worldwide), *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*, *IFLR1000*, *PLC Cross-Border Investment Funds Handbook*, *Who's Who Legal: The International Who's Who of Private Funds Lawyers* and *Who's Who of Professionals*. Chris has participated in the UK Financial Services Authority's Legal Experts Group in respect of AIFMD and has been an active participant on various AIMA and other industry committees on matters relating to the hedge fund industry. Chris is a frequent speaker at industry conferences and seminars, including invitation-only conferences for clients of prime brokers and other industry participants. He has also written on a wide range of hedge fund and regulatory topics. Recently, Chris was invited to be the general editor of the *Chambers Alternative Funds Guide 2019* — a guide examining key industry trends and regulatory and tax matters impacting funds, managers and investors. He has also authored a chapter on "Conflicts of Interest" in *Investment Management, Law and Practice* (Oxford University Press) and co-authored a chapter on "United Kingdom Considerations" in *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). Chris attended law school at the College of Law, Guildford and holds an M.A., with honors, from Pembroke College, University of Oxford.

Environmental, Social and Governance (ESG)

I. Alternative Funds and the Responsible Investing Trend

A. *Background*. In recent years, the alternative funds market has seen a surge in responsible investing.

B. What Is Responsible Investing?

1. There is no single definition. However, the United Nations-supported Principles for Responsible Investment ("UN PRI") define responsible investing as "an approach to investing that aims to incorporate ESG factors into investment decisions, to better manage risk and generate long-term returns."[1]

2. Responsible investing may encompass one or more of the following specific types of investing.

(a) *ESG Investing/Sustainable Investing.* Investors consider ESG factors during the investment process and direct capital toward companies that have strong business practices as they relate to ESG.

(b) *Socially Responsible Investing.* Values-oriented approach where investors do not invest in companies that participate in businesses that misalign with their values.

(c) *Impact Investing*. Allocation of capital with the express purpose of generating a positive social impact alongside a financial return.

(d) *Ethical Investing*. Using investor's own ethical principles as the main filter for securities selection. This method is highly dependent on the investor's views.

(e) *Green Investing*. Activities that focus on companies or projects that are committed to the conservation of natural resources, alternate energy sources, implementation of clean air/water and other environmentally-conscious business practices.

(f) *Shared-Value Investing.* Profit-driven, social impact investing that creates value for both society and shareholders.[2]

(i) In 2019, the Business Roundtable, a group of nearly 200 CEOs of major U.S. corporations, issued a statement redefining the "purpose of a corporation." Instead of serving shareholders and maximizing profits, they reimagined it to serve all stakeholders of the company by investing in employees, delivering value to customers, dealing ethically with suppliers and supporting the broader community.[3]

(1) Among the 200 signatories were Jeff Bezos of Amazon, Tim Cook of Apple and Dennis Muilenburg of Boeing.[4]

(g) Some consider "Responsible Investing" to be a spectrum on which all the above types of investing, including ESG investing, lie — but no defined vernacular has been established as of yet.[5]

(h) While each of the above labels assumes that ESG factors are being considered at some point during the investment process, they each have their own nuances.

C. Environmental, Social, and Governance (ESG) Factors

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[1] UN PRI, https://www.unpri.org/about/what-is-responsible-investment.

[2] Where ESG Fails, https://www.institutionalinvestor.com/article/b1hm5ghqtxj9s7/Where-ESG-Fails.

[3] The CEOs of Nearly 200 Companies Just Said Shareholder Value is No Longer Their Main Objective, https://www.cnbc.com/2019/08/19/the-ceos-of-nearly-two-hundred-companies-say-shareholder-value-is-no-longer-their-main-objective.html.

[4] *Id.*

[5] Preparing for the Impact Revolution: How Fund Managers Can Implement the Philosophy of "Doing Well by Doing Good," https://www.hflawreport.com/2686956/preparing-for-the-impact-revolution-how-fund-managers-can-implement-the-philosophy-of-doing-well-by-doing-good-.thtml.

1. Background

   (a) What exactly are ESG Factors?

      (i) There is no universal answer — the answer is usually in the eye of the beholder. Broadly, however, ESGs are various environmental, social and governance factors that are taken into account when making investment decisions.

   (b) Examples of ESG Factors

      (i) *Environmental*. Green energy, renewable energy, pollution, climate change, carbon emissions and resource depletion.

      (ii) *Social*. Working conditions (including child labor), health and safety, impact on indigenous peoples, diversity in the workplace, anti-gun and anti-abortion.

      (iii) *Governance*. Executive pay, board composition, corporate tax strategy, bribery/corruption and political influence.

   (c) Further complicating the above classification system is the fact that ESG factors are often interlinked and it can be challenging to classify particular issues as only environment, social or governance–related.

2. Types of ESG Strategies

   (a) *Affirmative Strategy*. Invest in companies that focus and/or prioritize specific ESG factors.

   (b) *Negative Strategy*. Avoid certain types of investments and/or companies that operate in unwanted ways.

      (i) Leading negative/exclusionary criteria for institutional investors include: companies doing business in Sudan, tobacco-related businesses and companies that lack equal employment opportunities (e.g., in emerging market jurisdictions).

   (c) *Takeaway*. There are many different considerations within ESG investing and not all are relevant to all investments. For example, a real estate fund manager might want to ensure that buildings are energy efficient and constructed from sustainable materials. In contrast, an equity manager may be more interested in the governance of an investee company.[6]

II. Importance: Why Should We Care?

A. Responsible investing is one of the biggest trends reshaping the global asset management industry.

1. Historically, such investing was much less prominent in the United States than in the EU.

   (a) The EU has even issued legislation on sustainable finance with regards to ESG disclosures and the new version of the U.K. Financial Reporting Council's Stewardship Code[7] (first published in 2010) sets out detailed expectations on how ESG issues should be integrated into the investment process. U.K. FCA authorized private fund managers are required to disclose on their website the nature of their commitment to the Stewardship Code or their alternative investment strategy.[8]

   (b) In the past, advisers would report that they had not been asked about ESG considerations by investors and would therefore assume that investors do not care. Rather, that their sole focus was on returns.

[6] *See* Alternative Funds, p. 4.

[7] *See* https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Dec-19-Final.pdf.

[8] *See* https://www.handbook.fca.org.uk/handbook/COBS/2/2.html#D153.

(c) This has shifted in the past decade. In 2016, there were $22.89 trillion in global assets being professionally managed via responsible investment strategies.[9] This represented approximately 25% of total assets being managed by the global asset management industry.[10]

(d) From 2016-2017, 71.4% of hedge fund firms reported increased investor interest in responsible investment.[11]

(i) A separate study in 2019 found that an overwhelming majority of investors said that an ESG policy was either critically important (63%), or somewhat important (26%), when deciding whether to invest with a given manager.[12]

(ii) These numbers suggest that impact investing or responsible management of funds is by no means a short-term trend. Rather, it is likely to continue to shape the asset management industry — likely with permanent consequences.

B. Reasons Behind the Trend

1. The focus on responsible investing is linked with a generational change in attitude. Millennials are actively thinking about responsible investing as a guiding principle for their investment decisions. In fact, they are twice as likely to make ESG investments as the overall investor population.[13]

(a) Furthermore, Baby Boomers are expected to pass down their money to future generations with an unprecedented $30 trillion to change hands over the course of the next several decades.[14]

2. It is also driven by socially conscious investors seeking to achieve high returns while making a positive social impact.[15]

(a) With the downfall of large companies, such as PG&E, environmental considerations have moved to the forefront.

(b) Nike has vowed to source 100% renewable energy across all of its operations by 2025.[16]

3. Variations Across the Trend

(a) Interestingly, to date, private equity managers have embraced responsible investing at a much higher rate than hedge funds, as evidenced by the number of signatories to the UN PRI.

(i) Of the UN PRI signatories in 2016, approximately 5% (53) identify themselves as hedge funds, while 23% (253) identify themselves as private equity firms.[17]

(b) One explanation may be that private equity, which requires longer time horizon to gauge efficacy, lends itself better to this type of investing than hedge funds, which hedge shorter-duration risks.

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[9] From Niche to Mainstream: Responsible Investment and Hedge Funds, p. 7.

[10] From Niche to Mainstream: Responsible Investment and Hedge Funds, p. 7.

[11] From Niche to Mainstream: Responsible Investment and Hedge Funds, p. 14.

[12] EY 2019 Survey Finds Hedge Funds losing Ground to PE; Need for Cost Controls; and Growth of Non-Traditional Investment Products, ESG and Separate Accounts (Part One of Two), https://www.hflawreport.com/4194722/ey-2019-survey-finds-hedge-funds-losing-ground-to-pe-need-for-cost-controls-and-growth-of-non-traditional-investment-products-esg-and-separate-accounts-part-one-of-two.thtml.

[13] What is ESG Investing, https://www.fool.com/investing/what-is-esg-investing.aspx.

[14] What is ESG Investing, https://www.fool.com/investing/what-is-esg-investing.aspx.

[15] The Past, Present and Future of ESG Investing in the Hedge Fund Industry (Part One), https://www.hflawreport.com/2551991/the-past-present-and-future-of-esg-investing-in-the-hedge-fund-industry-part-one-of-two.thtml.

[16] What is ESG Investing, https://www.fool.com/investing/what-is-esg-investing.aspx.

[17] The Past, Present and Future of ESG Investing in the Hedge Fund Industry (Part One), https://www.hflawreport.com/2551991/the-past-present-and-future-of-esg-investing-in-the-hedge-fund-industry-part-one-of-two.thtml.

(c) Other explanations include risk exposure and investor pressure. The private equity community arguably takes a more active role in managing companies and is warier of ESG-related risks. As for investor pressure, private equity funds face pressure from responsible investors (such as pension funds), which heavily consider ESG-related factors when investing.

III. United Nations Principles for Responsible Investment

A. In 2005, the United Nations invited the world's largest institutional investors to join a process to draft principles for responsible investment. By 2006, a group of six principles had been released.[18]

B. What are they?

1. The UN PRI are a set of six principles that offer signatories actions for integrating responsible investment into their investment decisions.[19]

2. Specifically, the principles include:

(a) Incorporation of ESG issues into investment analysis and decision-making processes;

(b) Active ownership and incorporation of ESG issues into fund ownership policies and practices;

(c) Seeking appropriate disclosure on ESG issues by the entities in which the fund invests;

(d) Promoting acceptance and implementation of the Principles within the investment industry;

(e) Working together to enhance the fund's effectiveness in implementing the Principles; and

(f) Reporting on activities and progress.

C. Unlike the other types of responsible investing (sustainable, impact, green, etc.), which have a moral or ethical component, the UN argues that responsible investing can and should be pursued by investors whose sole purpose is financial return.

1. To ignore ESG factors is to ignore risks and opportunities that have a material effect on an investment's return.

D. Who has joined UN PRI and what does joining mean?

1. By 2016, approximately 1,054 managers had become signatories to the principles. As previously mentioned, 5% of these identified themselves as hedge funds. 23% identified themselves as private equity advisers.

2. By 2018, the percentage of signatories that identified as private equity firms jumped to 29% (a total of 431, compared to the previous 253 firms).[20]

3. Today, the UN PRI boasts over 1,600 signatories representing over $70 trillion assets under management.[21]

4. One explanation for the lower number of hedge fund signatories is that many early adopters of PRI have large institutional investors, such as European pension plans, driving this issue (whereas small to medium-sized managers have not been confronted with this by their investors).[22]

5. In addition to committing to the principles, signatories must pay an annual fee to PRI and publicly report on their responsible investing activity.

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[18] The Past, Present and Future of ESG Investing in the Hedge Fund Industry (Part One), https://www.hflawreport.com/2551991/the-past-present-and-future-of-esg-investing-in-the-hedge-fund-industry-part-one-of-two.thtml.

[19] From Niche to Mainstream: Responsible Investment and Hedge Funds, p. 6.

[20] 2018 Private Equity Snapshot: Summary, https://www.unpri.org/private-equity/2018-private-equity-snapshot-summary/3999.

[21] The Remarkable Rise of ESG, https://www.forbes.com/sites/georgkell/2018/07/11/the-remarkable-rise-of-esg/#2c3e4c181695.

[22] The Past, Present and Future of ESG Investing in the Hedge Fund Industry (Part One), https://www.hflawreport.com/2551991/the-past-present-and-future-of-esg-investing-in-the-hedge-fund-industry-part-one-of-two.thtml.

(a) This requires a company's service providers to adapt and adhere to the PRI as well.

(b) The UN has identified a number of firms that used the PRI label but were not compliant.

IV. Implementation of ESG Strategies

A. General Recommendations

1. Adopt an ESG policy, which itself should be a general statement of principle rather than a discrete list of procedures.

2. The policy should commit to process only, not to any results or specific outcomes (i.e., a good faith effort to identify/manage ESG risks.)

   (a) Be mindful that failing to adhere to an advertised policy may violate agreements with investors and general securities laws.

B. Structuring Options

1. *SMAs*. Some large institutions seek to bypass commingled funds by allocating to separately managed accounts (SMAs). This tactic allows them to dictate the specific ESG parameter they wish to have applied to the account or be excluded from the account.

2. "Opt out" right*s* excuse specific investors, as opposed to the entire fund, from participating in investments that would violate the investors' ESG investing factors.

   (a) This can be negotiated in a side letter agreement with the investment manager.

   (b) It is critical that the fund's governing documents permit the investment manager/general partner to:

      (i) Excuse certain investors from participating in a capital call (in the private equity context); or

      (ii) Permit an investor to opt out of certain investments (in the hedge fund context).[23]

3. An alternative to the "opt-out" right is to allow the investor to invest in a fund that runs in parallel to the main fund.

   (a) This parallel fund would follow the same investment strategies as the main fund, except with respect to investments in companies/securities that would violate the investor's ESG policy.[24]

4. Investors may also employ affirmative integration of ESG factors by a manager.

   (a) These are typically drafted as non-binding, flexible guidelines that permit investment professionals to take ESG factors into account when implementing the investment strategy.

   (b) Typically, no single factor is dispositive.

5. *Springing ESG Provisions*. Provisions in the main fund agreements whereby the manager incorporates a springing procedure into its policy.

   (a) Such a policy may include an introduction describing the manager's general commitment to ESG investing. However, the procedural aspects are only structured to "spring" upon:

      (i) Request by an investor and subject to the discretion of the investment manager; or

[23] The Past, Present and Future of ESG Investing in the Hedge Fund Industry (Part Two), https://www.hflawreport.com/2551991/the-past-present-and-future-of-esg-investing-in-the-hedge-fund-industry-part-two-of-two.thtml.

[24] The Past, Present and Future of ESG Investing in the Hedge Fund Industry (Part Two), https://www.hflawreport.com/2551991/the-past-present-and-future-of-esg-investing-in-the-hedge-fund-industry-part-two-of-two.thtml.

(ii) Alignment of ESG-specific procedures with the fund's investment strategy.[25]

V. Challenges to Implementation

A. Two Commonly Cited Challenges

1. *Inadequate Methodologies for the Calculation of Sustainability Risks*. There is no agreed-upon universal methodology. Rather, there are enormous disparities in the methods being used by investment management firms with regards to ESG calculation and analysis in the context of investment decisions.

2. *Lack of Relevant Disclosures From Companies*. Without companies publicly disclosing data that shows their ESG-related performance, firms find it difficult to evaluate the ESG impact of a potential investment.

3. There are now several initiatives to encourage more companies to report and disclose ESG factors.

   (a) Examples include the Sustainability Accounting Standards Board ("SASB") and the Carbon Disclosure Project ("CDP"), which encourage companies to disclose data such as employee compensation and carbon emissions data, respectively.

   (b) Some large companies, such as ExxonMobil, are embracing these disclosures due to continued pressure from their investors.[26]

4. In 2016, the SEC issued a concept release seeking public comment on amending regulation S-K, which governs the reporting of non-financial statements for public companies. Specifically, the SEC sought guidance as to which sustainability issues are relevant to investors when making informed voting/investment decisions.

B. Additional Concerns

1. *A Lack of Practical Understanding*. Unclear what exactly an ESG commitment entails, because it seems broad and impractical.

2. *Skepticism With Regards To Returns*. Many managers are skeptical about the viability of their investments being able to generate double-digit returns while implementing ESG strategies.

3. *Lack of Attractive Opportunities*. Some managers cite a lack of attractive investment opportunities when considering a responsible investment approach.

4. *Fund Manager's Fiduciary Duty*. Fear that ESG commitments are at the expense of shareholder value and that this violates a manager's duty.[27]

C. However, remember that these concerns may fade as responsible investment and implementation of ESG strategies become more mainstream.

VI. How Is ESG Investing Shaping the Alternative Funds Industry and What Is Its Future?

A. As mentioned earlier, there is no one-size-fits-all approach to ESG investing.

1. This is partly due to the fact that private fund advisers have had to incorporate ESG factors at the request of investors and have done so through a variety of approaches to meet the diverse needs of such investors.

B. As we go forward, we will likely see small adjustments in the investment management framework. For example, 30 years ago intangible assets represented only a third of the market, whereas today they account for roughly 90%.

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[25] The Past, Present and Future of ESG Investing in the Hedge Fund Industry (Part Two), https://www.hflawreport.com/2551991/the-past-present-and-future-of-esg-investing-in-the-hedge-fund-industry-part-two-of-two.thtml.

[26] From Niche to Mainstream: Responsible Investment and Hedge Funds, p. 29.

[27] The Past, Present and Future of ESG Investing in the Hedge Fund Industry (Part One), https://www.hflawreport.com/2551991/the-past-present-and-future-of-esg-investing-in-the-hedge-fund-industry-part-one-of-two.thtml.

C. There is a potential for accounting standards to change in order to better capture the importance of these intangibles, including ESG factors.

D. *Data Providers*. This interest and increase in ESG investing has led to the creation of several data providers, such as MSCI and Sustainalytics, which generate ESG ratings for companies. This may be a useful approach for fund managers moving forward with this trend.[28]

E. There is a potential that 401(k) options will change, as many millennials have expressed a desire for ESG investing as an option within their 401(k) plans.[29]

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[28] Preparing for the Impact Revolution: How Fund Managers Can Implement the Philosophy of "Doing Well by Doing Good," https://www.hflawreport.com/2686956/preparing-for-the-impact-revolution-how-fund-managers-can-implement-the-philosophy-of-doing-well-by-doing-good-.thtml.

[29] What Is ESG Investing?, https://www.fool.com/investing/what-is-esg-investing.aspx.

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Julian has a reputation among his peers and clients as a terrific negotiator and an excellent strategist. He is consistently recognized as one of the country's leading real estate lawyers by *Chambers USA*, *The Legal 500 US* (listings of the top lawyers in the US) and *NY Super Lawyers*. *Chambers USA* describes Julian as offering "a wealth of expertise across the real estate spectrum," "creative," "solution-oriented," "very practical, very thoughtful and very thorough" and as being "highly commended" for his "extensive lending experience." *The Legal 500 US* includes the following words of praise from a major investment banking client: "An awesome attorney — my first choice on all deals." Julian is a prolific writer, publishing numerous articles in the *NY Law Journal* and other publications, including the "Commercial Real Estate" chapter of *Business and Commercial Litigation in the Federal Courts*. He is also a sought-after and active speaker at conferences on a wide array of topics, including real estate private equity, restructurings, financings, distressed debt and trends. He recently moderated a discussion on "Capital Market Activities Impacting the Real Estate Market" at the iGlobal Forum Real Estate Private Equity Summit. Julian received his J.D. from Fordham University School of Law and his B.A. from Emory University.

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Real Estate Funds, Deals and Financing

I. Introduction

A. Real estate funds operate optimally when both fund counsel and deal counsel understand fully the documents governing both the funds and the real estate investments.

B. When structuring real estate funds, fund counsel should be mindful of provisions that will allow the client's deal team to make investments and obtain financing on the target investments as flexibly as possible.

C. Similarly, once the fund is closed, deal counsel should be familiar with the terms of the governing fund documents. Deal counsel that is accustomed to working closely with fund counsel will structure investments that do not present issues under the fund documents.

D. Note that real estate investment issues may arise in a variety of contexts beyond real estate funds, such as distressed debt funds that acquire real estate when foreclosing on debt instruments or venture capital funds that invest in real-property holding corporations.

II. Investment Considerations

A. Is the fund's capital sufficient to make an investment?

1. The governing fund documents will cap the size of a single investment (including follow-on investments) and may cap the amount that may be invested during a calendar year. Thus, as investment sizes begin to outpace available fund commitments, fund counsel and deal counsel should anticipate the client's need to arrange financing through one or more of the alternatives discussed below.

   (a) Possible alternatives to fund restrictions on a single deal size include: (i) the right of the LP Advisory Committee to increase the concentration cap; and (ii) the right of the fund to close on deals during the marketing period of the fund based on an assumed size of fund.

   (b) Available capital may be increased by including broad rights to recall distributions. For example, many funds are permitted to recall all distributions of capital made during the investment period.

2. If the deal size exceeds the fund's concentration limit, then the general partner will likely seek co-investors.

   (a) Investors may have negotiated for co-investment rights up front in their side letters.

   (b) Strategic co-investors may make sense for the transaction.

   (c) Co-investments may be structured as joint ventures, in which case the joint venture partner is likely to seek significant rights.

      (i) Control of the joint venture may shift from the fund (and its general partner) to co-investors or the operator/manager of the property.

      (ii) The party/investor who does not control the joint venture generally retains veto rights over "major decisions." Examples of "major decisions" include merger, change of company purpose, acquisition of additional property, dilutive issuance, additional capital contributions, annual plan, material agreements, loans, bankruptcy and tax matters.

      (iii) Unlike funds, documents governing joint ventures are likely to contain more restrictive transfer provisions, including rights of first offer, rights of first refusal, drag along rights, tag along rights and buy/sell provisions.

B. Is the type of property to be acquired restricted under the governing fund documents?

1. In most cases, the investment strategy of the fund will be sufficiently clear (e.g., development, residential, unimproved land, office, hotel or retail). However, mixed-use properties and investments in debt securities could be restricted. Deal counsel should work with fund counsel to confirm that gray areas are evaluated.

2. Governing fund documents may restrict not just the type of asset a fund may acquire, but also how the asset may be developed or operated, or the manner in which it may be disposed of. Accordingly, both fund and deal counsel must understand the contemplated business plan for a fund's investments.

C. The Location of the Investment

1. Confirm that the property is located in a permitted geographic area.

2. Geographic restrictions may be included in governing fund documents and sometimes may be so narrow as to specify in which metropolitan sub-markets a fund may invest.

3. Some funds are subject to geographic diversification requirements, prohibiting excess exposure in geographic areas.

4. As discussed below, if a fund manager causes more than one fund under management to invest in properties competing for the same tenants, fiduciary conflict issues may arise.

D. The Timing of the Investment

1. If the investment is not being made during the investment period, then the investment should be a permitted follow-on investment or an investment that was committed to be made during the investment period.

2. Broad definitions of follow-on investments will facilitate investments in complementary properties.

3. Follow-on investments are likely to be capped after the investment period.

4. The timing of the closing of an investment will need to take into account capital call notice periods.

E. Other Fund Considerations

1. Expenses to be incurred to pursue the transaction may not be permitted to be borne by the fund.

   Fees and expenses of the organization of project entities should be borne by the fund. Ongoing taxes payable by project-level entities may also be payable by the fund.

2. An investment structure could affect management fees payable by the fund to the manager.

   The definition of "net invested capital" should be carefully drafted so that a dividend recapitalization will not trigger management fee reductions if the dividend is treated as a return of profits, not capital.

3. If the fund will be paying a third party a management fee or carried interest, confirm that the fund partnership documents permit such arrangement.

III. Debt Considerations

A. The Amount of Debt that Is Recourse to the Fund

1. The governing fund document will generally have a limit on recourse indebtedness, which is typically a percentage of the acquisition cost or fair-market value of the fund's portfolio.

2. Permitted guarantees should include "bad boy" guarantees, completion guarantees in connection with construction loans and environmental indemnities.

   (a) Even though the fund may have the authority to enter into certain guarantees, if there is a property-level joint venture, the fund should consider requiring the operating partner to provide guarantees, due to the operating partner's day-to-day management responsibilities.

   (b) The property-level joint venture agreement or separate reimbursement agreement will generally allocate guaranty payment obligations to the party that is at fault.

B. Parallel funds and alternative investment vehicles may be required to provide joint and several guarantees of indebtedness for a project.

1. Internally, the associated fund vehicles should enter into contribution agreements with one another to achieve proportionate debt exposure. In some cases, it may be necessary to provide several, but not joint, guaranties.
2. Generally, investment vehicles that are not required by their organizational documents to invest in tandem should not guarantee indebtedness in respect of each other's investments. That is, while it may be appropriate for "Fund II A" and "Fund II B" to enter into a joint and several guaranty, "Fund I" should never guarantee indebtedness of "Fund II."

C. Financing/Lender Requirements

1. Restrictions on Transfers

   Deal counsel should ensure that loan documents take into account the intricacies of a fund. For instance, lenders typically will seek to restrict "direct and indirect" transfers of interests in the borrowing entity (the property owner). If not negotiated, such restrictions could restrict transfers of interests in the fund. These transfers should be carved out from the restrictions provided under the loan documents.

2. Fund as a "carve-out" or other guarantor under loan documents.

   Lenders generally will require the fund, as a guarantor, to satisfy certain ongoing financial requirements (i.e., net worth/liquidity) and other covenants. The very essence of a fund is to acquire and to dispose of assets. Therefore, it is imperative that the loan documents do not restrict the fund from operating in its ordinary course or impose financial covenants that are overly restrictive given the fund's capital or operating structure.

3. ERISA Covenants in Loan Documents
4. OFAC Representations in Loan Documents for Limited Partners

IV. Tax Considerations

A. U.S. and non-U.S. tax considerations at the fund, investor and SPE level are complex and change frequently. Therefore, it is imperative that fund and deal counsel interact regularly with tax counsel to confirm compliance and optimal structuring.

B. UBTI Issues

1. Assuming the fund is subject to restrictions on the incurrence of UBTI, consider whether the fund's allocations are "fractions rule" compliant
   (a) Limited applicability: only for pension plans, educational organizations, 501(c)(25) organizations and church retirement accounts
   (b) No sale-leaseback investments
   (c) No seller-financed investments
   (d) No contingent purchase price
2. Common aspects of an investment (other than leverage) that could give rise to UBTI
   (a) Use of leverage
   (b) "Flipping" a property
   (c) Converting a property to condominiums and disposing of the condominium units
   (d) Developing and disposing of a property
   (e) Operating a parking facility or a similar "service" business

C. Use of REITs

1. 100% excise tax imposed on REITs for income earned from prohibited transactions: e.g., "flipping a property," converting a property into inventory, such as a conversion of a fee interest into condominiums and disposing of the condominium units, developing and disposing of a property.

2. Operating a parking facility or a similar "service" business which is over and above those services customarily furnished or rendered in connection with the rental of real property.

3. Pension-held REITs and closely held REITs present their own sets of issues.

D. Structuring the transaction should take into account the tax needs of non-U.S. investors.

1. *Leveraged-Blocker*. A single leveraged-blocker is the simplest structure for non-U.S. investors to use but is not the most tax efficient. The use of such a blocker avoids the need for a non-U.S. investor to file a U.S. federal income tax return or to pay branch profits taxes. Non-U.S. investors who own less than 10% of the blocker may receive interest payments from the blocker free of U.S. withholding tax. Non-U.S. investors who own 10% or more of the blocker need to rely on tax treaties or they will be subject to a 30% withholding tax. The blocker is subject to U.S. corporate income tax at regular corporate rates reduced by allowable interest deductions. During the life of the fund, cash can be repatriated through: (i) interest payments (as described above); (ii) tax-free principal pay-down (at the cost of reducing future interest deductions); or (iii) dividends subject to 30% withholding tax, or lower if a treaty rate is applicable. Upon the liquidation of the fund, the blocker can also be liquidated, so that it can distribute cash without being subject to a 30% withholding tax.

    (a) In structuring the leverage for the blocker, attention needs to be given to the AHYDO rules and the new Section 163(j) limitation on interest deductions. In many scenarios, a blocker invested in a real estate fund will be able to rely on the "real property trade or business" exemption from the Section 163(j) limitation.

    (b) A disposition of an interest in the fund by a non-U.S. investor during the life of the blocker entity may subject such investor to: (i) net income tax in the U.S.; (ii) branch profits tax (to the extent that the investor is a corporate entity); and (iii) U.S. tax filings.

2. *Multiple Leveraged-Blockers*. In this variation of the leveraged-blocker structure, each property investment of the fund is made in a separate leveraged-blocker. The advantage of the multiple leveraged-blockers is that at the end of the life of each investment (as opposed to the liquidation of the fund) the blocker liquidates, allowing the cash to be repatriated tax-free.

3. *Domestically-Controlled REITs*. Under an exception to the FIRPTA rules, a non-U.S. investor that disposes of shares in a domestically controlled REIT is not subject to U.S. tax. Ideally, each REIT owns a single property to facilitate the disposition of each property. Disposing of a REIT is more complex than a disposing of the actual real estate asset itself. Distributions from the REIT that are not attributable to the disposition of real property, however, are subject to a 30% withholding tax or lower treaty rate.

E. Unblocked fund investments may, however, result in investors having to make filings in multiple states.

1. Investors will most likely be required to file a tax return in each state in which the fund owns a property.

2. Investing through a REIT or a leveraged blocker may avoid the need for investors to file tax returns in multiple states.

V. ERISA Issues

A. Many real estate private equity funds have limited partners that are pension plans that are subject to the Employee Retirement Income Security Act ("ERISA"). This can have significant implications for the manner in which the underlying investments by these funds must be structured.

B. If a private fund raises capital from an ERISA-regulated investor and fails to satisfy certain regulatory exceptions, the private fund may be deemed itself to hold directly the assets of the ERISA-regulated investor ("plan assets"). If this happens, the fund manager is deemed to be an ERISA fiduciary and will be subject to complex conflict-of-interest rules and transactional prohibitions that may make the fund very difficult to operate.

C. There are three exceptions to these rules that real estate funds typically rely upon:

1. *The "25% test."* A fund with one or more ERISA investors will not be deemed to hold "plan assets" if, immediately after the most recent acquisition of any equity interest in the fund, not more than 25%of the value of any class of equity interests in the fund (each tested separately) is held by ERISA investors. There are a few interpretive tricks in applying these rules. Among other things, each class of interests must be tested separately, which means limited partner interests are tested separately (i.e., excluding the general partner's interest), and if there are deemed to be different classes of limited partner interests issued by the fund, each class is also tested separately. Also, affiliates of the general partner (including entities managed by the general partner) holding interests in any class are normally excluded from the denominator for purposes of testing that class. In the case of an arrangement involving related funds that invest in parallel, each fund is tested separately, but they may need to be tested together if investors' capital commitments appear to be divided among the parallel vehicles to get around the rule.

2. *Real Estate Operating Company* ("REOC"). A private fund will be deemed to be a REOC, and therefore will not be deemed to hold plan assets, if, among other things, more than 50% of its investments, valued at historical cost, are real estate assets over which it obtains the right to participate directly in their management and development (so-called, "qualifying investments"), and the fund actually is engaged directly in real estate management or development activities in the ordinary course of its business. Hence, not every investment made by a REOC must be a "qualifying investment." Once again there are several nuances that must be understood by deal counsel. Among other things:

   (a) These so-called "management rights" must be substantial. Hence, a typical triple-net sale/leaseback deal would not be a "qualifying investment," because these investments typically contemplate that the tenant, not the owner/landlord, will manage and operate the property. Investments in real estate related indebtedness are also often challenging to structure as qualifying investments.

   (b) The "50% test" in respect of qualifying investments must be met at the time at which a fund makes its first long term investment (i.e., investment other than in cash equivalents). Hence, if the first investment is not qualifying, the fund can never qualify as a REOC.

   (c) The "50% test" must be met once, annually, thereafter, during a 90-day window known as an "annual valuation period." However, care must be taken to attend to the timing of this testing, especially if not every investment is qualifying. This is especially true once the fund seeking to qualify as a REOC begins disposing of its investments.

3. *Venture Capital Operating Company* (*"VCOC").* The VCOC requirements are similar to the REOC requirements, but with slightly different nuances. A private fund will be deemed to be a VCOC if, among other things, more than 50%of its investments, valued at historical cost, are in operating companies as to which it obtains direct contractual management rights (so-called, "qualifying venture capital investments"). Once again, there are several nuances that must be understood by deal counsel. Among other things:

   (a) The fund must actually exercise such management rights in the ordinary course of business, as to at least one operating company.

   (b) Once again, the "50% test" in respect of qualifying investments must be met at the time at which a fund makes its first long-term investment. If the first investment is not qualifying, the fund can never qualify as a VCOC.

   (c) Although the DOL regulations use the words like "venture capital investments" in "operating companies," we and most other practitioners in this area believe that REOCs can constitute qualifying investments for VCOCs, because REOCs are treated as "operating companies" under the regulation. Hence, a real estate private equity fund can be structured so that, for example, the fund itself is a VCOC and its underlying joint ventures with local operating partners are REOCs. Note that a REOC, however, cannot treat an investment in an underlying REOC as a qualifying investment.

(d) Once again, the "50% test" must be met once, annually, during a 90-day annual valuation period.

(e) VCOCs have an advantage over REOCs in that they no longer have to pass the "50% test" once they are in their "distribution period." For these purposes, a VCOC can elect to enter its distribution period once it has sold, and distributed the proceeds of, assets representing (by cost) 50% or more of the maximum amount it had ever invested (other than short-term investments). Hence, if a real estate fund is structured as a VCOC, rather than a REOC, and not all of its investments are qualifying, once the fund has sold most of its qualifying investments (measured at cost), it can still hold non-qualifying investments without being deemed to hold plan assets. This advantage affords more flexibility in managing a fund's exit strategies.

(f) *The Takeaway*. In connection with each acquisition and disposition (as well as documents containing ERISA representations and/or covenants), deal counsel should be aware of a fund's ERISA compliance strategy and should consult with fund and ERISA counsel should any of the foregoing issues arise.

VI. Conflict Issues

A. Duty to Provide Investment Opportunities

1. The fund must be given the opportunity to make an investment before the general partner or its affiliates are allowed to participate in the investment.

2. Parallel funds typically invest pro rata, except for designated exceptions.

3. If the fund reaches its concentration limit, the general partner could participate in co-investments if expressly permitted by the governing fund agreement.

B. Expense Allocation

1. If multiple funds participate in the same investment at different times during the life of the investment, allocating expenses equitably may provide conflicting incentives. Additionally, funds that have not yet begun their investment periods may be asked to bear broken-deal expenses for unconsummated investments in which they have not yet, but would have, participated.

2. Allocating expenses proportionately to co-investors may not always be possible or reasonable, depending on the circumstances surrounding the applicable co-investment and the financial and other terms (including the timing of the investment) governing the relationship of the co-investor to the funds with respect to the portfolio investment.

C. Property Servicing Arrangements With Affiliates

1. If an affiliate of the general partner will provide property management or other services, the governing fund agreement should allow for such arrangement without offsets to management fees.

2. The governing fund agreement may require that such services be provided at market rates.

3. Consider defining property servicing rates up front with the right to seek approval from the LP Advisory Committee.

D. Other Transactions With Affiliates

1. If an affiliate of the fund already has an investment in the property, proper conflicts clearance is required.

2. If the seller of a property to be acquired by a fund is an affiliate of the fund, proper conflicts clearance is required.

E. Investments in Different Elements of the Capital Structure

1. The fund and an affiliate of the fund may invest in different layers of the capital structure of a portfolio investment.

2. Equity holders and debt holders of a particular investment may have conflicting interests during the term of such an investment, especially if the investment is underperforming.

3. Holders of different tranches or types of debt or equity of an investment may face conflicting interests, as well, including with respect to liquidating an investment.

F. Valuation

1. Given the often illiquid nature of real estate investments, valuation of a fund's investments may present conflicts for a fund and its manager, especially when the valuation affects compensation.

2. Fund managers may want to provide investors with access to their valuation policy and allow transparency into any future revisions. The use of broker price opinions should be expressly disclosed if applicable.

3. Valuation matters are especially crucial for open-end real estate funds.

VII. Regulatory Considerations

A. Investment Company Act of 1940

1. The fund may not meet the real estate fund definition under the Investment Company Act.

2. Investments made through tiered structures are likely to result in the fund's not being able to take advantage of the real estate fund exemption ("3(c)(5)(C)" exemption) under the Investment Company Act. Reliance on this exemption also results in limitations on the composition of a fund's portfolio that do not arise for funds relying on the 3c1 exemption or the 3c7 exemption described below.

3. Thus, if the fund does not qualify for the real estate fund exemption, it will need to rely on the "3(c)(1)" exemption (i.e., the fund must not have more than 100 beneficial owners) or the "3(c)(7)" exemption (i.e., all of the fund's investors must be qualified purchasers) to avoid having to register as an investment company.

4. Investors subject to the Volcker Rule are likely to be sensitive to the fund's choice of exemption, as the Volcker Rule prohibits certain investors from participating in funds that rely on 3(c)(1) or 3(c)(7) exemptions and can result in limitations on a fund's ability to engage in transactions with counterparties affiliated with the relevant Volcker rule-subject investor.

B. Investment Advisers Act of 1940

Because the assets under management in a 3c1 or 3c7 fund count as regulatory assets under management for Advisers Act purposes, the majority of fund managers advising real estate funds are registered with the SEC as investment advisers.

C. CFIUS

Enacted in late 2018, the Foreign Investment Risk Review Modernization Act ("FIRRMA") expands the jurisdiction and powers of the Committee on Foreign Investment in the United States ("CFIUS"), the U.S. interagency committee that conducts national security reviews of foreign investment in the United States. FIRRMA authorizes CFIUS to review certain transactions by foreign investors in certain real estate in close proximity to air or maritime ports, military installations or other sensitive national security facilities. Accordingly, certain investments by a fund that include non-U.S. investors could be subject to CFIUS jurisdiction.

D. Insurance Companies

One relatively new structure involves offering rated debt securities in a real estate fund to insurance companies. If structured properly, these investments can enable insurance companies to invest in a traditional fund structure while taking advantage of the favorable regulatory capital treatment of debt.

VIII. Conclusion

A. When structuring a real estate fund or venture, many complex, interrelated and multidisciplined issues can arise that make it critical for investment managers to select a team of fund and deal counsel who work closely with one another, as well as specialized tax, ERISA and Investment Company Act counsel, as necessary.

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Clients often seek David's advice on business matters and strategy and to assist on difficult negotiations. For many years, he has been named a "Leader in His Field" by *Chambers Global* and *Chambers USA* and has been recognized by *The International Who's Who of Private Funds Lawyers*, *PLC Cross-border Private Equity Handbook*, *The Legal 500 US* and *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*. A past member of the Advisory Board of The Financial Executives Alliance and the Banking Law Committee of the New York City Bar Association, David is a sought-after writer and speaker. Works he has authored or co-authored include the chapter "Management Company Structures and Terms" in *Hedge Funds: Formation, Operation and Regulation*, published by *ALM Law Journal Press*; "Just Like Starting Over: A Blueprint for the New Wall Street Firm," published by *The Deal*; and "Succession Planning," published by SRZ. He has spoken at conferences and seminars on a range of topics, including fundraising, merchant bank structures, liquidity events, credit and lending funds and co-investment vehicles. David received his J.D. from Brooklyn Law School and his B.A. from the State University of New York at Albany.

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Michael has been recognized by his peers and clients in *Benchmark Litigation: The Definitive Guide to America's Leading Litigation Firms and Attorneys*, *The Legal 500 US* and *New York Super Lawyers* in the area of business litigation. His litigation victories have been featured in *The Hedge Fund Journal*, *Hedge Fund Legal and Compliance Digest* and, recently, the Litigation Group, co-chaired by Michael, won *Law360's* "Asset Management Practice Group of the Year" for its representations of leading private investment funds. Michael's recent publications include contributing to *The Activist Investing Annual Review 2019* and co-authoring the "Information Sharing with Market Professionals" chapter in the *Insider Trading Law and Compliance Answer Book 2019* (Practicing Law Institute). Michael is a member of the Executive Committee of the Board of the Lawyers' Committee for Civil Rights Under Law. He is also a former law clerk to the Hon. Irving R. Kaufman, Circuit Judge for the U.S. Court of Appeals for the Second Circuit. Michael received his J.D. from Columbia Law School, where he was editor of the *Columbia Law Review*, and received his B.A., *magna cum laude*, from the University of California, Los Angeles.

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Pete is a fellow of the American College of Trial Lawyers. A recipient of the Department of Justice Director's Award for Superior Performance as an Assistant U.S. Attorney, Pete has performed with comparable skill as a private practitioner. Among the many publications that have recognized him as a leading litigator are: *The Best Lawyers in America* (corporate compliance law, criminal defense: white collar, and litigation securities), *Chambers USA*, *Ethisphere: Attorneys Who Matter*, *The Legal 500 United States*, *Washington DC Super Lawyers*, *Washingtonian's* "Washington's Top Lawyers" (criminal defense, white collar) and *The Washington Post* ("Their Own Defense," June 18, 2007). Pete obtained his J.D. from the University of Virginia School of Law, where he was Order of the Coif and on the management board of the *Virginia Law Review* and his B.A., with high honors, from University of Notre Dame. Upon graduation, he had the distinction of serving as a law clerk to the Hon. Richard L. Williams of the Eastern District of Virginia.

Litigation and Enforcement

I. Introduction

This outline summarizes enforcement actions, priorities and trends exhibited by the SEC, DOJ and other regulatory and enforcement authorities who administer the federal securities laws and related statutes, with a focus on issues affecting private funds. It also discusses private securities and M&A litigation relevant to private funds.

First, this outline recaps guidance for investment advisers and companies from the SEC's Office of Compliance Inspections and Examinations ("OCIE") before reviewing SEC enforcement statistics for 2019 and SEC enforcement priorities for 2020. Next, it provides updates on a change and a court challenge to different SEC policies regarding settlements, as well as on the consequences of four recent appellate decisions. After that, this outline analyzes the actions brought by the Enforcement Division in 2019 relevant to private funds. This outline then summarizes enforcement actions and other developments in the areas of insider trading, foreign bribery, sanctions and anti-money laundering. Finally, this outline examines significant court decisions affecting private securities and M&A litigation before ending with a discussion of the litigation risk to which private funds may be exposed through their portfolio companies.

II. OCIE

A. Examination Statistics for FY2019

1. OCIE completed 3,089 examinations in FY2019, a 2.7% decrease from FY2018.
2. OCIE completed 2,180 examinations of registered investment advisers ("RIAs") in FY2019, covering 15% of the population.
3. Examinations of investment companies increased in FY2019 by approximately 12% to over 150.
4. OCIE completed over 350 examinations of broker-dealers, 110 examinations of national securities exchanges and over 90 examinations of municipal advisers and transfer agents.
5. OCIE so far has made more than 150 enforcement referrals from FY2019 examinations.
   (a) OCIE reports that its examinations and referrals to the Enforcement Division have resulted in "dozens of settled actions against advisers to private funds."
6. Examinations closed in FY2019 have resulted in firms returning more than $70 million to investors.

B. OCIE's Examination Priority Relating to Private Funds for 2020[1]

OCIE will continue to focus on RIAs to private funds that have a greater impact on retail investors, such as firms that provide management to separately managed accounts side-by-side with private funds. Moreover, OCIE will review RIAs to private funds to assess compliance risks, including controls to prevent the misuse of material, non-public information and conflicts of interest, such as undisclosed or inadequately disclosed fees and expenses and the use of RIA affiliates to provide services to clients.

C. OCIE's Other Examination Priorities for 2020[2]

1. Protection of retail investors, including seniors and those saving for retirement, with a focus on:
   (a) Intermediaries that serve retail investors (e.g., RIAs, broker-dealers and dually-registered firms), including proper procedures and disclosures related to fees, expenses and conflicts of interest;

[1] 2020 Examination Priorities, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission (Jan. 7, 2020), available here.

[2] *Id.*

(b) Investments marketed to, or designed for, retail investors, such as mutual funds, exchange-traded funds, municipal securities and other fixed-income securities, and microcap securities (securities of companies with a market cap of <$250 million).

2. Information security, with areas of focus including (1) governance and risk management, (2) access controls, (3) data loss prevention, (4) vendor management, (5) training and (6) incident response and resiliency;

3. Financial technology (fintech) and innovation, including digital assets and electronic investment advice;

4. Additional focus areas involving registered investment advisers and investment companies:

   (a) RIA compliance programs;

   (b) Never-before and not recently examined RIAs;

   (c) Mutual funds and ETFs; and

   (d) RIAs to private funds (see above description).

5. With respect to broker-dealers and municipal advisers, the safety of customer cash and securities, risk management, certain types of trading activity, the effects of evolving commissions and other cost structures, best execution and payment for order-flow arrangements;

6. Anti-money laundering programs;

7. Market infrastructure; and

8. FINRA and MSRB.

D. Investment Adviser Issues Identified by OCIE in 2019 Risk Alerts

1. Issues Related to Principal and Agency Cross Trading[3]:

   (a) Failure to satisfy the requirement of Advisers Act Section 206(3)[4] (i.e., failing to obtain appropriate prior client consent for each principal trade and failing to provide sufficient disclosure regarding the potential conflicts of interest and terms of the transaction).

   (b) Failure to comply with Section 206(3) for principal trades involving a pooled investment vehicle that either is significantly owned by the adviser or is a client of the adviser.

   (c) Engaging in agency cross transactions even though the adviser had stated to clients that it would not engage in such transactions.

   (d) Failure to comply with the requirements of Rule 206(3)-2, which permits certain agency cross transactions without requiring transaction-by-transaction disclosure and consent.

   (e) Failure to adopt and implement policies and procedures relating to Section 206(3).

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[3] OCIE Risk Alert, Investment Adviser Principal and Agency Cross Trading Compliance Issues (Sept. 4, 2019), available here.

[4] Section 206(3) makes it unlawful for any investment adviser, directly or indirectly, acting as principal for his own account knowingly to (a) sell any security to a client or (b) purchase any security from a client ("principal trades"), without disclosing to such client in writing before the completion of such transaction the capacity in which the adviser is acting and obtaining the consent of the client to such transaction. Section 206(3) requires an adviser entering into a principal trade with a client to satisfy these disclosure and consent requirements on a transaction-by-transaction basis — blanket disclosure and consent are not permitted. Section 206(3) also prohibits an adviser, directly or indirectly, acting as broker for a person other than the advisory client, from knowingly effecting any sale or purchase of any security for the account of that client ("agency cross transactions"), without disclosing to that client in writing before the completion of the sale or purchase the capacity in which the adviser is acting and obtaining the consent of the client to the sale or purchase.

2. Compliance Issues Regarding Disciplinary Events[5]:
   (a) Failure to fully disclose information regarding disciplinary events of supervised persons or the adviser itself.[6]
   (b) Failure to adopt and implement compliance policies and procedures addressing the risks associated with employing individuals with prior disciplinary histories.
3. Failure to supervise persons with oversight and compliance responsibilities.[7]
4. Failure to Implement Compliance Policies and Procedures:[8]
   (a) Areas of inconsistent compliance practices most frequently cited by the staff: solicitation fees, management fees, compensation related to hiring personnel and oversight of firm compensation practices.
5. Failure to perform or adequately document annual compliance reviews.[9]
6. Disclosure of conflicts of interest, especially those related to compensation arrangements.[10]
7. Compliance issues related to regulation S-P[11]:
   (a) Failure to provide accurate privacy and opt-out notices to customers.
   (b) Failure to adopt and implement written policies and procedures that address administrative, technical and physical safeguards for the protection of customer records and information as required by Regulation S-P's Safeguards Rule.

E. Investment Company Issues Identified by OCIE in 2019 Risk Alerts[12]:
1. Fund Compliance Rule[13] Issues:
   (a) Failure of compliance programs to take into account the nature of funds' business activities.
   (b) Failure to follow or enforce policies and procedures.
   (c) Inadequate oversight of service providers (e.g., investment adviser, underwriter).

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[5] OCIE Risk Alert, Observations from Examinations of Investment Advisers: Compliance, Supervision, and Disclosure of Conflicts of Interest (July 23, 2019), available here.

[6] All registered advisers must promptly disclose in Form ADV certain legal or disciplinary events that would be material to a client's or a prospective client's evaluation of the adviser's integrity or its ability to meet its commitments to clients. *See* Amendments to Form ADV, Advisers Act Release No. 3060 (July 28, 2010).

[7] OCIE Risk Alert, Observations from Examinations of Investment Advisers: Compliance, Supervision, and Disclosure of Conflicts of Interest (July 23, 2019).

[8] *Id.*

[9] *Id.*

[10] *Id.*

[11] OCIE Risk Alert, Investment Adviser and Broker-Dealer Compliance Issues Related to Regulation S-P – Privacy Notices and Safeguard Policies (April 16, 2019), available here.

[12] OCIE Risk Alert, Top Compliance Topics Observed in Examinations of Investment Companies and Observations from Money Market Fund and Target Date Fund Initiatives (Nov. 7, 2019), available here.

[13] The fund compliance rule requires a fund to adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws by the fund, including policies and procedures that provide for the oversight of compliance for each investment adviser, principal underwriter, administrator and transfer agent of the fund (collectively, "service providers"). In addition, the fund board must approve the policies and procedures of the fund's service providers. The rule also requires that each fund annually review the adequacy and effectiveness of the policies and procedures of the fund and its service providers and the effectiveness of their implementation. The fund's chief compliance officer must also annually provide a written report to the fund board that addresses, among other things, the operation of the policies and procedures and material changes to those policies and procedures.

(d) Failure to perform annual reviews or address the adequacy of funds' policies and procedures

2. Issues related to disclosure to investors (e.g., failing to disclose the payment of fees to service providers or a change to an investment strategy).

3. Issues with the section 15(c) process[14]:

   (a) Failure to request or consider information reasonably necessary to evaluate a fund's investment advisory agreement.

   (b) Failure to adequately discuss or document the material factors and conclusions forming the basis for the board's approval of an investment advisory agreement.

4. Issues related to the fund code of ethics[15]:

   (a) Failure to implement the code of ethics through procedures designed to prevent violations (e.g., no procedures adequate to prevent access persons from misusing material non-public information).

   (b) Failure to follow or enforce the code of ethics (e.g., failing to collect or review personal securities holdings and transactions reports of the fund's access persons).

   (c) Failure of board to approve code of ethics.

   (d) Failure to provide board with required annual report regarding code of ethics violations and sanctions.

III. SEC Enforcement Overview

A. Actions

1. The SEC filed 526 standalone enforcement actions in FY2019, the most since FY2016; but 95 were self-reported by companies under the Share Class Selection Disclosure Initiative ("SCSD") (see § II.A). Without these self-reported cases, the number of standalone actions would have been the SEC's lowest of the last five years, which is not surprising given the 35-day government shutdown early in the year.[16]

2. The largest portion of the Enforcement Division's actions involved investment advisers and investment companies (36%), though that figure includes SCSD Initiative cases. Excluding SCSD cases, the most numerous type of action was those involving securities offerings, a large portion of which involved some form of pyramid or Ponzi scheme directed at retail investors (21%). Issuer reporting/accounting and auditing matters were the third most common type of enforcement action in FY2019 (17%).[17]

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[14] Section 15(c) of the 1940 Act requires a majority of the fund's independent directors to approve the fund initially entering into, or renewing, a contract or agreement with a person who undertakes regularly to serve or act as an investment adviser of or a principal underwriter for such fund. As part of this approval process, all board members of the fund have a duty to request and evaluate information that may be reasonably necessary for the board to evaluate the terms of the adviser's contract. In addition, the fund is required to preserve any documents or other written information its board considered in approving the terms or renewal of the contract or agreement between the fund and the adviser. Following a board's approval or renewal of an advisory contract, a fund's next shareholder report must discuss in reasonable detail the material factors and conclusions that formed the basis for the board's approval or renewal.

[15] The fund code of ethics rule requires funds, in addition to other entities, to adopt a written code of ethics containing provisions reasonably necessary to prevent their "access persons" from engaging in any fraudulent, deceptive or manipulative acts in connection with the purchase and sale of securities held or to be acquired by the fund. The rule also generally requires access persons to report their personal securities holdings and transactions in "covered securities" to the fund. 1940 Act Rule 17j-1.

[16] 2019 Annual Report, Division of Enforcement, U.S. Securities and Exchange Commission, at 14, available here.

[17] *Id.* at 15.

3. There was a marked decline in insider trading enforcement actions: 30 standalone cases (compared to 51 in FY2018).[18]

B. Remedies

1. The median amount of total combined monetary sanctions ordered in FY2019 was over $550,000, the highest in the last five years. The median penalty amount was $200,000 and the median disgorgement amount was $694,663.[19]

2. The 5% of cases that involved the largest financial remedies accounted for 70% of the financial remedies obtained by the SEC, which is in line with the previous five years.[20]

3. 69% of standalone actions, excluding actions brought as part of the SCSD Initiative (which applied only to entities), involved charges against one or more individuals, which is in line with the percentage from the last several fiscal years.[21]

4. Enforcement actions resulted in 595 bars and suspensions of wrongdoers in FY2019, an increase from FY2018.[22] Trading suspensions held steady from last year (271 in FY2019 versus 280 in FY2018).[23]

IV. SEC Enforcement Areas of Focus

A. Protecting Retail Investors

1. Share Class Selection Disclosure Initiative

The SCSD Initiative targets failure by mutual funds to disclose conflicts of interest associated with the receipt of certain fees by the adviser for placing retail advisory clients in a 12b-1 fee paying share class when a lower-cost or no-cost share class of the same mutual fund was available for the clients. Investment advisers who self-report such disclosure failures receive standardized settlement terms, requiring disgorgement but no civil penalty. Since February 2018, the SEC has ordered 95 investment advisory firms to return more than $135 million to investors.[24]

B. Cryptocurrency and Other Cyber-Related Issues

1. The SEC has continued to emphasize cryptocurrency and other cyber-related enforcement through its interdisciplinary Cyber Unit, which focuses on "violations involving distributed ledger technology, cyber intrusions, and hacking to obtain material, nonpublic information," as well as electronic market manipulation and unlawful trading schemes.[25]

2. This year saw an increase in enforcement actions involving cryptocurrencies, including actions targeting ICOs in violation of Securities Act registration requirements in addition to fraud cases.

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[18] *Id.* at 28.

[19] *Id.* at 16.

[20] *Id.* at 17.

[21] *Id.*

[22] "Bars and suspensions" refers to SEC orders prohibiting wrongdoers from serving as officers or directors of public companies, dealing in penny stocks, associating with registered entities such as broker-dealers and investment advisers, or appearing or practicing before the Commission as accountants or attorneys. *Id.* at 19.

[23] "The federal securities laws allow the SEC to suspend trading in any stock for up to ten trading days when the SEC determines that a trading suspension is required in the public interest and for the protection of investors." *Id.*

[24] Press Release 2019-28, "SEC Share Class Initiative Returning More Than $125 Million to Investors" (March 11, 2019), available here; Press Release 2019-200, "SEC Orders an Additional 16 Self-Reporting Advisory Firms to Pay Nearly $10 Million to Investors" (Sept. 30, 2019), available here.

[25] Press Release 2017-176, "SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors" (Sept. 25, 2017), available here.

Settlements with some of these ICO issuers establish a framework for future resolutions,[26] with remedies including:

(a) Establishing claims processes for harmed ICO investors, including notifying investors of their right to file claims;

(b) Registering the issuer's tokens with the SEC under Section 12(g) of the Exchange Act;

(c) Complying with applicable registration and reporting requirements; and

(d) No civil penalty for self-reporting unregistered offering to SEC.

3. The SEC has also brought a number of enforcement actions against third-party participants in digital asset offerings for violations of the anti-touting, broker-dealer registration and exchange registration provisions of the securities laws.[27]

C. Coordination with Law Enforcement[28]

1. The SEC has worked with federal and state criminal authorities to punish and deter certain types of securities law violators, including recidivists, microcap fraudsters, insider traders, Ponzi schemers and others who act with a high degree of scienter.

2. Other regulators and law enforcement offices requested and obtained access to SEC investigative files pertaining to more than 400 SEC investigations.

D. Accelerating the Pace of Investigations

1. In FY2019, the SEC took an average of just under 24 months to file an enforcement action after opening an investigation, slightly faster than last year. The SEC is striving to accelerate investigations and file enforcement actions sooner.[29]

2. The SEC was subjected to increased scrutiny by the D.C. Circuit for its delay in bringing an enforcement action against Volkswagen. The action was filed in March 2019, years after Volkswagen had resolved actions brought by other federal and state authorities and related civil actions. The D.C. Circuit ordered the SEC to file a declaration stating when it learned of each fact alleged in its complaint.[30]

E. Whistleblower Program

1. Since the program began in 2012, the SEC has awarded $387 million to 66 whistleblowers in actions resulting in more than $2 billion in financial remedies.[31]

2. The SEC received a record number of whistleblower claims in FY2019 and is working to streamline the process for evaluating claims for whistleblower awards.

3. Whistleblower awards can range from 10% to 30% of the money collected when the monetary sanctions exceed $1 million, providing a powerful incentive to potential whistleblowers to report

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[26] Press Release 2019-15, "Company Settles Unregistered ICO Charges After Self-Reporting to SEC" (Feb. 20, 2019), available here.

[27] Press Release 2018-268, Two Celebrities Charged with Unlawfully Touting Coin Offerings (Nov. 29, 2018), available here; Press Release 2019-181, SEC Charges ICO Incubator and Founder for Unregistered Offering and Unregistered Broker Activity (Sept. 18, 2019), available here; Press Release 2018-258, SEC Charges EtherDelta Founder with Operating an Unregistered Exchange (Nov. 8, 2018), available here.

[28] 2019 Annual Report, Division of Enforcement, U.S. Securities and Exchange Commission, at 7.

[29] *Id.*

[30] David Shepardson, "U.S. judge questions SEC on delay in filing Volkswagen suit," Reuters (May 10, 2019), available here.

[31] 2019 Annual Report, Division of Enforcement, U.S. Securities and Exchange Commission, at 8.

suspicions of misconduct and thus to regulated parties to implement effective, proactive compliance programs.[32]

4. In May, the SEC awarded more than $4.5 million to a whistleblower whose tip triggered the company to review the allegations as part of an internal investigation and subsequently report the whistleblower's allegations to the SEC. It was the first time the SEC made an award to a claimant under a provision of the whistleblower rules permitting claims by whistleblowers who first report a tip to a company if the whistleblower also reports the same tip to the SEC within 120 days.[33]

5. Last year in *Digital Realty Trust, Inc. v. Somers*, the Supreme Court held that Dodd-Frank's anti-retaliation provision applies only to whistleblowers who report misconduct to the SEC and not those who report misconduct internally. This ruling ultimately may harm companies by incentivizing prospective whistleblowers to report misconduct to the SEC before, or instead of, reporting it internally, thereby depriving companies of the opportunity to "get ahead of" an SEC investigation.

6. In July, the House passed H.R. 2515, the Whistleblower Protection Reform Act of 2019, which would extend the anti-retaliation provision to employees who report misconduct internally. The Senate has yet to take action on the bill.

V. Significant Developments Regarding Settlements with the SEC

A. Simultaneous Consideration of Settlement Offers with Waiver Requests

Some types of relief prescribed by settlements, such as an injunction against future violations of the securities laws or requiring an entity to retain an independent compliance consultant, can trigger regulatory disqualifications.[34] In many cases, the SEC has the authority to grant a waiver from these regulatory disqualifications. Parties seeking settlements often make waiver requests with their settlement offers.

During the previous administration, the SEC revoked the authority previously delegated to the regulatory divisions to decide waiver requests and required a party to make an unconditional offer of settlement without assurance that the Commission would grant the waiver. Because a potentially critical term of the settlement could not be negotiated, a party settling with the SEC was forced to accept the risk that the Commission would reject its waiver request and, as a result, the party would be bound by a settlement triggering a disqualification.

In July, the SEC announced a change in policy allowing prospective defendants negotiating a settlement that would trigger a regulatory disqualification to seek a waiver from such disqualification as part of settlement negotiations with the Commission.[35]

> "An offer of settlement that includes a simultaneous waiver request negotiated with all relevant divisions . . . will be presented to, and considered by, the Commission as a single recommendation from the staff."[36] Chairman Jay Clayton

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[32] SEC Press Release, "SEC Awards $4.5 Million to Whistleblower Whose Internal Reporting Led to Successful SEC Case and Related Action," (May 24, 2019), available here.

[33] SEC Press Release, "SEC Awards $4.5 Million to Whistleblower Whose Internal Reporting Led to Successful SEC Case and Related Action," (May 24, 2019), available here.

[34] These regulatory disqualifications may include loss of well-known seasoned issuer (WKSI) status for the purposes of securities offerings; loss of statutory safe harbors under the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act), for forward-looking statements, which were added by the Private Securities Litigation Reform Act of 1995 (PSLRA); loss of private offering exemptions provided by Regulations A, D and Crowdfunding under the Securities Act; loss of the exemption from registration under the Securities Act for securities issued by certain small business investment companies and business development companies provided by Regulation E; and the prohibition on a registered investment adviser from receiving cash fees for solicitation under Rule 206(4)-3 of the Investment Advisers Act of 1940 (Advisers Act).

[35] Statement by Chairman Jay Clayton Regarding Offers of Settlement (July 3, 2019), available here.

[36] *Id.*

Though the staff now may negotiate a settlement that includes a waiver from a regulatory disqualification, the Commission still may approve the settlement but not the waiver request. In those cases, however, the settlement would not be executed unless the prospective defendant decides to move forward with the part of the settlement offer that was accepted. If the prospective defendant does not so notify the staff, the settlement offer effectively would be deemed withdrawn and the party would not be bound by its terms.

B. Challenge to the "Neither-Admit-Nor-Deny" Settlement

Typically, a prospective defendant settles an enforcement action without admitting or denying the findings or allegations contained in a Commission order or complaint.

> "Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, **and without admitting or denying the findings herein**, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings . . . ." SEC Cease-and-Desist Order

In January, the Cato Institute filed a lawsuit challenging the constitutionality of this policy as a violation of a settlement defendant's First Amendment right to free speech. The Cato Institute's standing to bring the suit is premised on its desire to publish a manuscript in which the author accuses the SEC of coercing him into a settlement despite his belief that the charges against him were baseless.[37]

The SEC filed a motion to dismiss in May arguing, in part, that the Cato Institute failed to state a First Amendment claim because the no-deny provisions are freely negotiated and not imposed against a defendant's free will. The district court has not yet ruled on the SEC's motion to dismiss.

VI. Significant Appellate Rulings

A. Fallout from the Supreme Court's *Kokesh* Decision Continues[38]

In 2017, the Supreme Court unanimously held that a five-year statute of limitations applies to the SEC's authority to order disgorgement of ill-gotten gains from defendants in *Kokesh v. SEC*.[39] The SEC estimates this ruling has caused the Commission to forgo about $1.1 billion in disgorgement in filed cases.[40] More significantly, *Kokesh* has prompted the Enforcement Division to shift focus and resources to investigations of more recent misconduct, prioritizing actions with the greatest potential to return funds to investors.

In an ominous footnote to the *Kokesh* opinion, however, the Court hinted that it may welcome a challenge to the SEC's authority to obtain disgorgement at all, stating that its decision was limited to the applicability of the statute of limitations and did not reach the issue of "whether courts possess authority to order disgorgement in SEC enforcement proceedings . . . ."[41] So far, the Second Circuit has upheld disgorgement awards post-*Kokesh*.[42] But on November 1, the Supreme Court agreed to hear a case challenging the SEC's authority to collect disgorgement, with a decision likely to be issued by the end of June 2020.[43] A decision in favor of the petitioners in the Supreme Court would curtail the SEC's ability to pursue disgorgement in civil actions filed in federal court, which *Kokesh* has already limited to those within the statute of limitations.

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[37] *Cato Institute v. Sec. & Exch. Comm'n*, Case No. 1:19-cv-00047 (D.D.C. Jan. 9, 2019).

[38] *See Schulte Roth & Zabel Alert*, SEC's Disgorgement Authority Under Review (Nov. 22, 2019), available here.

[39] *Kokesh v. Sec. & Exch. Comm'n*, 137 S. Ct. 1635 (2017).

[40] 2019 Annual Report, Division of Enforcement, U.S. Securities and Exchange Commission, at 21.

[41] *Kokesh*, 137 S. Ct. at 1642 n.3.

[42] *See,* e.g., *SEC v. Rio Tinto plc and Rio Tinto Limited, Thomas Albanese, and Guy Robert Elliott*, No. 17 Civ. 7994 (AT), 2019 WL 1244933, at *22 (S.D.N.Y. Mar. 18, 2019) (collecting cases).

[43] *SEC v. Liu*, 754 F. App'x 505, 509 (9th Cir. 2018), *cert. granted.*

But such a decision would soon be rendered obsolete if Congress were to grant the SEC express authority to seek disgorgement, and members of Congress have already advanced new legislation to do just that. On Nov. 18, 2019, the House of Representatives passed the Investor Protection and Capital Markets Fairness Act (H.R. 4344) with wide bipartisan support. The bill would reaffirm the SEC's statutory authority to seek disgorgement as a remedy in federal court, subject to a new 14-year statute of limitations. The bipartisan support indicates strong interest in expanding the enforcement authority and remedies currently available to the SEC in federal court.

A parallel measure was introduced in the Senate in March by Senators Mark Warner (D-Va.) and John Kennedy (R-La). That bill, the Securities Fraud Enforcement and Investor Compensation Act (S. 799), would authorize the SEC to seek disgorgement, subject to the existing five-year statute of limitations. Significantly, the bill would also grant the SEC authority to seek restitution of losses sustained by investors resulting from securities law violations, subject to a 10-year statute of limitations. Restitution has the potential to be a much more powerful financial remedy than disgorgement, as the financial benefit to a defendant can be far less than the harm alleged by a class of investor-victims. The Senate has referred the bill to the Committee on Banking, Housing and Urban Affairs, which has yet to take any further action as of Jan. 10, 2020.

B. *Robare Group, Ltd. v. SEC*

On April 30, 2019, the D.C. Circuit held that in order to establish a "willful" violation of Section 207 of the Investment Advisers Act of 1940, the SEC must prove that the investment adviser was more than merely negligent.[44]

The SEC had found that the defendants had willfully omitted a material fact (specifically, certain conflicts of interest) in their Form ADV registration, even though the Commission found that the failure to disclose constituted negligence and not intentional fraud. Following an earlier D.C. Circuit decision, the Commission interpreted "willfulness" to mean intentionally committing an act which constitutes the violation, regardless of whether the offender is aware that he/she is violating the law. In *Robare Group*, the D.C. Circuit clarified that negligent conduct cannot constitute a "willful" violation of Section 207. Rather, at least one individual must have subjectively intended to omit the material information from the Form ADV.[45]

It remains to be seen whether the decision will be extended to other securities law provisions requiring a willfulness finding, such as Exchange Act Sections 15(b)(4)[46] and (b)(6)[47] and Advisers Act Sections 203(e)[48] and (f).[49] Thus far, the SEC has taken the position that *Robare Group* is limited to Advisers Act Section 207.[50]

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[44] *Robare Grp. v. Sec. & Exch. Comm'n*, 922 F.3d 468 (D.C. Cir. 2019).

[45] Still, negligently drafted or omitted statements in Form ADVs are subject to liability under Section 206(2) and the SEC may initiate cease-and-desist proceedings under Section 203(k) and obtain monetary penalties.

[46] Exchange Act Section 15(b)(4) applies to willful misstatements of material facts or omissions to state a material fact in registrations or reports filed by broker-dealers.

[47] Exchange Act Section 15(b)(6) applies to willful violations of Commission orders barring a person from being associated with broker-dealers, investment advisers and various other securities professionals.

[48] Advisers Act Section 203(e) applies to willful misstatements of material facts or omissions to state a material fact in registrations or reports filed by investment advisers.

[49] Advisers Act Section 203(f) applies to willful violations of Commission orders barring a person from being associated with an investment adviser.

[50] *See,* e.g., *In the Matter of Hefren-Tillotson, Inc.*, File No. 3-19514 (Sept. 25, 2019), n.3 ("'Willfully,' for purposes of imposing relief under Section 203(e) of the Advisers Act and Section 15(b)(4) of the Exchange Act, 'means no more than that the person charged with the duty knows what he is doing.'") (quoting *Wonsover*).

C. *Lorenzo v. SEC*

In March, the Supreme Court held that someone who knowingly disseminates a false or misleading statement made by another person can be primarily liable under the fraudulent scheme provisions of Rule 10b-5(a) and (c).[51] The decision clarifies the scope of the Court's 2011 decision in *Janus Capital Group, Inc. v. First Derivative Traders*, which held that only the "maker" of a statement can be primarily liable for its falsity under Rule 10b-5(b).[52] The "maker" of a statement is the "person or entity with ultimate authority over the statement."

> Rule 10b-5(a) extends liability to those who participate in a "device, scheme, or artifice to defraud," while Rule 10b-5(c) applies to participants in an "act, practice or course of business" that "operates . . . as a fraud or deceit."

In *Lorenzo*, an employee of a registered broker-dealer, at the request of his boss, sent two emails to potential investors using his boss's exact language, which the employee knew misrepresented the valuation of a company. Under *Janus*, the employee could not be held primarily liable under Rule 10b-5(b) because his boss, not he, was the "maker" of the statement. But the Court found that the employee could be primarily liable under Rule 10b-5(a) and (c) for disseminating statements he understood to be false to investors.

While the *Lorenzo* decision allows the SEC and private plaintiffs to seek primary liability for securities fraud from more prospective defendants, it may have limited practical effect on SEC enforcement actions because the Commission already can bring actions against such prospective defendants for secondary liability for aiding and abetting or causing a violation by another.[53]

But the ruling may have significant consequences for private securities litigation, where private plaintiffs, who cannot recover for secondary liability, may be able to seek recovery from more defendants by alleging participation in a fraudulent scheme.

D. *SEC v. Scoville*

In January, the Tenth Circuit held that the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") allows the SEC and DOJ to bring fraud claims and claims under Section 17 of the Securities Act based on sales of securities that do not qualify as domestic transactions if the defendant engages in fraudulent conduct within the United States.[54]

The Tenth Circuit's decision resulted from an SEC civil enforcement action against Scoville and the company he founded, Traffic Monsoon LLC, alleging that the business was actually a Ponzi scheme. Traffic Monsoon sold "Adpacks," which offered the buyer visits to the buyer's website in order to improve the site's ranking in search engine search results, as well as the opportunity to share in Traffic Monsoon's revenue up to a maximum amount of $55. As a result, the Tenth Circuit held that Monsoon's Adpacks were investment contracts and thus securities subject to the anti-fraud provisions of the Securities Act and Exchange Act.

The defendants argued that under the Supreme Court's decision in *Morrison v. National Australia Bank Ltd.*,[55] the anti-fraud provisions of the federal securities laws did not apply to the sale of Adpacks to

[51] *Lorenzo v. Sec. & Exch. Comm'n*, 139 S. Ct. 1094 (2019).

[52] *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135, 142 (2011).

[53] "Congress defined aiding and abetting liability to be the provision of "substantial assistance" to a securities law violator. It is important for us and the courts not to ascribe primary liability to every violation and thus write aiding and abetting out of the statute. Instead, we have to think carefully about where the line between primary and secondary liability lies in particular cases. Even substantial conduct may not qualify as a primary violation." Speech by Commissioner Hester M. Peirce, "Reasonableness Pants," (May 8, 2019), available here.

[54] *Sec. & Exch. Comm'n v. Scoville*, 913 F.3d 1204 (10th Cir. 2019).

[55] *Morrison v. National Australia Bank Ltd.*, 561 U.S. 247 (2010), held that the anti-fraud provisions of the federal securities laws apply only to transactions in securities listed on a U.S. exchange or transactions in other securities in the United States.

individuals outside the United States, which accounted for most of Traffic Monsoon's Adpack sales. The Tenth Circuit disagreed, holding that the Dodd-Frank Act, which was enacted less than a month after the *Morrison* decision, amended the anti-fraud provisions to allow for their extraterritorial application to foreign transactions if the wrongful conduct occurred in the United States or had a "foreseeable substantial effect" within the United States. This "conduct-and-effects" test was universally applied to determine the extraterritorial application of the securities laws prior to *Morrison*.

The Supreme Court denied a petition for *certiorari* in November.

VII. Recent SEC Enforcement Actions Against Investment Advisers

A. Overview of Key Enforcement Priorities

1. Conflicts of Interest
2. Failure to Seek Best Execution
3. Misstatements/Omissions
4. Excessive Fees
5. Valuation Issues
6. Allocation Issues
7. Insider Trading

B. Conflicts of Interest

1. *In the Matter of Talimco, LLC*[56]

Talimco, an investment adviser, breached its fiduciary duty to its client, a collateralized debt obligation ("CDO"), when the CDO sold a mortgage loan participation to another Talimco client, a commercial real estate investment fund created by Talimco. As the adviser to both the seller and buyer of the asset, Talimco had a conflict of interest. Talimco's COO convinced two unwilling parties to bid on the asset by assuring them that they would not win the auction, thereby depriving the CDO of the opportunity to receive multiple bona fide bids for the asset. The fund later sold the asset at a profit, resulting in fees for Talimco.

Talimco paid almost $83,000 in disgorgement and prejudgment interest and agreed to fully cooperate with any and all SEC investigations and other proceedings arising from the order.

2. *In the Matter of Foundations Asset Management, LLC* ("FAM")[57]

FAM, a registered investment adviser, improperly received approximately $254,000 in compensation from a private real estate fund and its manager while acting as an unregistered broker in violation of Section 15(a) of the Exchange Act. FAM solicited clients and recommended they invest in the real estate fund's promissory notes without disclosing the compensation arrangement between FAM and the fund, resulting in false and misleading statements in FAM's ADV Brochures in violation of Sections 206(2) and 207 of the Advisers Act.

FAM paid more than $278,000 in disgorgement and prejudgment interest, along with an $85,000 civil penalty. FAM also agreed to post a notice of the SEC settlement/order on its website and to relinquish its right to receive "trailing fees" for investments in the real estate fund.

[56] *In the Matter of Talimco, LLC*, Investment Advisers Act Rel. No. 5202 (March 15, 2019).

[57] *In the Matter of Foundations Asset Management, LLC*, Investment Advisers Act Rel. No. 86446 (July 24, 2019).

3. *In the Matter of MVP Manager LLC* (“MVP”)[58]

   MVP, a private fund manager whose funds invest in pre-IPO companies, on three occasions received brokerage commissions from counterparties selling pre-IPO company securities to MVP’s client funds. MVP failed to adequately disclose this conflict of interest to its client funds.

   MVP paid more than $169,000 in disgorgement and prejudgment interest, as well as a civil penalty of $80,000.

4. *In the Matter of Strategic Planning Group, Inc.* (“SPG”)[59]

   SPG, a registered investment adviser, invested its clients’ funds in the stock of a publicly traded company for which SPG’s principals previously had worked as outside consultants. Each of SPG’s two principals had provided consulting services to the public company for three years and received 100,000 shares of the company’s stock. SPG and its principals breached their fiduciary duty to SPG’s clients by failing to disclose the conflict of interest under which SPG’s principals had a potential incentive to invest SPG clients’ funds in the public company to support or increase the company’s stock price.

   SPG paid a civil penalty of $200,000.

5. *In the Matter of Fieldstone Financial Management Group, LLC* (“Fieldstone”)[60]

   From 2014 to 2016, Fieldstone, formerly a registered investment adviser, invested more than $7 million in securities issues by Aequitas Commercial Finance, LLC on behalf of 40 of its advisory clients. Fieldstone did so without disclosing to its clients that Aequitas had provided Fieldstone with a $1.5-million loan and access to a $2-million line of credit under terms that created an incentive for Fieldstone and its principal to recommend the Aequitas investments.

   Fieldstone and its principal were ordered to pay, jointly and severally, disgorgement and prejudgment interest totaling approximately $1.05 million along with a civil penalty of $275,000. Fieldstone’s principal was permanently barred from the securities industry.

C. Failure to Seek Best Execution

1. Section 206 of the Advisers Act imposes on investment advisers a fiduciary duty to act for the benefit of their clients. That duty includes, among other things, an obligation to seek best execution for client transactions — i.e., to seek the most favorable terms reasonably available under the circumstances.

2. *In the Matter of Lefavi Wealth Management, Inc.* (“LWM”)[61]

   LWM, a registered investment adviser, failed to seek best execution for its advisory clients by recommending and investing certain advisory client assets in non-traded real estate investment trusts, business development companies and private placements (collectively, “Alternative Investments”) at a higher share price that reflected a 7% commission, even though it could have invested the same client assets in the same Alternative Investments at a lower share price.

   LWM did not disclose that it could have invested advisory client assets in the same Alternative Investments at a lower share price, nor did it disclose the conflict of interest associated with its receipt of additional compensation for investing advisory client assets in Alternative Investments at a higher share price that included a commission.

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[58] *In the Matter of MVP Manager LLC*, Investment Advisers Act Rel. No. 5319 (Aug. 13, 2019).

[59] *In the Matter of Strategic Planning Group, Inc.*, David A. Rourke, and Jarrod A. Sherman, Investment Adviser Act Rel. No. 5363 (Sept. 24, 2019).

[60] *In the Matter of Fieldstone Financial Management Group, LLC*, Securities Act Rel. No. 10655 (July 1, 2019).

[61] *In the Matter of Lefavi Wealth Management, Inc.*, Investment Advisers Act Rel. No. 5336 (Sept. 3, 2019).

LWM paid more than $1.38 million in disgorgement and prejudgment interest, along with a $150,000 civil penalty.

3. *In the Matter of Hefren-Tillotson, Inc.* ("Hefren")[62]

   Hefren, a registered investment adviser and broker-dealer, received financial compensation of $1.95 per client trade from its unaffiliated clearing broker. Hefren received this compensation, which it failed to disclose to clients, by charging its clients more than what Hefren was charged by the clearing broker to clear and execute trades. The undisclosed compensation caused Hefren to violate its duty to seek best execution for its advisory clients.

   Hefren paid almost $300,000 in disgorgement and prejudgment interest and an $80,000 civil penalty.

D. Misstatements and Omissions

1. *SEC v. American Growth Funding II, LLC*[63]

   American Growth Funding II LLC ("AFG II"), an investment vehicle used to finance high-risk, high-interest loans, promised investors 12% annual returns and falsely claimed in its private placement memoranda ("PPMs") that its financial statements were being audited each year. AGF II also made misrepresentations in its PPMs about its management and concealed details about deteriorating loan values that could imperil full payment of the promised returns to investors.

   AGF II consented to entry of a judgment in the Southern District of New York requiring it to pay a civil penalty of $75,000 and disgorgement in the amount of $577,731, less amounts paid by AGF II to unaffiliated third parties.

   The SEC also charged the brokerage firm AGF II used as its placement agent for soliciting sales of AGF II securities despite the brokerage firm's knowledge that the PPMs were inaccurate. A jury ultimately found the brokerage firm and its principals liable for violating the antifraud provisions of the '33 and '34 Acts.[64]

2. *In the Matter of Garrison Investment Group, LP and Garrison Capital Advisers LLC* ("Garrison")[65]

   Garrison, a registered investment adviser with a combined $3.6 billion AUM, arranged a series of loan transactions in which its clients — a closed-end investment company and private funds — participated along with third-party co-investors. Under Rule 17d-1,[66] Garrison had to submit an application to the SEC in order for the closed-end investment company to be able to participate in the transactions.

   Garrison omitted from that application (i) the co-investment vehicles through which the co-investors would participate in the loan transactions and (ii) the fact that the Garrison entity advising the private funds would receive the co-investors' pro rata share of the upfront fee revenue (paid by the corporate borrowers), per agreement with the co-investors. Due to these omissions, the Co-Invest Order issued by the SEC did not include all participating Garrison affiliates and prohibited Garrison from receiving compensation from the loan transactions except for advisory fees. As a result, Garrison engaged in prohibited transactions.

   Garrison paid a $250,000 civil penalty.

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[62] *In the Matter of Hefren-Tillotson, Inc.*, Investment Advisers Act Rel. No. 5369 (Sept. 25, 2019).

[63] SEC Litigation Release No. 24382 (Jan. 25, 2019).

[64] SEC Press Release, "Jury Rules in SEC's Favor, Finds Brokerage Firm and Two of Its Executives Liable for Fraud" (May 15, 2019), available here.

[65] *In the Matter of Garrison Investment Group, LP and Garrison Capital Advisers LLC*, Investment Advisers Act Rel. No. 5345 (Sept. 13, 2019).

[66] Rule 17d-1 of the Investment Company Act prohibits any affiliate of a registered investment company from participating with the registered investment company in or effecting any joint enterprise or profit-sharing plan unless it first obtains an order from the SEC regarding the joint enterprise.

3. *In the Matter of Cetera Investment Advisers LLC* ("Cetera")[67]

Cetera, an investment adviser with $10.1 billion in AUM, paid cash fees to 350 banks for solicitation activities without ensuring that advisory clients were informed of the relationship between the adviser and the soliciting banks as required by the Solicitor Rule of the Advisers Act.

Rule 206(4)-3, the "Solicitor Rule," prohibits a registered investment adviser from paying a solicitor a cash fee for solicitation activities unless, among other things, the solicitor furnishes the client with a separate written disclosure document identifying the solicitor and the investment adviser, describing the nature of the relationship between the solicitor and the investment adviser, and specifying the terms of the compensation arrangement.

Cetera paid a $185,000 civil penalty.

E. Excessive Fees

1. *In the Matter of ECP Manager LP* ("ECP")[68]

ECP, a private equity fund adviser, charged excessive management fees following the write-off of a private equity fund investment. The shareholders agreement for the relevant fund provided that ECP's normal management fee of 2% per year of total invested capital contributions must be reduced as a result of certain triggering events, including write-offs of specific portfolio investments.

In June 2010, the fund received warrants on the common stock of an African mining company. The Fund's financial statements valued the warrants at zero beginning with the period ended March 31, 2014, and, in June 2014, the warrants expired as worthless. Nevertheless, ECP included approximately $3.41 million of invested capital contributions attributable to the warrants in the base amount used to calculate management fees that were charged to the fund after the warrants had expired. As a result, the fund was overcharged $102,304 in management fees.

ECP paid more than $122,000 in disgorgement and prejudgment interest.

2. *In the Matter of Corinthian Capital Group, LLC* ("Corinthian")[69]

Corinthian, a registered investment adviser with $270 million in AUM, failed to apply a $1.2 million management fee offset due to a private equity fund client for capital contributions made to finance an acquisition. Corinthian also caused the fund to overpay approximately $590,000 in organizational expenses by charging such fees based on estimates before they were actually incurred and by improperly classifying placement fees as organizational expenses. Last, Corinthian improperly used fund assets to fund its advisory operations.

Corinthian paid a civil penalty of $100,000, its CEO paid a civil penalty of $25,000 and its CFO paid a civil penalty of $15,000.

F. Valuation Issues

1. *SEC v. Direct Lending Investments, LLC*[70]

Direct Lending Investments ("DLI"), an investment adviser who advised a combination of private funds that invested in various lending platforms, for years arranged with one lending platform to falsify borrower payment information to make it appear that borrowers had made far more monthly payments than they actually had made. Using this falsified payment information, DLI overstated the valuation of its funds' position in the lending platform by approximately $53 million, resulting in the

[67] *In the Matter of Cetera Investment Advisers LLC*, Investment Advisers Act Rel. No. 5371 (Sept. 26, 2019).

[68] *In the Matter of ECP Manager LP*, Investment Advisers Act Rel. No. 5373 (Sept. 27, 2019).

[69] *In the Matter of Corinthian Capital Group, LLC*, Investment Advisers Act Rel. No. 5229 (May 6, 2019).

[70] *Direct Lending Investments, LLC*, Litigation Rel. No. 24432 (March 25, 2019), No. 2:19-cv-02188 (C.D. Cal. filed March 22, 2019).

misrepresentation of the funds' performance by 2–3% annually from 2014 to 2017. The SEC alleges that DLI collected approximately $11 million in excess management and performance fees from the funds as a result of the scheme.

The court has appointed a receiver for the funds. Disgorgement and penalty amounts have yet to be decided.

2. SEC enforcement action against private fund manager

A private fund manager ("fund manager") failed to adopt and implement compliance policies and procedures reasonably designed to conform valuations of fund assets with GAAP.

GAAP provides that assets should be valued at "fair value," which it defines as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." GAAP further provides that the methods used to measure fair value "shall maximize the use of relevant observable inputs and minimize the use of unobservable inputs," and that valuation models must be calibrated to relevant observable market data, including transaction prices, to ensure that they reflect current market conditions.

According to the SEC, the fund manager's valuation policy lacked procedures regarding how it should ensure consistency in measuring "fair value" in the context of the specific markets relevant to the fund and the specific types of inputs available to the fund manager. In fact, the fund manager's policy did not mention any valuation techniques or methodologies, nor did it mention the requirement that valuation models, upon which the fund manager relied heavily, must be calibrated to relevant observable market data. Moreover, the fund manager's Risk Management Committee lacked the expertise to determine whether bonds were valued in accordance with GAAP because none of the committee's three members had relevant experience in bond valuation.

The fund manager's valuation policy included a pricing-source protocol that prescribed when and how the fund manager was to use prices provided by third-party pricing vendors. According to the SEC, the pricing-source protocol gave significant discretion to the fund manager's traders as to when to use external prices, selection of pricing sources, and when and how to challenge prices provided by pricing sources, without adequate controls to address the potential conflict of interest arising from traders' ability to determine the fair value assessment of a portion of the positions they manage.

The SEC also stated that the fund manager failed to implement its existing valuation policy, finding that oversight of the valuation process was inadequate to ensure consistency and that valuations conformed with GAAP. For example, contemporaneous explanations for certain valuations include references to market activity at a higher price than the valuation and "sell[ing] for a profit when needed." As a result, the fund manager may have undervalued certain securities in its client fund's portfolio.

The fund manager agreed to pay a $5-million civil penalty, conclude its work with an independent compliance consultant and fully comply with the consultant's requests and schedule for submissions to the SEC.

G. Allocation Issues

1. *In the Matter of Laurel Wealth Advisors, Inc.* ("Laurel")[71]

Laurel, a registered investment adviser, failed to reasonably supervise an investment adviser representative ("IAR") who engaged in undisclosed "cherry-picking," a practice of fraudulently allocating profitable trades in an omnibus account to favored accounts.

[71] *In the Matter of Laurel Wealth Advisors, Inc.*, Investment Advisers Act Rel. No. 5330 (Aug. 26, 2019).

The IAR placed orders in his omnibus account to buy securities for allocation to his client or personal accounts, but he delayed the allocation of securities until after the trades were executed, by which time share prices had either increased or decreased such that those trades had unrealized profits on the trade date. The IAR allocated a disproportionate number of profitable trades to his personal accounts, while allocating a disproportionate number of unprofitable trades to his clients' accounts, resulting in the IAR receiving at least $56,227 in ill-gotten gains.

Laurel also failed to implement policies and procedures reasonably designed to prevent cherry-picking and other violations of the Advisers Act. For most of the period in which the IAR engaged in cherry-picking, Laurel had not yet implemented a compliance procedure that required IARs to pre-clear and obtain written approval before trading in their personal accounts, despite the fact that Laurel had stated throughout that entire period in its Forms ADV that it had such a procedure.

VIII. Insider Trading

A. Enforcement Statistics

1. The SEC brought 32 insider trading proceedings against 46 defendants in FY2019, including 22 civil actions and eight standalone administrative proceedings

2. Represents just 6% of standalone enforcement actions, down from 10% in FY2018

B. Second Circuit Appellate Developments

1. *United States v. Blaszczak*

On Dec. 30, 2019, the Second Circuit handed down a ruling making it easier for the Department of Justice to criminally prosecute insider trading in the context of registered securities.[72] In *U.S. v. Blaszczak*, the defendants had been acquitted of Title 15 securities fraud but found guilty of Title 18 securities fraud. The Title 15 securities fraud provisions were enacted by the Exchange Act of 1934 and implemented by Rule 10b-5. The Title 18 securities fraud provisions, appearing at 18 U.S.C. § 1348, are much newer, enacted as part of the Sarbanes-Oxley Act of 2002. Both the Title 15 and Title 18 fraud provisions prohibit in general terms schemes to "defraud." Critically, neither statute defines the word "defraud."

On appeal, the defendants argued that the term "defraud" should have the same meaning across the Title 18 fraud provisions and the Title 15 fraud provisions, so that the elements of insider-trading fraud are the same under both statutes. Although it does not appear in the statutory text, one of the elements of Title 15 insider-trading fraud is the *Dirks* personal-benefit test, which requires the government to prove that the insider received a personal benefit in exchange for tipping material, non-public information. The defendants asserted that this personal-benefit test should be considered an element of Title 18 insider-trading fraud, too.

The Second Circuit disagreed, holding that *Dirks'* personal-benefit test does not apply to the Title 18 securities fraud provisions, and thus, insider traders may be convicted without a showing that the insider received a personal benefit for tipping the confidential information. The court explained that the personal-benefit test was derived from the purpose of the Title 15 securities fraud statute (i.e., the Exchange Act of 1934), which was to "eliminate the use of inside information for *personal advantage*." The Title 18 securities fraud statute (i.e., Sarbanes-Oxley Act of 2002), on the other hand, was "intended to provide prosecutors with a different — and broader — enforcement mechanism to address securities fraud than what had been previously provided in the Title 15 fraud provisions." In other words, Congress enacted the Title 18 securities fraud provisions in order to make prosecuting insider trading easier, which in part meant not having to prove a personal benefit to the tipper. As a result, the court upheld the defendants' convictions under the Title 18 securities fraud provisions.

[72] *United States v. Blaszczak*, Nos. 18-2811, 18-2825, 18-2867, 18-2878, 2019 WL 7289753 (2d. Cir. Dec. 30, 2019).

While certainly providing the DOJ with an important tool to criminally prosecute insider trading, the *Blaszczak* ruling does not mean prosecutors will bring all insider trading cases under Title 18 going forward. The Title 18 fraud provisions apply only to trading in registered securities, whereas the Title 15 fraud provisions apply to trading in any security, registered or unregistered. In addition, the Title 18 fraud provisions impose only criminal liability, meaning that civil insider trading charges brought by the SEC still must be pursued under Title 15. Future criminal defendants charged with insider trading in registered securities, however, are likely to face charges under both provisions.

In a key preliminary holding, in the Second Circuit found that a government agency's "nonpublic predecisional information" constitutes "property" under the Title 18 securities fraud provisions. This finding was necessary because the inside information that the *Blaszczak* defendants misappropriated and traded on belonged to the Centers for Medicare & Medicaid Services ("CMS") and related to new rules the agency was contemplating. After emphasizing that Supreme Court precedent "did not . . . establish any rigid criteria for defining property," the court found that "CMS has a property right in keeping confidential and making exclusive use of its nonpublic predecisional information," and thus held that such information may constitute government property for purposes of the Title 18 fraud provisions. However, one of the three judges on the panel dissented on this issue, arguing that CMS's confidential predecisional information should not be considered the agency's "property" because the premature disclosure of such information "has no economic impact on the government" and need not affect the substance or timing of the planned regulation.

2. *Martoma II*

In 2017, the Second Circuit in *Martoma I* abrogated its earlier decision in *Newman* by holding that tippees may be convicted for trading on material, non-public information the tippee received as a gift, even if the tipper and tippee did not share a "meaningfully close personal relationship."[73] In June 2018, a divided Second Circuit panel revisited that decision in *Martoma II*.[74] In an amended opinion, the panel concluded that *Newman's* "meaningfully close personal relationship" standard may be merely one of the many ways to establish a personal benefit to the tipper, along with a quid pro quo or an "intent to benefit" the tippee.[75]

(a) In *Salman*, the Supreme Court held that "when a tipper gives inside information to 'a trading relative or friend,' the jury can infer that the tipper meant to provide the equivalent of a cash gift. In such situations, the tipper benefits personally because giving a gift of trading information is the same thing as trading by the tipper followed by a gift of the proceeds."[76]

C. Legislative Developments

1. On Dec. 5, 2019, the House of Representatives passed a bill that would explicitly prohibit insider trading.[77] The Insider Trading Prohibition Act is meant to provide an express prohibition and more precise definition of insider trading so that enforcement authorities like the SEC and DOJ do not have to continue relying on general anti-fraud statutes to prosecute insider trading.

The bill would ban the trading of securities "while in possession of material, nonpublic information…if such person knows, or recklessly disregards, that such information has been obtained wrongfully." It also forbids passing along confidential information that could enable insider trading and shields employers from derivative liability for wrongdoing by their employees. However, thanks to a last-

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[73] *United States v. Martoma*, 869 F.3d 58 (2d Cir. 2017) (*Martoma I*).

[74] *United States v. Martoma*, 894 F.3d 64, 71 (2d Cir. 2017) (*Martoma II*).

[75] *Id.* at 77-78.

[76] *Salman v. United States*, 137 S. Ct. 420, 427-28 (2016).

[77] Andrew Kragie and Jody Godoy, "House Passes 1st Explicit Ban On Insider Trading," *Law360* (Dec. 5, 2019), available here.

minute amendment, the bill adopts the personal-benefit test to prove insider trading in certain circumstances, likely including in cases brought under Rule 10b-5 of the Exchange Act.

D. 2019 Enforcement Actions

1. *SEC v. Tsai*[78]

In August, the SEC charged a junior analyst at a New York investment bank for trading on confidential information about a private equity firm's plans to acquire Electronics for Imaging Inc. The SEC alleges that soon after learning about the deal, Tsai purchased EFII call options through a brokerage account that he concealed from the investment bank. Tsai later sold the options for a profit of approximately $98,750, shortly after the deal was announced in mid-April 2019.

On Dec. 16, 2019, Tsai consented to entry of a final judgment in the Southern District of New York ordering him to pay approximately $100,000 in disgorgement and prejudgment interest.

Tsai is still facing criminal charges brought by the U.S. Attorney's Office for the Southern District of New York.

2. *SEC v. Fettner*[79]

In May, the SEC brought settled charges against a man who traded on inside information he had learned on a visit to the home of his longtime friend, who was the general counsel of a company. Without his friend's awareness, Fettner viewed documents contemplating an acquisition by his friend's company, then purchased the target company's stock in the brokerage accounts of his ex-wife and ex-girlfriend. Fettner also persuaded his father and another girlfriend to purchase stock in the target company.

Fettner consented to entry of a judgment in the Southern District of Florida ordering him to pay a civil penalty of almost $253,000. The ex-wife and ex-girlfriend, in whose accounts Fettner had made the trades, agreed to disgorge alleged profits of $250,000 plus prejudgment interest.

3. *In the Matter of Timothy M. Rooney, Sr.*[80]

Rooney, a former representative of a registered broker-dealer and investment adviser, traded in securities of Vera Bradley Inc. using material, non-public information he obtained from a senior employee of Vera Bradley, who was a friend and customer of Rooney's. Rooney purchased Vera Bradley stock and options in his personal brokerage account and in the accounts of his wife, mother, brother and many of his other customers, ultimately selling the stock for combined profits of approximately $575,000.

Rooney paid more than $160,000 in disgorgement and prejudgment interest, along with a civil penalty of more than $715,000. Rooney was also barred from the securities industry.

4. *In the Matter of Lorenz Erne*[81]

Erne, a former senior executive of a Swiss pharmaceuticals and diagnostics company, the parent company of which is Roche Holding Ltd ("Roche"), purchased stock in Spark Therapeutics Inc. ("Spark"), a gene therapy company. Using material, non-public information he had learned through his employment, Erne made the trades ahead of a February 2019 announcement that Spark had entered into a merger agreement with a Roche affiliate, resulting in illicit profits of almost $160,000.

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[78] Litigation Release No. 24568, SEC Charges Investment Banking Analyst with Insider Trading (Aug. 16, 2019), available here.

[79] SEC Press Release, "SEC Charges Nevada Man Who Traded on Confidential Information Taken from Lifetime Friend" (May 7, 2019), available here.

[80] *In the Matter of Timothy M. Rooney, Sr.*, Exchange Act Rel. No. 86489 (July 26, 2019).

[81] *In the Matter of Lorenz Erne*, Exchange Act Rel. No. 86690 (Aug. 15, 2019).

Roche was ordered to disgorge the $160,000 and pay a civil penalty of almost $80,000.

IX. Foreign Corrupt Practices Act ("FCPA")

A. Both the DOJ and the SEC were very active in enforcing the FCPA in 2019.

1. As of early December, the FCPA unit of the DOJ had resolved seven corporate cases with criminal resolutions, as well as two additional cases that were resolved with declinations and disgorgement under the FCPA Corporate Enforcement Policy. The corporate resolutions amounted to $1.6 billion, and a total of $2.8 billion recovered globally through coordinated resolutions. This is the largest amount ever recovered by the DOJ in FCPA cases in a single year (versus previous high of $1.3 billion in 2016).[82]

2. The FCPA unit of the DOJ also announced more charges against individuals than any other year in history (34), and publicly announced more guilty pleas by individuals than ever before (30).

3. The SEC brought 18 FCPA actions against 15 entities and five individuals, with monetary relief of nearly $515 million (together with monetary relief in parallel criminal actions, over $1.4 billion).[83]

B. In March 2019, the Director of the CFTC announced that the CFTC was "committed . . . to enforcing the CEA provisions that encompass foreign corrupt practices."[84]

C. Noteworthy FCPA Actions

1. *In the Matter of Cognizant Technology Solutions Corporation* ("Cognizant")

In February, the DOJ issued a declination to Cognizant, a New Jersey-based information technology company. Cognizant also settled civil FCPA charges brought by the SEC by agreeing to pay $19 million in disgorgement and a penalty of $6 million. The company also agreed to fully cooperate with the SEC's investigation and to make periodic reports to the SEC on the status of its remediation and implementation of compliance measures.[85]

Between 2014 and 2016, Cognizant allegedly authorized contractors to pay a total of $3.6 million in bribes to Indian government officials to obtain government construction-related permits and operating licenses in connection with the construction and operation of commercial office buildings, resulting in violations of the anti-bribery, books and records and internal controls provisions.

DOJ issued a declination to Cognizant, citing the company's voluntary self-disclosure within two weeks of its board learning of the misconduct, its "thorough and comprehensive investigation," "full and proactive cooperation," "lack of prior criminal history" and its "full remediation," including terminating or disciplining employees involved in the misconduct.[86]

DOJ did indict two executives, Cognizant's president and chief legal officer, for authorizing at least one bribe payment and directing their subordinates to conceal the bribe by doctoring the contractor's change orders.[87]

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[82] U.S. Dept. of Justice, "Assistant Attorney General Brian A. Benczkowski Delivers Remarks at the American Conference Institute's 36th International Conference on the Foreign Corrupt Practices Act," (Dec. 4, 2019), available here.

[83] 2019 Annual Report, Division of Enforcement, U.S. Securities and Exchange Commission, at 14.

[84] U.S. Commodity Futures Trading Commission, "Remarks of CFTC Director of Enforcement James M. McDonald at the American Bar Association's National Institute on White Collar Crime," (March 6, 2019), available here.

[85] *In the Matter of Cognizant Technology Solutions Corporation*, Exchange Act Rel. No. 85149 (Feb. 15, 2019), available here.

[86] Declination Letter Re: Cognizant Technology Solutions Corporation, Fraud Section, U.S. Dept. of Justice (Feb. 13, 2019), available here.

[87] SEC Litigation Release No. 24402, SEC Charges Cognizant and Two Former Executives With FCPA Violations (Feb. 15, 2019), available here.

2. *U.S. v. Mobile TeleSystems PJSC*; *In the Matter of Mobile TeleSystems PJSC*

   In March 2019, Mobile TeleSystems Public Joint Stock Company ("MTS"), Russia's largest mobile phone company, paid $850 million in penalties to the DOJ and SEC to resolve FCPA violations relating to Uzbekistan.[88]

   According to MTS's admissions, MTS and its wholly-owned Uzbek subsidiary paid approximately $420 million in bribes from 2004 to 2012 to Gulnara Karimova, a former Uzbek official who had influence over the Uzbek governmental body that regulated the telecom industry. The bribes were paid so that MTS could enter the Uzbek market, gain valuable telecom assets, and continue operating in Uzbekistan. MTS and its subsidiary admittedly structured and concealed the bribes through payments to shell companies that members of management knew were beneficially owned by Karimova. Also, MTS acquired the subsidiary for a price that it knew was inflated in order to bribe Karimova to allow an older MTS subsidiary to continue operating in Uzbekistan. MTS's subsidiaries made payments to purported charities and for sponsorships to entities related to Karimova, as well.

   DOJ stated that MTS did not voluntarily disclose its misconduct, did not fully cooperate and did not timely and adequately remediate.

   DOJ also filed charges against Karimova, who is the daughter of the former president of Uzbekistan, with conspiracy to commit money laundering. It also charged Bekhzod Akhmedov, the former CEO of the older MTS subsidiary who solicited and facilitated bribe payments to Karimova from various telecomm companies, with violations of the FCPA and money laundering.

   In connection with the settlement, MTS and one of its subsidiaries also agreed to retain a compliance monitor for three years. This was the third case brought by the SEC and the DOJ involving public companies operating in the Uzbek telecommunications market. Altogether, the three actions have led to $2.6 billion recovered by U.S. and foreign authorities.

3. *In the Matter of Walmart, Inc.*; *U.S. v. WMT Brasilia S.a.r.l.*

   Bringing an end to a long-running and highly publicized investigation, in June, Walmart Inc. agreed to pay the DOJ and SEC $282.7 million and to retain a corporate compliance monitor for two years to settle allegations that it violated the FCPA.[89]

   According to the settlement documents, from 2000 through 2011, Walmart's subsidiaries in Brazil, China, India and Mexico operated without a system of sufficient anti-corruption related internal accounting controls, resulting in payments to third-party intermediaries that may have been paid to government officials. Walmart also failed to sufficiently investigate known corruption allegations and to mitigate known risks.

   DOJ reduced Walmart's penalty by 20–25% compared to the applicable U.S. Sentencing Guidelines ("U.S.S.G.") fine range, crediting the company for its full cooperation in Brazil, China and India (but not in Mexico).

   Walmart spent more than $900 million investigating potential FCPA offenses and enhancing its anti-bribery compliance program, according to various SEC filings.

4. *U.S. v. Technip USA Inc.*; *In the Matter of TechnipFMC plc*

   Also in June, TechnipFMC plc, a U.K. oil and gas services company, entered into a three-year deferred prosecution agreement with the DOJ in connection with a criminal information charging the company with conspiracy to violate the anti-bribery provisions of the FCPA. TechnipFMC's U.S. subsidiary

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[88] DOJ Press Release 19-200, "Mobile TeleSystems PJSC and Its Uzbek Subsidiary Enter into Resolutions of $850 Million with the Department of Justice for Paying Bribes in Uzbekistan," (March 7, 2019), available here; *In the Matter of Mobile TeleSystems PJSC*, Exchange Rel. No. 85261 (March 6, 2019), available here.

[89] DOJ Press Release 19-691, "Walmart Inc. and Brazil-Based Subsidiary Agree to Pay $137 Million to Resolve Foreign Corrupt Practices Act Case," (June 20, 2019), available here.

pleaded guilty to the same charge. Under the DPA, TechnipFMC will pay a total criminal fine of over $296 million, with approximately $214 million to be paid to Brazilian authorities.[90]

TechnipFMC also settled civil FCPA charges related to a bribery scheme in Iraq brought by the SEC, agreeing to pay more than $5-million disgorgement and prejudgment interest.[91] Brazil was not mentioned in the SEC settlement.

From 2003 to 2013, TechnipFMC's predecessor company made more than $69 million in "commission payments" to intermediaries, who passed along portions of such payments as bribes to Brazilian government officials employed by Petrobras to obtain and retain business with Petrobras. The company also made bribe payments to a Brazilian political party and some of its officials.

From 2008 to 2013, TechnipFMC's other predecessor company (the two predecessors merged to form TechnipFMC) gave over $794,000 to Monaco-based intermediary who paid some of the money as bribes to at least seven Iraqi government officials, including officials at the Ministry of Oil, in order to obtain and retain business in Iraq.

DOJ credited TechnipFMC for its "substantial cooperation" with the investigation and for taking "extensive remedial measures," including separating from or taking disciplinary measures against former and current employees, making changes to its business operations in Brazil and making "specific enhancements to the company's internal controls and compliance program," such as requiring additional compliance training. As a result, TechnipFMC received a 25% reduction off the applicable U.S.S.G. fine.

5. *In the Matter of Quad/Graphics, Inc.*

In September, Quad/Graphics Inc. agreed to pay $10 million to resolve FCPA violations.[92] The SEC alleged that Quad/Graphics engaged in multiple bribery schemes in Peru and China. In addition, the SEC alleged that Quad/Graphics violated the books and records provisions of the FCPA by creating false records to conceal commercial transactions with a state-controlled Cuban telecommunications company that was subject to U.S. sanctions and export controls laws.

This settlement is notable, in particular, insofar as the SEC used the FCPA books and records provisions to levy fines for sanctions and export control violations.

It is also notable that the DOJ issued a declination letter with respect to, and despite, "the bribery committed by employees of the Company's subsidiaries in Peru and China" based on an assessment of the factors set forth in the Corporate Enforcement Policy and the Principles of Federal Prosecution of Business Organizations.[93]

6. *U.S. v. Telefonaktiebolaget LM Ericsson*; *SEC v. Telefonaktiebolaget LM Ericsson*

In December, the Swedish company Ericsson, another telecom, agreed to pay the DOJ and SEC over $1 billion in the second largest FCPA enforcement action ever (behind Petrobras' $1.78-billion global settlement in 2018).[94]

The SEC alleged that Ericcson violated the anti-bribery, books and records and internal controls provisions of the FCPA, while DOJ charged Ericcson with conspiracy to violate the same provisions. According to the government, Ericcson collected about $84 million in slush funds that it used to bribe

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[90] DOJ Press Release 19-714, "TechnipFMC Plc and U.S.-Based Subsidiary Agree to Pay Over $296 Million in Global Penalties to Resolve Foreign Bribery Case," (June 25, 2019), available here.

[91] *In the Matter of TechnipFMC plc.*, Exchange Act Rel. No. 87055 (Sept. 23, 2019), available here.

[92] *In the Matter of Quad/Graphics, Inc.*, Exchange Act Rel. No. 87128 (Sept. 26, 2019), available here.

[93] U.S. Dept. of Justice, Letter re: Quad/Graphics Inc. (Sept. 19, 2019), available here.

[94] DOJ Press Release 19-1360, "Ericsson Agrees to Pay Over $1 Billion to Resolve FCPA Case," (Dec. 6, 2019), available here; SEC Press Release 2019-254, "SEC Charges Multinational Telecommunications Company with FCPA Violations," (Dec. 6, 2019), available here.

officials via intermediaries in Djibouti, China, Vietnam, Indonesia and Kuwait. These intermediaries often were engaged through sham contracts and paid pursuant to false invoices, and the payments to them were improperly accounted for in Ericsson's books and records.

DOJ said Ericsson didn't receive full credit for cooperation because the company failed to "disclose allegations of corruption with respect to two relevant matters," was late producing some materials to DOJ, and didn't "take adequate disciplinary measures" against some of the employees involved in the corruption.

7. *United States v. Baptiste*. In a criminal trial brought by the DOJ, the chairman and CEO of an investment firm and a member of the firm's board of directors were convicted in the U.S. District Court for the District of Massachusetts for conspiring to violate the FCPA for their roles in a scheme to bribe Haitian officials to gain business advantages for their firm.[95]

8. *United States v. Hoskins.* In a criminal trial, Lawrence Hoskins, a U.K. resident and a former senior executive with Alstom S.A., was convicted after a two-week trial in the District Court for the District of Connecticut of six counts of violating the FCPA.[96] Although Hoskins is not a U.S. citizen and did not personally take any of his actions within the United States, the DOJ secured a conviction on the theory that Hoskins participated in a bribery scheme to secure a contract for a U.S. subsidiary and in that capacity was acting as the U.S. subsidiary's agent.

9. There were also a number of actions relating to hiring practices. One financial institution agreed to pay $6.3 million in September for hiring relatives of public officials in Asia, and another agreed to pay the SEC $16 million to settle FCPA offenses for hiring relatives of public officials in China and Russia.

D. DOJ's FCPA Corporate Enforcement Policy

1. Revisions were made in March and November of this year.

2. There is a presumption that a company will receive a declination[97] absent aggravating circumstances if the company:

(a) Voluntarily self-discloses FCPA violations to DOJ;

(i) In order for a company's disclosure to be voluntary, the company must (1) disclose the conduct to DOJ "prior to an imminent threat of disclosure or government investigation," (2) disclose the conduct "within a reasonably prompt time after becoming aware of the offense," with the burden on the company to demonstrate timeliness, and (3) disclose all relevant facts known to it, including all relevant facts about all individuals substantially involved in or responsible for the violation of law.

(b) Fully cooperates; and

(i) Full credit for full cooperation requires (1) timely disclosure of all facts relevant to the wrongdoing, including attribution of facts to specific sources, (2) proactive, rather than reactive, cooperation, (3) timely preservation, collection, and disclosure of relevant documents, including with respect to overseas documents, (4) de-confliction of witness interviews and other steps in the DOJ's investigation, when requested, and (5) endeavoring to make witnesses with relevant knowledge available for the DOJ to interview if requested.

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[95] *United States v. Baptiste*, No. 17-cr-10305 (D. Mass. June 20, 2019).

[96] *United States v. Hoskins*, No. 3:12-cr-00238 (D. Conn. Nov. 8, 2019).

[97] A declination pursuant to the FCPA Corporate Enforcement Policy is a case that would have been prosecuted or criminally resolved except for the company's voluntary disclosure, full cooperation, remediation, and payment of disgorgement, forfeiture, and/or restitution.

(c) Timely and appropriately remediates

(i) Full credit for timely and appropriate remediation now requires by the time of resolution: (1) a root cause analysis, (2) a system for appropriate retention of business records, including "personal communications and ephemeral messaging platforms," (3) appropriate discipline of employees, and (4) an effective compliance program, the criteria for which are substantially similar to those used by OFAC in assessing the adequacy of a company's compliance program.

3. If there are aggravating factors, a company that satisfies the above three requirements:

(a) Will be eligible for a reduction of 50% off the low end of the fine range prescribed by the U.S. Sentencing Guidelines, except in the case of a criminal recidivist; and

(b) Generally will not be required to appoint a monitor, as long as the company has implemented an effective compliance program.

4. If a company does not voluntarily disclose its misconduct to DOJ, but later fully cooperates and timely and appropriately remediates, the company will be eligible for a reduction of up to 25% off the low end of the U.S.S.G fine range.

(a) If a company does not meet all the criteria for full cooperation and timely and appropriate remediation, it still will be eligible for some cooperation credit if it meets the criteria set forth in the Principles of Federal Prosecution of Business Organizations, but the credit generally will be markedly less than for full cooperation, depending on the extent to which the cooperation was lacking.

5. The policy applies to a company uncovering potentially willful violations at a company it has recently acquired in a merger or acquisition.

E. DOJ's Evaluation of Corporate Compliance Programs

1. In April, DOJ updated its guidance on how prosecutors should evaluate corporate compliance programs for purposes of determining the appropriate (1) form of any resolution or prosecution; (2) monetary penalty, if any; and (3) compliance obligations contained in any corporate criminal resolution (e.g., monitorship or reporting obligations).[98]

2. Three "fundamental questions":

(a) Is the corporation's compliance program well designed?

(b) Is the program being applied earnestly and in good faith? In other words, is the program being implemented effectively?

(c) Does the corporation's compliance program work in practice?

3. In making a determination as to whether the corporation's compliance program is well designed, the guidance advises prosecutors to review the company's risk assessment, policies and procedures, training and communications, confidential reporting structure and investigation process, third-party management and mergers and acquisitions process.

4. In making a determination as to whether the company's compliance program is being implemented effectively, prosecutors are advised to review commitment to compliance by senior and middle management, autonomy and resources of the compliance function, compliance incentives and disciplinary measures.

5. When analyzing whether the company's compliance program works in practice, prosecutors are instructed to consider whether the company shows continuous improvement, periodic testing and

[98] U.S. Dept. of Justice Criminal Division, "Evaluation of Corporate Compliance Programs" (April 30, 2019), available here.

review with respect to compliance, the company's investigation of misconduct and the company's analysis and remediation of any underlying misconduct.

X. Sanctions and Export Controls Enforcement

A. The Department of Treasury and OFAC have been very active this year, on each of the enforcement, policy development, and rulemaking fronts.

B. Policy and Rule Developments

1. In May, OFAC issued a Framework for Compliance Commitments ("Framework").[99] OFAC regulations do not require companies to maintain a sanctions compliance program. Nonetheless, OFAC encourages firms subject to U.S. jurisdiction — including foreign entities that conduct business in or with the United States, U.S. persons or using U.S.-origin goods or services — to adopt a formal sanctions compliance program. The Framework is intended to assist such firms in developing, implementing and updating their respective sanctions compliance programs. While each firm's risk-based sanctions compliance program will depend on a variety of factors, including the company's size and sophistication, products and services, customers and counterparties and geographic locations, each sanctions compliance program should incorporate five essential components of compliance: (1) management commitment; (2) risk assessment; (3) internal controls; (4) testing and auditing; and (5) training. 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.

2. In June, OFAC also issued an interim final rule amending the Reporting, Procedures and Penalties Regulations ("RPPR"), 31 CFR Part 501 ("Interim Final Rule").[100]

   (a) The rule significantly broadens the reporting requirements expanding both (i) the transactions that qualify for reporting; and (ii) the category of persons required to report on rejected transactions. Specifically, the rule requires:

      (i) Reporting of all "rejected transactions," which are defined broadly to include any transaction rejected because it would violate sanctions, including transactions "related to wire transfers, trade finance, securities, checks, foreign exchange and goods or services."

      (ii) Reporting by all U.S. persons and persons subject to U.S. jurisdiction. Previously, only financial institutions ("FIs") were subject to the reporting requirements.

   (b) There are a number of other changes in the interim final rule, including with respect to the scope of and kind of information reported, how information is submitted, license application procedures, Freedom of Information Act disclosures and the scope of OFAC's subpoena power. In addition, the rule implements an increase in the maximum term of imprisonment for willful violations of the Trading with the Enemy Act from 10 to 20 years.

3. In December, the DOJ issued a revised Voluntary Self-Disclosure Policy for Business Organizations that closely parallels the DOJ's FCPA cooperation policy.[101]

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[99] U.S. Dept. of Treasury, "A Framework for OFAC Compliance Commitments," (May 2, 2019), available here.

[100] 31 C.F.R.§ 501, "Reporting, Procedures and Penalties Regulations," (June 21, 2019) available here.

[101] DOJ Press Release 19-1391, "Department of Justice Revises and Re-Issues Export Control and Sanctions Enforcement Policy for Business Organizations," (Dec. 13, 2019), available here.

The primary statutes governing export control and sanctions requirements are the Arms Export Control Act (AECA); the Export Control Reform Act (ECRA); and the International Emergency Economic Powers Act (IEEPA). U.S. Department of Justice, "Export Control and Sanctions Enforcement Policy for Business Organizations," Dec. 13, 2019, available here.

(a) Under the policy, there is a presumption that a company will receive a non-prosecution agreement ("NPA") and will not pay a fine, absent aggravating factors, if the company:

(i) Voluntarily self-discloses export control or sanctions violations to the Counterintelligence and Export Control Section ("CES") of DOJ's National Security Division;

In order for a company's disclosure to be voluntary, the company must (1) disclose the conduct to CES "prior to an imminent threat of disclosure or government investigation," (2) disclose the conduct to CES "within a reasonably prompt time after becoming aware of the offense," with the burden on the company to demonstrate timeliness, and (3) disclose all relevant facts known to it at the time of the disclosure, including as to any individuals substantially involved in or responsible for the misconduct at issue.

Effectively, this means the company must submit its voluntary self-disclosure to DOJ at substantially the same time that it is submitted to the appropriate regulatory agency (DDTC, BIS or OFAC).[102]

(ii) Fully cooperates; and

Full credit for full cooperation requires: (1) timely disclosure of all facts relevant to the wrongdoing, including attribution of facts to specific sources, (2) proactive, rather than reactive, cooperation, (3) timely preservation, collection, and disclosure of relevant documents, including with respect to overseas documents, (4) de-confliction of witness interviews and other steps in the DOJ's investigation, when requested, and (5) endeavoring to make witnesses with relevant knowledge available for the DOJ to interview if requested; and

(iii) Timely and appropriately remediates.

Full credit for timely and appropriate remediation now requires: (1) a root cause analysis, (2) a system for appropriate retention of business records, including "personal communications and ephemeral messaging platforms," (3) appropriate discipline of employees, and (4) an effective compliance program, the criteria for which are substantially similar to those used by OFAC in assessing the adequacy of a company's compliance program.

(b) If there are aggravating factors,[103] a company that satisfies the above three requirements:

(i) Will be eligible for a reduction of at least 50% off the statutory base penalty — effectively capping the fine at the dollar value of the violative transactions.

(ii) Will not be required to appoint a monitor, as long as the company has implemented an effective compliance program.

(c) This policy now applies to financial institutions, which were exempted from the original policy published in 2016, and to a company uncovering potentially willful violations at a company it has recently acquired in a merger or acquisition.

(d) While the revised policy makes the requirements for achieving full cooperation credit more defined, it also signals an increased focus by the DOJ in prosecuting willful sanctions violations.

[102] Self-reports to other regulatory agencies and not to DOJ will not qualify a company for the benefits of a VSD under this policy.

[103] Aggravating factors include: exports of items controlled for nuclear nonproliferation or missile technology reasons to a proliferator country; exports of items known to be used in the construction of weapons of mass destruction; exports to a Foreign Terrorist Organization or Specially Designated Global Terrorist; exports of military items to a hostile foreign power; repeated violations, including similar administrative or criminal violations in the past; and knowing involvement of upper management in the criminal conduct.

C. Enforcement Actions

1. As of mid-December, OFAC had announced settlements of 26 cases, totaling more than $1.3 billion in penalties. This is more in number of settlements and amount of fines than previous years.

2. Most of the settlements are related to violations of the Cuban and Iranian sanctions programs.

3. There are a number of general trends in sanctions enforcement by both the DOJ and OFAC: (a) willful conduct, including wire stripping or otherwise obscuring the interest or involvement of sanctioned parties in transactions sent to or through U.S. intermediaries, (b) operations or technical problems that have gone unfixed, (c) successor liability cases and (d) cases where a company failed to identify its supply or output chains. Examples include:

   (a) *U.S. v. UniCredit Bank AG* and UniCredit Settlements with OFAC

   UniCredit Bank AG ("UCB AG"), an affiliate, UniCredit Bank Austria, and their parent company, UniCredit SpA, agreed to pay more than $1.3 billion to settle criminal and civil actions brought by federal and state authorities.[104] According to OFAC, among other things, UniCredit operated U.S. dollar accounts on behalf of the Islamic Republic of Iran Shipping Lines ("IRISL") and several companies owned by or otherwise affiliated with IRISL, and managed the accounts of those companies in a manner that obscured the interest or involvement of IRISL in transactions sent to or through U.S. intermediaries. According to the DOJ, between 2002 and 2011, UCB AG processed at least $393 million of transactions through the U.S. financial system on behalf of IRISL, which is designated as a weapons of mass destruction proliferator, and other Iranian entities subject to U.S. sanctions. And, according to OFAC, for a number of years up to and including 2011 (UCB AG) and 2012 (UCB Austria and UCB S.p.A), all three banks processed payments to or through the United States in a manner that did not disclose the underlying sanctioned persons or countries to U.S. financial institutions.

   (b) Apple Inc. Settlement with OFAC

   Apple agreed to pay $467,000 to settle violations of the Foreign Narcotics Kingpin Sanctions Regulations with OFAC. According to OFAC, Apple continued to host apps owned by SIS, a Slovenian software company, for two years after OFAC had added SIS and its majority owner to the List of Specially Designated Nationals Blocked Persons ("SDN List"). Apple failed to identify that SIS, an App Store developer, was added to the SDN List and was therefore blocked. Apple claimed that it failed to block SIS because its sanctions screening tool failed to match the upper case name "SIS DOO" in Apple's system with the lower case name "SIS d.o.o." as written on the SDN List.

   In all, Apple made 47 payments associated with the blocked apps, including payments directly to SIS, after OFAC put SIS on the SDN List. Apple collected $1.2 million over 54 months from customers who downloaded the blocked apps.

   OFAC credited Apple for a previously clean sanctions compliance record, responding "to numerous requests for information in a prompt manner," reconfiguring its primary sanctions screening tool, and instituting mandatory training for all employees on export and sanctions regulations.

   (c) Stanley Black & Decker Settlement with OFAC

   In March, Stanley Black & Decker ("Stanley") agreed to settle its potential civil liability for 23 apparent violations of Iran sanctions for more than $1.8 million.[105] Between June 2013 and

[104] DOJ Press Release 19-383, "UniCredit Bank AG Agrees to Plead Guilty for Illegally Processing Transactions in Violation of Iranian Sanctions," (April 15, 2019), available here; *see also* Department of Treasury Press Release, available here.

[105] U.S. Dept. of Treasury, Settlement Agreement between the U.S. Department of the Treasury's Office of Foreign Assets Control and Stanley Black & Decker, Inc. and its foreign subsidiary, Jiangsu Guoqiang Tools Co., Ltd. (March 27, 2019), available here.

December 2014, a Chinese subsidiary that Stanley had recently acquired allegedly exported or attempted to export 23 shipments of power tools and spare parts, with a total value over $3 million, to or through Iran. According to OFAC, members of the subsidiary's management directed these shipments with knowledge that they violated U.S. sanctions and tried to conceal them by using conduits, creating false bills of lading, and instructing customers not to write "Iran" on documents.

OFAC determined that Stanley voluntarily self-disclosed the apparent violations on behalf of its subsidiary and that the apparent violations constitute an egregious case.

(d) e.l.f. cosmetics settlement with OFAC

In January, e.l.f. cosmetics ("ELF") agreed to pay $996,000 to settle its potential civil liability for 156 apparent violations of North Korea sanctions.[106] The apparent violations involved the importation of false eyelash kits from two suppliers located in the People's Republic of China that contained materials sourced by these suppliers from the Democratic People's Republic of Korea.

OFAC determined that ELF voluntarily self-disclosed the apparent violations and that the apparent violations constituted a non-egregious case, despite calling ELF's compliance program "either non-existent or inadequate."

4. OFAC has signaled that it may hold private equity firms responsible for sanctions violations of its foreign portfolio companies, even where the private equity firm does not have direct involvement in the underlying violations by its portfolio companies.

XI. Anti-Money Laundering

A. FinCEN still has not finalized the AML investment adviser rule, which would prescribe minimum standards for anti-money laundering programs to be established by certain investment advisers and to require such investment advisers to report suspicious activity to FinCEN pursuant to the Bank Secrecy Act ("BSA"). We do not know when or if the proposed rule will be finalized.

B. Due to the fact that there currently is not a rule requiring RIAs to have AML programs, many of the anti-money laundering program enforcement cases may not be directly relevant to private funds. Private funds may, however, be asked for various reasons to represent that they have implemented an AML program reasonably designed to comply with the BSA. Moreover, criminal AML and forfeiture statutes may be applicable to private funds.

C. There have been a number of noteworthy policy pronouncements that may be relevant relating to AML enforcement in the areas of cryptocurrencies and cannabis.

1. Joint Statement on Cryptocurrencies[107]

In October 2019, the chairmen of the CFTC and SEC and the director of FinCEN issued a joint statement reminding "persons engaged in activities involving digital assets" of their AML obligations under the BSA.

As noted in the Joint Statement, AML obligations apply to entities that the BSA defines as "financial institutions" and include establishing and implementing an effective AML program and meeting recordkeeping and reporting requirements, such as filing suspicious activity reports ("SARs").

The joint statement makes clear that it is not the label or terminology that market participants use for digital assets that determines whether they are subject to AML/CFT obligations. Rather, "it is the facts and circumstances underlying an asset, activity or service, including its economic reality and use

[106] U.S. Dept. of Treasury, Settlement Agreement between the U.S. Department of the Treasury's Office of Foreign Assets Control and e.l.f. Cosmetics, Inc. (Jan. 31, 2019), available here.

[107] Heath Tarbert (CFTC), Kenneth Blanco (FinCEN), Jay Clayton (SEC), Leaders of CFTC, FinCEN, and SEC Issue Joint Statement on Activities Involving Digital Assets (Oct. 11, 2019), available here.

(whether intended or organically developed or repurposed), that determines the general categorization of an asset, the specific regulatory treatment of the activity involving the asset, and whether the persons involved are 'financial institutions' for purposes of the BSA."

The nature of the digital assets-related activity not only determines whether the entity is a "financial institution," but also will determine which agency is responsible for overseeing the activity and person, and whether the person has registration and other obligations under the federal securities laws.

Certain BSA obligations that apply to a broker-dealer in securities, mutual fund, futures commission merchant or introducing broker, such as developing an AML program or reporting suspicious activity, apply very broadly and without regard to whether the particular transaction at issue involves a "security" or a "commodity," as those terms are defined under the relevant federal statutes.

The joint statement also clarifies an ambiguity about what regulations apply to covered persons or entities who are regulated by the SEC or CFTC (such as introducing brokers, futures commission merchants, broker-dealers in securities and mutual funds), but who also engage in money transmission activities. In that situation, such persons or entities would be subject to the BSA obligations of the type of regulated entity that they are and "would not be subject to BSA requirements that are applicable only to Money Services Businesses (MSBs)."

2. Joint Statement on Financial Services to Hemp-Related Businesses[108]

On December 3, 2019, the Federal Reserve, Federal Deposit Insurance Corporation, FinCEN and the Office of the Comptroller of the Currency issued a joint statement "to provide clarity regarding the legal status of commercial growth and production of hemp and relevant requirements for banks under" the BSA.

On Oct. 31, 2019, the U.S. Department of Agriculture issued an interim final rule establishing the domestic hemp production regulatory program to facilitate the legal production of hemp. The interim final rule includes requirements for maintaining information on the land where hemp is produced, testing hemp for tetrahydrocannabinol (THC) levels, disposing of plants with more than 0.3% THC and licensing for hemp producers.

BSA Considerations

Because hemp is no longer a Schedule I controlled substance under the Controlled Substances Act, banks are not required to file a SAR on customers solely because they are engaged in the growth or cultivation of hemp in accordance with applicable laws and regulations. For hemp-related customers, banks are expected to follow standard SAR procedures and file a SAR if indicia of suspicious activity warrants.

When deciding to serve hemp-related businesses, banks must comply with applicable regulatory requirements for customer identification, suspicious activity reporting, currency transaction reporting, and risk-based customer due diligence, including the collection of beneficial ownership information for legal entity customers.

In the context of marijuana-related businesses, banks should continue following FinCEN guidance FIN-2014-G001 – BSA Expectations Regarding Marijuana-Related Businesses.

D. DOJ Civil Forfeiture Settlement Regarding 1MDB

On the forfeiture side, in October, the DOJ resolved a major civil forfeiture action that involved money laundering.

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[108] Board of Governors of the Federal Reserve System, SR 19-14: Statement on Providing Financial Services to Customers Engaged in Hemp-Related Businesses (Dec. 3, 2019), available here.

Specifically, the DOJ settled its civil forfeiture cases against assets acquired by Jho Low using funds allegedly misappropriated from 1Malaysia Development Berhad ("1MDB"), Malaysia's investment development fund, and laundered through financial institutions in the U.S. and other jurisdictions.[109] Jho Low agreed to surrender assets with an estimated value of over $700 million, including high-end real estate in Beverly Hills, New York and London; a luxury boutique hotel in Beverly Hills; and tens of millions of dollars in business investments that Low allegedly made with funds traceable to misappropriated 1MDB monies. Together with the prior disposition of other 1MDB-related forfeiture cases, the government now has recovered more than $1 billion in assets associated with the 1MDB international money laundering scheme, the largest civil forfeiture ever concluded by DOJ.

According to DOJ, more than $4.5 billion in funds belonging to 1MDB were allegedly misappropriated from 2009 through 2015 by high-level officials of 1MDB and their associates, including Low, through a criminal conspiracy involving international money laundering and bribery. Low still faces criminal conspiracy charges in two U.S. jurisdictions.

E. In addition, to the extent a private fund voluntarily seeks to comply with the AML program requirements of the BSA and its implementing regulations or relies on major financial institutions to perform AML diligence and monitoring, there have been a number of notable AML enforcement actions, both domestically and abroad, against major financial institutions that may be instructive. Examples of such enforcement actions include:

1. Danske Bank Investigations

A mid-level executive turned whistleblower revealed a history of money laundering at Denmark's largest bank that totaled over $220 billion in laundered funds between 2007 and 2015.[110] In September 2018, Danske Bank released the findings from an internal investigation revealing that over $235 billion flowed from Russia and other former Soviet countries through Danske's Estonian branch in order to be converted into "clean" money. Estonian regulators forced Danske Bank out of the country in February 2019, and the DOJ, SEC, European Banking Authority and other European authorities currently are investigating Danske Bank. Investigations into Danske Bank have led to investigations of the Estonian branches of Deutsche Bank and Swedbank.

2. *In the Matter of MUFG Bank Ltd.*

In February, the Office of the Comptroller of the Currency ("OCC") issued a cease-and-desist order for three U.S. branches of Japan's biggest bank after finding weaknesses in their due-diligence and risk management procedures.[111] According to the OCC, the three branches had "systematic deficiencies" in how they monitored high-risk transactions and correspondent accounts for foreign financial institutions, including failing to timely file reports of suspicious customer activity.

The OCC's order does not impose a financial penalty, but it does order MUFG to strengthen its risk assessment procedures and compliance with anti-money-laundering laws, develop a remediation plan, and ensure that it has qualified compliance officers at its branches to conduct regular audits and risk assessments.

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[109] DOJ Press Release 19-1,176, "United States Reaches Settlement to Recover More Than $700 Million in Assets Allegedly Traceable to Corruption Involving Malaysian Sovereign Wealth Fund, (Oct. 30, 2019), available here.

[110] Dominic Chopping and Samuel Rubenfeld, "SEC Joins List of Authorities Probing Money Laundering at Danske Bank." *The Wall Street Journal*, (Feb. 21, 2019), available here.

[111] Kristin Broughton, "U.S. Regulator Asks MUFG Branches to Strengthen Anti-Money-Laundering Controls," *The Wall Street Journal,* (Feb. 22, 2019), available here.

Separately, in June 2019, MUFG agreed to pay $33 million to resolve claims by the New York Department of Financial Services and New York Attorney General that it violated anti-money laundering requirements while operating in New York.[112]

3. *In re BNP Paribas Securities Corp. and BNP Paribas Prime Brokerage, Inc.*

In October, FINRA announced that it had fined BNP $15 million for AML program and supervisory failures relating to (a) penny stock deposits and resales and (b) wire transfers, over the course of four years. FINRA also found that BNP's AML program was understaffed. The enforcement action arose out of FINRA's examinations of the firm.[113]

XII. Related Civil Litigation and Portfolio Company Litigation

A. Federal Court Rulings Regarding Private Securities Litigation

1. *Varjabedian v. Emulex Corp.*

The Ninth Circuit caused a circuit split by holding that a private litigant claiming a violation of Section 14(e) of the Exchange Act need plead only negligence on the part of a defendant who misrepresented or omitted a material fact in connection with a tender offer.[114] Previously, the Second, Third, Fifth, Sixth and Eleventh Circuits had held that a claimant must plead that the defendant acted with scienter.

The Supreme Court granted certiorari in January 2019, heard oral arguments and then dismissed the cert petition without explanation.[115] Based on oral argument, however, it appeared that several justices questioned whether there is a private right of action to bring a Section 14(e) claim but dismissed the matter because the standing issue had not been fully explored in the lower courts.[116] As a result, the circuit split remains, potentially leading to an increase in tender offer litigation in the Ninth Circuit, where the more lenient negligence standard will make it easier for plaintiffs to defeat motions to dismiss. It is widely expected that the Supreme Court will grant cert for a Section 14(e) case in the near future to revisit this issue.

2. *Singh v. Cigna Corp.*

In March, the Second Circuit held that plaintiffs failed to identify a materially false statement as a matter of law in alleging that defendant Cigna's statements about its commitment to regulatory compliance procedures were materially misleading in light of an undisclosed history of non-compliance with Medicare regulations.[117] The Second Circuit affirmed the district court's dismissal of the case, calling Cigna's statements about its policies and procedures in its Code of Ethics mere "puffery."

3. *Packer v. Raging Capital*

In August, a federal district court ruled that a private fund was the "beneficial owner" of registered equity shares it owned, and thus subject to liability for short-swing profits under Section 16 of the Exchange Act, even though the fund had delegated voting and investment authority to its investment

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[112] *See* Settlement Agreement dated June 24, 2019 by and between MUFG Bank Ltd., and Linda Lacewell, in her official capacity as Acting Superintendent of Financial Services of the New York Department of Financial Services and Letitia James, in her official capacity as New York State Attorney General, available here.

[113] *In re BNP Paribas Securities Corp. and BNP Paribas Prime Brokerage, Inc.*, FINRA AWC No. 2016051105201 (Oct. 23, 2019), available here.

[114] *Varjabedian v. Emulex Corp.,* 888 F.3d 399 (9th Cir. 2018).

[115] *Emulex Corp. v. Varjabedian*, --S.Ct.--, 2019 WL 1768137, at *1 (April 23, 2019).

[116] *See* Tr. of Oral Arg., *Emulex Corp. v. Varjabedian*, 2019 WL 1598075, at *43-44, (April 15, 2019) (No. 18-459).

[117] *Singh v. Cigna Corp.*, 918 F.3d 57 (2d Cir. 2019).

adviser.[118] The ruling is significant because private funds have relied upon this type of delegation to avoid qualifying as a "beneficial owner" subject to Section 16.

Beneficial ownership of shares of a class of registered equity securities under Section 16(a) refers to the power to vote or dispose of such shares, or the right to acquire such power within 60 days. The SEC staff has taken the position that a party need not report as a beneficial owner if that party "has delegated all authority to vote and dispose of its stock to an investment adviser and [] does not retain the right under the contract to rescind the authority granted to the investment adviser within 60 days."[119] Following the staff's guidance, many investors (including private funds) have delegated such authority to their investment advisers in their investment adviser agreements to avoid the reporting requirements and potential liability of a beneficial owner. However, in 2012 the Second Circuit cast some doubt on the efficacy of this arrangement in *Huppe v. WPCS Int'l Inc.*,[120] holding that a limited partnership could not avoid qualifying as a beneficial owner by delegating voting and disposal power to its general partner.

In *Raging Capital*, a district court in the Eastern District of New York found a private fund holding more than 10% of a publicly traded common stock liable for almost $5 million in short-swing profits, despite the fact that the private fund had delegated to its investment adviser complete authority to buy, sell, and vote all securities in the private fund's account. The court rested its decision on three independent bases, the first of which suggests that the type of delegation endorsed by the SEC staff may no longer be a viable shield from short-swing profit liability. Citing language in the Second Circuit's *Huppe* decision, the district court explained that the agency relationship between the private fund and its investment adviser rendered the fund's delegation ineffectual because the investment adviser, as the private fund's agent, would exercise its voting and disposal power on behalf of the fund. In fact, the district court went so far as to say that *Huppe* "ha[d] disposed of such delegation theories."

The court also found that even if delegation were a viable shield from short-swing profit liability, the private fund had failed to effectively delegate its voting and investment authority for two reasons. First, nothing prevented the defendants, which included the private fund, its investment adviser and their common control person (who signed the investment adviser agreement on behalf of the fund and the adviser), from altering the agreement to restore the relevant authority to the private fund in 60 days or fewer. Second, voting and investment authority must be delegated to an unaffiliated third party in order to operate as a liability shield, according to treatises cited by the court. The private fund and its investment adviser, however, were affiliated due to their common control person.

This decision is currently on appeal to the Second Circuit.[121] In connection therewith, the Managed Fund Association has filed an amicus brief.[122]

B. Recent Delaware Rulings

1. *Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.*

In April, the Delaware Supreme Court held that the proper approach to determining fair value in an appraisal action is to subtract synergies from the deal price.[123]

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[118] *Packer v. Raging Capital Mgmt., LLC*, 2019 WL 3936813 (E.D.N.Y. Aug. 20, 2019) (*Raging Capital*).

[119] SEC Div. of Corp. Fin., *Compliance and Disclosure Interpretations, Exchange Act Sections 13(D) and 13(G) and Reg. 13D-G Beneficial Ownership Reporting*, Q. 105.04 (Sept. 14, 2009).

[120] 670 F.3d 214, 221 (2d. Cir. 2012).

[121] *Packer v. Raging Capital Mgmt., LLC*, 2019 WL 3936813 (E.D.N.Y. Aug. 20, 2019), *appeal docketed*, Nos. 19-2703, 19-2852 (2d. Cir. Sept. 6, 2019).

[122] Amicus Curiae Brief in Support of Appellants, *Packer v. Raging Capital Mgmt., LLC*, Nos. 19-2703, 19-2852 (2d. Cir. filed Sept. 6, 2019).

[123] *Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.*, 2019 WL 1614026 (Del. April 16, 2019) (Per Curiam).

In prior decisions, the Delaware Supreme Court had stated that the deal price often will be the best measure of fair value in appraisal actions involving open, competitive and arm's-length mergers of publicly-traded companies.[124] Unlike those cases, however, *Verition Partners* involved a merger resulting in significant synergies, which by statute must be deducted as part of the fair value determination. Thus, the Delaware Supreme Court used the target company's calculation of deal synergies and subtracted that number from the deal price to determine the fair value of the target's shares.

2. *In re PLX Tech. Inc. Stockholders Litigation*

In May, the Delaware Supreme Court affirmed a Court of Chancery ruling that an activist investor's agent sitting on the company's board of directors had breached his fiduciary duty and that the activist investor, as the director's principal, was liable for aiding and abetting his breach.[125] However, the court also held that the plaintiffs had failed to prove any damages, negating any chance of recovery from the activist investor.

The case arose from the acquisition of a stake in PLX Technology Inc. ("PLX") by an activist investor, who then induced PLX to sell itself to another public company, Avago. Prior to the sale, a co-managing member of the activist investor was elected to PLX's board of directors ("activist director"). The activist director received a tip from an Avago executive via a third party that indicated when and how much Avago was likely to bid for PLX, but failed to share the information with other members of PLX's board or management team, and steered the board to accept a deal price that Avago was willing to pay. After a trial, the Court of Chancery found that "by withholding this information from the rest of the Board, [the activist director] breached his fiduciary duty and induced the other directors to breach theirs[,] . . . fatally undermin[ing] the sale process."[126]

Despite its finding that PLX's board had breached its fiduciary duty in carrying out the sale process, the Court of Chancery held that the plaintiffs had failed to prove any damages because "the sale process was sufficiently reliable" such that the deal price should be accorded "heavy, if not overriding, probative value," as the Delaware Supreme Court has held in the context of appraisal actions. After noting that the post-signing market check failed to yield a topping bid, the Court of Chancery found that, given the significant synergies estimated to result from the sale, the deal price "exceeded the value of the Company on a stand-alone basis." On appeal, the Delaware Supreme Court affirmed the finding of no damages and declined to reach the issue of the fiduciary duty breach.

The case is notable for the Delaware Supreme Court's willingness to extend its recent appraisal jurisprudence, such as *Verition Partners*, into other contexts in which courts are asked to determine a company's "fair" or proper value.

3. *Olenik v. Lodzinski*

In April, the Delaware Supreme Court provided further guidance on how early the "dual protections" outlined in *Kahn v. M&F Worldwide Corp.* ("MFW") must be put in place in order for a take-private transaction to be accorded deferential business judgment review.[127]

Under *MFW*, a take-private transaction proposed by a controlling shareholder will be subject to business judgment review if two procedural protections were in place for the duration of the transaction: (i) the approval of an independent, adequately empowered special committee that fulfills its duty of care; and (2) the uncoerced, informed vote of a majority of the minority

[124] See e.g., *DFC Global Corp. v. Muirfield Value Partners, L.P.*, 172 A.3d 346 (Del. 2017).

[125] *In re PLX Tech. Inc. Stockholders Litig.*, 2019 WL 2144476 (Del. May 16, 2019).

[126] *In re PLX Tech. Inc. Stockholders Litig.*, No. CV 9880-VCL, 2018 WL 5018535, at *47 (Del. Ch. Oct. 16, 2018), *aff'd*, 211 A.3d 137 (Del. 2019).

[127] *Olenik v. Lodzinski*, 208 A.3d 704 (Del. 2019).

shareholders. However, if those two procedural protections were not instituted from the beginning of negotiations, the traditional "entire fairness" standard applies.[128]

The transaction at issue in *Olenik* was a stock-for-stock merger between two companies controlled by the same shareholder, which, the plaintiffs alleged, was substantially responsible for the formulation and execution of the transaction. Reversing the Chancery Court's dismissal of the claims, the Delaware Supreme Court held that the plaintiffs had sufficiently pled that the merged companies and their controlling shareholder had engaged in "substantive economic negotiations" before putting the dual protections in place.

The Delaware Supreme Court's earlier ruling in *Flood v. Synutra International, Inc.* clarified that *MFW's* dual protections need not be in place during "preliminary discussions" or included in the controlling shareholder's initial written offer, but must be in place "early in the process and before there has been any economic horse trading."[129] *Olenik* provides additional clarity by holding that "early in the process" means before "substantive economic discussions," which most likely includes negotiation of price and other significant deal terms.

4. *venBio Select Advisor LLC v. Forrester, et al.*[130]

   In November, the Delaware Court of Chancery denied two motions to dismiss a complaint alleging breaches of fiduciary duties against purportedly independent directors. The ruling is significant because the breach of fiduciary duty was alleged to have occurred when the purportedly independent directors acted out of an entrenchment motive — i.e., to maintain their directorships in the face of an impending proxy contest — in lieu of acting for the benefit of the corporation and its shareholders.

   The decision highlights certain risks for directors (even independent ones) when acting in the context of a proxy contest. Although the director defendants in *venBio* were ostensibly independent and had no material financial motive to remain on the board, the actions they took to approve a significant transaction just before the potential loss of their directorships at the corporation's annual meeting amounted to improper entrenchment tactics and breaches of their fiduciary duties. This decision shows that Delaware law is not so formalistic as to automatically allow a supposedly independent board to approve significant corporate actions without giving due consideration to real-life circumstances.

C. Portfolio Company Litigation

1. Private equity firms face litigation risk through their portfolio companies by having the firm's managers or directors sit on a portfolio company's board, participating in the selection of portfolio company management, and implementing policy.

2. Corporate Veil-Piercing Risk

   (a) When one corporate entity controls another to the extent that the second entity is merely the alter ego of the first, courts may put aside limited liability and hold a corporation's shareholders or directors personally liable for the corporation's actions or debts.

   (b) *Marchan v. John Miller Farms, Inc.*[131]

   The plaintiffs were injured by equipment manufactured and sold by companies ("manufacturers") owned by an affiliate of a private equity fund. The affiliate had been created by the private equity fund's principals in order to make investments in the agricultural industry.

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[128] *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).

[129] *Flood v. Synutra International, Inc.*, 195 A.3d 754, 756 (Del. 2018).

[130] *venBio Select Advisor LLC v. Forrester, at al.*, No. 2017-0108-JTL (Del. Ch. Ct. Nov. 13, 2019).

[131] No. 3:2016-cv-00357 (D.N.D. Dec. 11, 2018).

The private equity fund's principals were shareholders and board members of the affiliate, but the private equity fund itself was not a shareholder of the affiliate or the manufacturers.

Despite the private equity fund's argument that it lacked unity of ownership and unity of interest with the affiliate, a district court in the District of North Dakota denied its motion for summary judgment, holding that whether to pierce the corporate veil is a question of fact for the jury. The case settled this year.

3. In recent years, private equity firms have been investing more and more heavily in the health care space, particularly in retail health care companies, which have a very high level of exposure to False Claims Act ("FCA") liability.[132] FCA liability is not limited to the individual or entity that files a false claim, but extends to individuals owning or managing companies engaged in fraud.

   (a) *Ex rel. Medrano Diabetic Care RX, LLC*[133]

   On Sept. 18, 2019, the Department of Justice announced a $21.35-million settlement with compounding pharmacy Patient Care America, two of its executives and the pharmacy's private equity backer, Riordan, Lewis & Haden Inc.[134] The private equity firm and the pharmacy will fund substantially all of the settlement. The case may be the first in which the DOJ has intervened against a private equity firm in a False Claims Act matter.

   The FCA complaint, which the DOJ filed in intervention almost three years after a whistleblower initiated the litigation, alleged that the pharmacy had paid kickbacks to independent marketers to procure prescriptions for compound pain medications and that the private equity firm knew and approved of the illegal kickbacks.

4. Insurance Coverage For Portfolio Companies: *Charter Oak Fire Ins. v. American Capital Ltd.*

   In February, the Fourth Circuit upheld an insurance coverage award of $87 million to a publicly traded private equity firm, American Capital, that was involved in mass tort litigation with a pharmaceutical portfolio company.[135] American Capital had been named as a co-defendant in more than 1,000 product liability lawsuits brought by users of the blood-thinning drug heparin.

   The insurers argued they did not have to defend the product liability suits under American Capital's liability insurance policy because American Capital had not sought coverage for any subsidiaries in its insurance applications. American Capital countered that the portfolio company was covered under the policy's "majority interest clause," which provided coverage for "any organization, other than a partnership or joint venture, over which [American Capital] maintain[s] ownership or majority interest on the effective date of the policy." The Fourth Circuit affirmed the district court's finding that the "majority interest clause" was ambiguous and thus, must be interpreted against the insurers as drafters of the clause. As a result, American Capital's ownership of more than half of the portfolio company's voting *and* nonvoting shares was enough to satisfy the "majority interest clause."

   The insurers also argued they did not have to defend the product liability suits because the suits related to the conduct of a noninsured joint venture between the portfolio company and a Chinese pharmaceutical company. American Capital's policy excluded any joint venture not named in its application. However, the district found that this "joint venture clause" did not preclude coverage because several of the complaints against the insureds did not mention the joint venture and there

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[132] The False Claims Act imposes liability (typically on government contractors) for submitting false claims for payment to the government. Alexander Owens, "First of Its Kind? Private Equity Firm and Its Portfolio Company Settle FCA Lawsuit," *The Legal Intelligencer* (Sept. 27, 2019), available here.

[133] No. 15 Civ. 62617 (S.D. Fla.).

[134] DOJ Press Release, "Compounding Pharmacy, Two of Its Executives, and Private Equity Firm Agree to Pay $21.36 Million to Resolve False Claims Act Allegations," (Sept. 18, 2019), available here.

[135] *Charter Oak Fire Insurance v. American Capital, Ltd.*, No. 17-2015 (4th Cir. 2019).

was evidence that some of the contaminated heparin came from sources other than the joint venture. Applying Maryland's rule requiring an insurer to defend "if there is a potentiality that the claim could be covered by the policy," the district court held, and the Fourth Circuit affirmed, that the heparin lawsuits created a potential for covered judgments against the insureds, and therefore, the insurers had a duty to defend.

Private equity firms should consider the organization and operations of their portfolio companies when acquiring liability insurance. PE firms should pay special attention to "majority interest clauses," including how "majority interest" is defined, and be aware that insurance companies may seek to modify the "standard" language to avoid coverage for these types of claims in the future.

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Common Brokerage and Trading Issues

I. Short Selling Considerations: Regulation SHO and Regulation M, Rule 105

A. Introduction: Regulation SHO ("Reg SHO") and Regulation M, Rule 105

1. Generally: What Is Reg SHO?

(a) Reg SHO was adopted to address concerns regarding failures to deliver securities sold short, and potentially abusive naked short selling. There are several portions of Reg SHO that impact fund managers.

(b) 17 CFR 242.200(g) defines a "short sale" as "any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller."

(c) Order Marking and Locates

(i) Reg SHO imposes on short sales of equity securities a marking requirement and a locate requirement. The marking requirement means that sell orders must be marked long or short, and the long or short marking must reflect the net position of the seller. 17 CFR 242.200(g)(1). The locate requirement means that short orders must indicate where the shares sold can be obtained in order to settle the transaction. 17 CFR 242.203.

2. Generally: What Is Regulation M, Rule 105?

(a) Rule 105 makes it unlawful for any person to "sell short," during the "Rule 105 restricted period," an equity security that is being offered for cash pursuant to a registration statement in a firm commitment underwritten offering and purchase the offered securities in the offering.

B. How Does Reg SHO Apply to Fund Managers?

1. Order Marking and Locates

(a) Reg SHO's order marking and locate rules apply only to broker-dealers, not their customers. But fund managers can still be impacted.

(b) The industry practice for complying with Rule 200(g) in the prime brokerage context "is for an executing broker to reasonably rely on a customer's representation of a 'long' sale, in that the customer's positions are held away at the prime broker." Similarly, broker-dealers are permitted to rely on a customer representation that a short sale is supported by a locate from another source, provided that such reliance is reasonable.[1]

(c) In recent years, the SEC has also looked at the conduct of fund managers transmitting orders to broker-dealers, and whether those fund managers have provided accurate information regarding their net long or short positions in the security, or the availability of a locate, to the broker-dealers handling their orders. Where advisers have inaccurately calculated net aggregate and short positions, and thus misidentified short sales as long, the SEC has charged them with derivatively causing the brokers' Reg SHO violations. The SEC can also bring charges under Rule 10b-21, which makes it a "manipulative or deceptive device or contrivance" to submit an order that deceives a broker-dealer, a participant of a registered clearing agency, such as a prime broker, or a purchaser about its intention or ability to deliver the security on or before the settlement date. *See* 17 CFR § 240.10b-21.

(i) For the purpose of order marking, the SEC has consistently maintained that sellers must aggregate all long and short positions to determine its net position in the security. In order to mark an order "long" the seller must either own, or be in possession of, (through a borrow, for example) the

[1] *See* Q&A 4.3 Division of Market Regulation: Responses to Frequently Asked Questions Concerning Regulation SHO ("Reg SHO FAQs").

shares sold.

(ii) The SEC has identified three principal ways sellers can violate the order marking or locate rules:

(1) A short seller misrepresents to an executing broker that a "locate" has been obtained from a specific source (who did not actually provide a locate); or

(2) A seller misrepresents to an executing broker that they are "long" the securities being sold (but actually do not own the shares being sold); and

(3) The seller fails to deliver the securities sold on settlement date.[2]

2. How to Comply with Reg SHO

(a) What constitutes "owning" a security for purposes of 17 CFR 242.200?

(i) Exchange Act Rules 200(b)-(f) set out when a person is "deemed to own" a security for purposes of Reg SHO under the Exchange Act. Specifically, a person is deemed to own a security if:

(1) It or its agent has title to it;

(2) The person has purchased, or entered into an unconditional contract, binding on both parties thereto, to purchase it, but has not yet received it;

(3) Owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange;

(4) Has an option to purchase or acquired it and has exercised such option;

(5) Has rights or warrants to subscribe to it and has exercised such rights or warrants; or

(6) Holds a security or futures contract to purchase it, has received notice that the position will be physically settled and is irrevocably bound to receive the underlying security.

(ii) In addition, Exchange Act Rule 200(c) states that a person is only deemed to own a security to the extent that they have a net long position. For purposes of determining the net long position for persons other than broker-dealers, the person must aggregate all of its positions in the security attributable to the same legal entity (i.e., at the individual fund level) and, pursuant to guidance issued by the SEC's Trading and Markets staff, a seller must generally decrement for all unexecuted sell orders but cannot increase the net long position for unexecuted buy orders.

(b) Order Marking Practical Considerations

(i) Carefully structure and comply with prime brokerage agreements regarding what position and trade information must be supplied to the prime brokers regarding positions.

(ii) Ensure that any trade files provided for the purpose of calculating net positions are accurate and complete.

(iii) Recognize that any short or long designation on an order must reflect the net position of the entity. Ensure long positions with a particular prime broker are netted against any short positions held elsewhere.

(iv) Where multiple prime brokers are used, ensure that trade files produced to each prime broker include all trading activity across all brokers.

(v) In multi-prime arrangements where the seller is net long, arrangements should be made with the relevant prime brokers to ensure free of payment deliveries are made to ensure that orders

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[2] 17 CFR 242.200(g) defines a "short sale" as "any sale of a security which the seller does not own *or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller."* (emphasis added).

marked long are not consummated with the delivery of borrowed shares.

(c) Locates

(i) As a best practice, responsibility for locates should be allocated to prime brokers.

(ii) If the manager is responsible for finding locates for any short sales, the locate must be found prior to the entering each short sale order. Standing instruction letters or blanket assurances do not qualify.

(iii) If the manager relies on an "easy to borrow" list to satisfy locate requirement, that list must be current and not stale.

C. How Does Rule 105 of Regulation M Apply to Fund Managers?

1. Protecting the Pricing Mechanisms of the Securities Markets

(a) According to the SEC, "[a] fundamental goal of Rule 105 of Regulation M is protecting the independent pricing mechanisms of the securities markets so that offering prices result from the natural forces of supply and demand unencumbered by artificial forces. The Rule is particularly concerned with short selling that could artificially depress market prices. Generally, the offering prices of follow-on and secondary offerings are set at a discount to a stock's closing price just prior to pricing. A person who expects to receive offering shares may attempt to profit by aggressively short-selling the security just prior to the pricing of the offering, thereby depressing the offering price, and then purchasing lower-priced securities in the offering."[3]

The main text of the rule is as follows.

(i) In connection with an offering of equity securities for cash pursuant to a registration statement or a notification on Form 1-A (§ 239.90 of this chapter) or Form 1-E (§ 239.200 of this chapter) filed under the Securities Act of 1933 ("offered securities"), it shall be unlawful for any person to sell short (as defined in § 242.200(a)) the security that is the subject of the offering and purchase the offered securities from an underwriter or broker or dealer participating in the offering if such short sale was effected during the period ("Rule 105 restricted period") that is the shorter of the period:

(1) Beginning five business days before the pricing of the offered securities and ending with such pricing; or

(2) Beginning with the initial filing of such registration statement or notification on Form 1-A or Form 1-E and ending with the pricing.

D. 17 CFR § 240.105

1. Strict Liability

(a) As evident from the text of the rule, Rule 105 is a strict liability rule. If you are participating in a public offering of securities and sell short in the restricted period, a violation has occurred. There is no requirement of any knowledge, let alone scienter to make out a violation. Compliance with Rule 105 is crucial for Fund Managers for a number of reasons.

2. Consequences of Violations

(a) Even a single violation can lead to charges; Rule 105 is not intended to catch only systematic "scams."

(b) Charges can be brought for even trivial amounts, but penalties can be sought in excess of the overall disgorgement.

(c) Rule 105 violations are also required to be reported in certain filings (e.g., 13D, ADV), and Rule 105

[3] *See* OCIE Risk Alert Rule 105 of Regulation M: Short Selling in Connection with a Public Offering, available here.

violations fall under the category of “market manipulation” and can also lead to censure, suspension or a lifetime ban of being associated with an investment advisor or broker-dealer, all of which can cause investor concern and affect your ability to keep and/or raise capital for your funds.

3. Understanding Rule 105 to Avoid Violations

   (a) Rule 105 applies to <u>firm commitment</u> underwritten offerings of equity securities for cash.

   (b) Firm Commitment vs. Best Efforts Offerings

      (i) *Firm Commitment Underwritten Offering*. One or more investment banks agree to act as an underwriter and are thereby obligated to purchase a fixed number of securities from the issuer, which they resell to the public.

      (ii) *Best Efforts Offering*. An investment bank agrees to act as placement agent to do its best to sell the offering to the public but does not buy the securities from the issuer and does not guarantee that it will sell any amount of the securities.

   (c) What is the “subject equity security”?

      (i) Rule 105 only applies to equity securities. Thus, an offering on non-convertible debt would not fall under the rule. An offering of convertible debt would fall under the rule as convertible debt is itself an equity security. However, the rule prohibits only the selling short of the “security that is the subject” of the offering, therefore a short sale of the underlying common stock would not prohibit participation in an offering of the convertible debt. However, be careful, the anti-fraud and anti-manipulation provisions of the federal securities laws still apply.

      (ii) Options and other derivatives are not considered the same as the subject equity securities with respect to an offering of common stock under the rule. However, again, the SEC has made clear that the anti-fraud and anti-manipulation provisions of the federal securities laws still apply in this context.

   (d) What is the Rule 105 Restricted Period?

      (i) The shorter of the period:

         (1) Beginning five business days before the pricing of the offered securities and ending at pricing; and

         (2) Beginning at the initial filing of the registration statement and ending at pricing.

      (ii) How do you calculate the five business day period?

         (1) “Business day” refers to a 24-hour period determined with reference to the principal market for the securities to be distributed, and that includes a complete trading session for that market.

         (2) If pricing occurs after the principal market closes, then the day of pricing is included in the five-business day period. For example, if pricing occurs on a Thursday after the principal market closes, then the restricted period would begin at the close of trading on the previous Thursday and end at pricing on the following Thursday.

         (3) *Problems with holidays.* If the principal market is closed for a holiday, then such date will not count as a business day within the five-business day period.

   (e) How do you calculate the period beginning from the initial filing of the registration statement?

      (i) Start with the issuer’s initial filing of a registration statement for the secondary offering. Oftentimes this is done well in advance (sometimes years) before the secondary at hand. But sometimes it is done by WKSIs (because they can file an automatic shelf registration statement) right before the offering, in which case, this period may be shorter than the five-business day period.

(ii) A prospectus supplement containing the specific information with respect to the offering might be filed right before the offering. This is not the initial registration statement.

(f) What is a short sale?

(i) "The term short sale shall mean any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller" 17 CFR § 242.200(a). This definition from Reg SHO is imported into Rule 105.

(ii) A person is deemed to own a security when that person:

(1) Has title to it;

(2) Has purchased it pursuant to an unconditional contract, binding on both parties, to purchase it but has not yet received it;

(3) Owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange;

(4) Has an option to purchase it and has exercised the option; or

(5) Holds a security futures contract and received notice that it will be physically settled and is irrevocably bound to receive the underlying security. 17 CFR § 200.242(b).

(g) Unexpected Situations Where You Could End Up Having a Short Sale

(i) As explained in Section II(A)(2)(a) above, short and long determinations are made on a net basis, i.e., you will only be deemed to own a security if you are net long. If you sell securities you own, but your net position is short, you will actually be selling short within the meaning of the statute. In a Rule 105 situation, calculating your net position is crucial to avoiding a violation.

(ii) If you are party to a call contract where the counterparty can force you to sell and you don't already own the underlying security, an exercise by the counterparty can cause you to have a short sale.

(iii) A preexisting short position can be increased by your broker to the extent stock dividends are issued by the issuer and the party you have borrowed from has the right to receive those dividends. It isn't clear whether the SEC would consider such an increase in your short position to be an actual short sale.

(iv) The movement of a short position from one fund to another as part of an internal rebalancing could be deemed to be a short sale, but it is not clear if the SEC could consider such a transaction to be an actual short sale for purposes of Rule 105.

4. Exceptions to Rule 105

(a) Bona Fide Purchases

(i) Even if a person has shorted during the Rule 105 restricted period, they can still participate in the offering if they have a "bona fide purchase" of the subject security:

(1) A purchase of, or purchases that total to, a number of securities at least equal to the number of securities shorted during the restricted period;

(2) During regular trading hours;

(3) That is reported; and

(4) Effected after all short sales that occurred during the Rule 105 restricted period (all purchases

must be after the last short sale to count!) and no later than the business day prior to the day of pricing.

(5) For example, if pricing occurs on Wednesday after the close of regular trading, the bona fide purchase could not be made during regular trading on Wednesday, it would have had to be made during regular trading on Tuesday.

(ii) A person relying on the bona fide purchase exception cannot have effected a short sale within the 30 minutes prior to the close of regular trading hours on the business day prior to the day of pricing. Continuing with the example above, the person could not have shorted in the last half hour of trading on Tuesday.

(b) *Separate Accounts.* A person is not prohibited from purchasing the offered securities if the person sold short during the Rule 105 restricted period in a separate account. What is a separate account?

(i) Accounts that operate without coordination of trading or cooperation. The accounts should have separate and distinct investment and trading strategies and objectives; personnel for each account do not coordinate trading among or between the accounts; information barriers should be in place so investment decisions are not shared between accounts; accounts should maintain separate profit and loss statements, no allocation of securities between or among accounts and persons with oversight over the accounts do not have authority to execute trades or pre-approve trading decisions and do not in fact do so.

(ii) Similar to Reg SHO's independent trading unit exception, but it is available to anyone, not just broker-dealers.

(iii) The SEC has denied the "separate accounts" exception, even though there were two separate accounts with different strategies and portfolio managers, where information about securities positions and investment decisions were available to all of the firm's employees and sometimes communicated between strategies, the chief investment officer exercised oversight over the firm's multiple strategies and influenced trading decisions within the strategies, and the firm did not prohibit its personnel from coordinating trading between or among strategies.

5. Compliance: How do you ensure that you are not facilitating violations?

(a) Robust Compliance Policies

(i) Fund Managers should have a robust compliance policy in place specifically for Rule 105, discrete from a general anti-manipulation policy.

(ii) These policies and procedures should provide for pre-clearance of all secondary offering allocation requests. At a minimum, pre-clearance should entail:

(1) A determination whether the secondary offering is within the scope of Rule 105;

(2) If so, the delineation of the "restricted period" for purposes of Rule 105; and

(3) The identification of any short sales in the subject security during the restricted period.

(b) Training

(i) Portfolio managers, analysts and traders should have training regarding Rule 105.

(c) Special Precautions for the Separate Accounts Exception

(i) If the separate accounts exemption is being relied upon, both training and policies and procedures should focus upon adherence to the above-mentioned conditions for the exemption.

(d) Periodic Reviews

(i) Consider conducting a quarterly review of selected secondary offering allocations and Rule 105 compliance as a means of back-testing the efficacy of your Rule 105 procedures.

6. Enforcement

(a) In 2013, the SEC announced a Rule 105 Initiative that was designed to pursue "every Rule 105 violation over a *de minimis* amount that has come to its attention — promoting a message of zero tolerance for these offenses."[4]

(b) Since this initiative started, the SEC has fined dozens of firms millions of dollars in monetary sanctions for Rule 105 violations.

II. Execution Considerations for Fund Managers: Best Execution, Rule 606 and Soft Dollars

A. Introduction: Best Execution

1. Best Execution is commonly understood to refer to the duty owed by broker-dealers.

(a) "Brokers are legally required to seek the best execution reasonably available for their customers' orders. To comply with this requirement, brokers evaluate the orders they receive from all customers in the aggregate and periodically assess which competing markets, market makers, or electronic communications networks (ECNs) offer the most favorable terms of execution. Some of the factors a broker must consider when seeking best execution of customers' orders include: the opportunity to get a better price than what is currently quoted, the speed of execution, and the likelihood that the trade will be executed."[5]

2. Best Execution for Fund Managers

(a) The SEC has made clear that registered Investment Advisers, as a part of their fiduciary duties to their clients, must consider best-execution. "[W]hen an adviser has the responsibility to select broker-dealers and execute client trades, the adviser has an obligation to seek to obtain "best execution" of client transactions, taking into consideration the circumstances of the particular transaction. An adviser must execute securities transactions for clients in such a manner that the client's total costs or proceeds in each transaction are the most favorable under the circumstances. In directing brokerage, an adviser should consider the full range and quality of a broker-dealer's services including, among other things, the value of research provided as well as execution capability, commission rate, financial responsibility, and responsiveness to the adviser."[6]

B. What are an adviser's obligations with respect to best execution?

(a) A 2018 Risk Alert from the SEC Office of Compliance Inspections and Examinations provides useful guidance on what the SEC expects of Advisers with respect to best execution. The Risk Alert identified certain categories of repeat deficiencies it found in examinations of Advisers. Included in these were deficiencies relating to how the Advisers reviewed the best execution provided by brokers, as well as client disclosure deficiencies involving best execution, and inadequate compliance policies and procedures.

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[4] *See,* SEC Press Release, "SEC Charges Six Firms for Short Selling Violations in Advance of Stock Offerings," available here.

[5] SEC Fast Answers: Best Execution, available here.

[6] SEC OCIE Risk Alert, "Compliance Issues Related to Best Execution by Investment Advisers," July 11, 2018, available here (hereinafter (OCIE Best Execution Alert).

2. Deficiencies Relating to Evaluating Best Execution by Brokers:

   (a) Failing to Perform Best Execution Reviews

      (i) "The staff observed advisers that could not demonstrate that they periodically and systematically evaluated the execution performance of broker-dealers used to execute client transactions. For example, the staff observed advisers that did not conduct an evaluation of best execution when selecting a broker-dealer to execute transactions or were unable to demonstrate, through documentation or otherwise, that they performed such an evaluation."[7]

   (b) Performing Best Execution Reviews that Were Not Adequate

      (i) "The staff observed advisers that did not consider the full range and quality of a broker-dealer's services in directing brokerage. For example, the staff observed:

         (1) Advisers that, as part of their best execution reviews, did not evaluate any qualitative factors relating to a broker-dealer including, among other things, the broker-dealer's execution capability, financial responsibility, and responsiveness to the adviser.

         (2) Advisers that, as part of their best execution reviews, did not solicit and review input from the adviser's traders and portfolio managers."[8]

   (c) Not Comparing Brokers' Performances Or Seeking Robust Comparisons in Evaluating Brokers

      (i) "The staff observed advisers that utilized certain broker-dealers without seeking out or considering the quality and costs of services available from other broker-dealers. For example, the staff observed:

         (1) Advisers that utilized a single broker-dealer for all clients without seeking comparisons from competing broker-dealers initially and/or on an ongoing basis to assess their chosen broker-dealer's execution performance.

         (2) Advisers that utilized a single broker-dealer based solely on cursory reviews of the broker-dealer's policies and prices.

         (3) Advisers that utilized a broker-dealer based solely on that broker-dealer's brief summary of its services without seeking comparisons from other broker-dealers."[9]

   (d) Deficiencies Relating to Best Execution Disclosures

      (i) Not fully or accurately disclosing best execution practices

         (1) "The staff observed advisers that did not provide full disclosure of best execution practices. For example, the staff observed advisers that did not disclose that certain types of client accounts may trade the same securities after other client accounts and the potential impact of this practice on execution prices. In addition, the staff observed advisers that, contrary to statements in their brochures, did not review trades to ensure that prices obtained fell within an acceptable range."[10]

   (e) Not Properly Disclosing "Soft Dollar" Arrangements[11]

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[7] OCIE Best Execution Alert at 2.

[8] *Id.*

[9] *Id.* at 2-3.

[10] *Id.* at 3.

[11] Advisers that "receive research or other products or services other than execution from a broker-dealer or a third party in connection with client securities transactions" (known as "soft dollar benefits") must disclose that fact and discuss whether those benefits create conflicts of interest. *See* Part 2A of Form ADV, Item 12.A.1.

(i) "The staff observed advisers that did not appear to provide full and fair disclosure in Form ADV of their soft dollar arrangements. For example, the staff observed:

(1) Advisers that did not appear to adequately disclose the use of soft dollar arrangements.

(2) Advisers that did not disclose that certain clients may bear more of the cost of soft dollar arrangements than other clients.

(3) Advisers that did not appear to provide adequate or accurate disclosure regarding products and services acquired with soft dollars that did not qualify as eligible brokerage and research services under the Section 28(e) safe harbor."[12]

(f) Disclosure and allocation issues relating to "mixed use" products or services. Mixed use products or services are those obtained from a broker-dealer in connection with client securities transactions which do not qualify for the Section 28(e) safe harbor.

(i) "The staff observed deficiencies related to mixed use allocations. For example, the staff observed advisers that did not appear to make a reasonable allocation of the cost of a mixed use product or service according to its use or did not produce support, through documentation or otherwise, of the rationale for mixed use allocations."[13]

(g) Deficiencies Related to Compliance Policies and Procedures

(i) Failing to have robust policies and procedures with respect to best execution

(1) "The staff observed advisers that appeared to have inadequate compliance policies and procedures or internal controls regarding best execution. For example, the staff observed:

a. Advisers that did not have any policies relating to best execution.

b. Advisers with insufficient internal controls because the advisers failed to monitor broker-dealer execution performance.

c. Advisers with policies that did not take into account the current business of the adviser, including the type of securities traded by the adviser."[14]

(ii) Failing to follow written policies and procedures

(1) "The staff observed advisers that did not follow their policies and procedures regarding best execution. For example, the staff observed:

a. Advisers that did not follow their own policies regarding best execution review, including seeking comparisons from competing broker-dealers to test for pricing and execution.

b. Advisers that did not allocate soft dollar expenses in accordance with their policies.

c. Advisers that did not follow their internal policies regarding the ongoing monitoring of execution price, research and responsiveness of their broker-dealers.

C. Where should fund managers look for information to evaluate best execution?

1. Rule 606: Broker-Dealer Data for Evaluating Best Execution

(a) Exchange Act Rule 606 requires broker-dealers to publicly disclose, on a quarterly basis, certain aggregated order routing information for customer orders[15] and to disclose separately to any customer,

[12] OCIE Best Execution Alert at 3.

[13] *Id.*

[14] *Id.* at 4.

[15] Exchange Act Rule 606(a).

upon request, certain customer-specific order routing information for the six-month period preceding the request.[16]

(b) In November 2018, the SEC adopted amendments to Rule 606 ("Amendments") to address changes in the equity market structure, order routing and handling practices since Exchange Act Rule 606 was originally adopted, including the increased percentage of orders being handled by trading algorithms and related routing systems.[17] The Amendments are intended to assist market participants in comparing the routing services of broker-dealers and the relative merits of competing trading centers, and to help customers evaluate how broker-dealers handle conflicts of interest and risks of information leakage.

(c) The Amendments, which became effective in May 2018 implement the following changes:

(i) Broker-dealers are required, upon customer request, to provide customer-specific disclosures regarding the broker-dealer's handling of a customer's orders in NMS stocks[18] submitted on a not-held basis for the prior six months, subject to two *de minimis* exceptions.[19]

(ii) Broker-dealers are required to include in the quarterly order routing reports required by Rule 606(a) all customer orders in NMS stocks submitted on a held basis, and to provide enhanced disclosures regarding payment for order flow,[20] including both the net aggregate amounts of payment received from identified market centers, and amounts received on a per share basis; and

(iii) Broker-dealers are required to offer their Rule 606 quarterly order routing reports and Rule 605 quarterly execution reports free and accessible on a website for three years from the date of posting.

(d) Now that more granular data is available and for a longer time, Advisers should avail themselves of it when conducting reviews of the execution quality provided by their broker-dealers.

2. Reg ATS-N – Information about ATS Executions

(a) ATS as Execution Venues: Evaluating new information:

(i) In July 2018, the SEC adopted amendments to Reg ATS, the regulation governing alternative trading systems. The new amendments impose extensive new transparency requirements on ATS that execute transactions in NMS stocks.

(ii) These ATS will be required to file new Form ATS-N and publicly disclose detailed information regarding the manner of operation of the ATS and the ATS-related activities of both the ATS' broker-dealer operator and the operator's affiliates.[21] The amendments also require ATS operators to memorialize their safeguards and procedures relating to the protection of subscribers' confidential trading information.

(b) Advisers may wish to consider this newly publicly available information in order to review what ATS's are available, the functionality provided by each (some may focus on block trading, for instance) and the costs associated with each (since ATS-N requires disclosure of the range of fees charged users).

[16] Exchange Act Rule 606(b).

[17] *See* Exchange Act Rel No. 34-84528 (Nov. 2, 2018), 83 Fed. Reg. 58338 (Nov. 19, 2018) ("Adopting Release").

[18] As that term is defined at Exchange Act Rule 600(b)(47).

[19] The two exceptions are a firm-level *de minimis* exception and a customer level *de minimis* exception.

[20] Payment for Order Flow, at a high level, is the amount of rebate that securities exchanges pay to broker-dealers in exchange for routing orders and thereby providing liquidity to their exchanges. *See* SEC Fast Answers, Payment for Order Flow, available here.

[21] Form ATS-N filings will be publicly posted through the SEC's Electronic Data Gathering, Analysis, and Retrieval system (EDGAR).

III. Broker-Dealer Registration Issues

A. Broker-Dealer Registration Requirements

1. Any person who engages in "broker" or "dealer" activity, as those terms are defined, respectively, at Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, as amended ("Exchange Act"), is required to register as a broker-dealer with the SEC pursuant to Section 15 of the Exchange Act.

(a) What is a "Dealer"?

(i) The Exchange Act defines the term "dealer" as "any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise."[22]

(ii) The courts and the SEC have identified certain indicia of "dealer" activity, including:

(1) Purchasing or selling securities as principal to or from customers[23];

(2) Carrying a dealer inventory in securities[24];

(3) Holding oneself out as a dealer or market-maker or as being otherwise willing to buy or sell one or more securities on a continuous basis[25];

(4) Engaging in trading in securities for the benefit of others (including any affiliate), rather than solely for the purpose of the person's investment, liquidity or other permissible trading objective[26];

(5) Participating in a selling group or underwriting with respect to securities[27];

(6) Engaging in purchases or sales of securities from or to an affiliated broker-dealer except at prevailing market prices[28];

(7) Having a regular clientele[29]; and

(8) Advertising or otherwise holding itself out as buying or selling securities on a continuous basis or at a regular place of business.[30]

(iii) Notably, the Exchange Act excludes from the definition of "dealer" any "person that buys or sells securities [ ] for such person's own account, either individually or in a fiduciary capacity, *but not as a part of a regular business.*"[31] This exclusion is intended to carve-out from the definition of "dealer" people who trade for their own accounts, but not as part of a regular business (e.g., "traders").

(b) What is a "Broker"?

(i) The Exchange Act defines the term "Broker" as "any person engaged in the business of effecting

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[22] *See* Exchange Act section 3(a)(5)(A).

[23] *See* Exchange Act Release No. 34-47364 (Feb. 13, 2003).

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] *Id.*

[28] *Id.*

[29] *See* Exchange Act Release No. 34-46745 (Oct. 30, 2002) ("*Bank Exemptions Proposing Release*").

[30] *See* Bank Exemptions Proposing Release; Joseph McCulley, SEC No-Action Letter (Aug. 2, 1972); Continental Grain Company, SEC No-Action Letter (Nov. 6, 1987).

[31] *See* Exchange Act Section 3(a)(5)(B). (*Emphasis added*).

transactions in securities for the account of others." While the terms "effecting transactions in securities" and "engaging in the business of effecting transactions in securities transactions" are not defined in the Exchange Act, the SEC has interpreted both terms broadly and stated that a person who participates in *any* of the steps necessary to engage in a securities transaction may be required under the Exchange Act to register as a broker.

(ii) Through no-action letters and other pronouncements, the SEC has identified certain indicia of "Broker" activity, including:

(1) Solicitation, negotiation, facilitation or execution of a transaction[32];

(2) Receipt of transaction-related compensation[33];

(3) Handling of securities or funds of others in connection with the transaction[34];

(4) Structuring a transaction;

(5) Identification of potential purchasers or sellers of securities;

(6) Engaging in credit-related activities;

(7) Participation in the order-taking or order-routing process[35];

(8) Arranging for, or performing of, clearance and settlement of executed trades;

(9) Holding oneself out as a broker, as conducting the activities of a broker, including executing trades or assisting others in settling securities transactions[36]; and

(10) Participation in the securities business with some degree of regularity.[37]

(iii) Issuer's Exemption

(1) Exchange Act rule 3a4-1 provides a non-exclusive safe harbor whereby "associated persons of an issuer"[38] will not be deemed to be "brokers" solely due to their participation in sales of the issuer's securities.

a. To qualify for the safe harbor, the associated person:

i. Must not be subject to a statutory disqualification (as that term is defined in section 3(a)(39) of the Exchange Act) at the time of his or her participation in the selling efforts[39];

[32] Exchange Act Release No. 34-44291 (May 11, 2001). Exchange Act Release No. 34-27017 (July 11, 1989).

[33] Exchange Act Release No. 34-20943 (May 9, 1984). *But see SEC v. Kramer*, et al., 778 F. Supp. 2d 1320 (M.D. Fla. 2011), stating that no single factor alone, including the receipt of transaction-based compensation, should be dispositive of "broker" status.

[34] SEC, Division of Trading and Markets, Guide to Broker-Dealer Registration (April 2008), available here.

[35] Exchange Act Release No. 34-44291 (May 11, 2001).

[36] *SEC v. Margolin*, Fed. Sec. L. Rep (CCH) 97,025 at 94,517 (S.D.N.Y. 1992). Swiss American Securities, Inc. and Streetline, Inc., SEC No-Action Letter (May 28, 2002).

[37] *Mass. Fin. Serv., Inc. v. SIPC*, 411 F. Supp. 411, 415 (D. Mass.), *aff 'd*, 545 F.2d 754 (1st Cir. 1976).

[38] An "associated person of an issuer" is defined as any natural person who is a partner, officer, director or employee of: (i) the issuer; (ii) a corporate general partner of a limited partnership that is the issuer; (iii) a company or partnership that controls, is controlled by or is under common control with, the issuer; or (iv) an investment adviser registered under the Investment Advisers Act of 1940 to an investment company registered under the Investment Company Act of 1940 which is the issuer.

[39] *See* Exchange Act rule 3a4-1(a)(1).

ii. Must not receive transaction-based compensation in connection with his or her selling efforts[40];

iii. Must not be an associated person of a broker-dealer at the time or his or her participation[41]; and

iv. Must satisfy one of three non-exclusive conditions relating to his or her selling activities,[42] including by (i) primarily performing substantial duties for or on behalf of the issuer other than in connection with securities transactions, (ii) not having been registered with a broker-dealer or investment adviser within the past 12 months and (iii) not having participated in the sale of any securities other than in reliance on one of the other provisions of Exchange Act rule 3a4-1.[43]

(c) Finders

(i) The term "finder" is commonly used to describe a person involved in putting together buyers and sellers of securities. However, the term "finder" is not defined in the Exchange Act; rather, analysis of whether a person acts as a "finder" requires an analysis of whether a person's activities in connection with a securities transaction are sufficiently limited that he or she does not meet the definition of "broker" under Exchange Act section 3(a)(4).

(ii) The SEC has provided guidance regarding where a person may be deemed to act as "finder" (as opposed to "broker") in the form of certain No-Action Letters.

(1) For instance, in a No-Action Letter to Richard S. Appel (dated Feb. 14, 1983), the staff indicated that broker-dealer registration was required where a person (i) provided names of potential investors to an issuer, (ii) received transaction-based compensation and (iii) participated in negotiations to the limited extent of describing the investment in general terms to prospective investors.

(2) In another No-Action Letter to Davenport Management, Inc., (April 13, 1993), the SEC denied requested no-action relief where a service provider would:

a. Act repeatedly and continuously as an intermediary in securities transactions;

b. Be actively involved in securities transactions, by negotiating their terms, providing advice regarding their terms, or providing other assistance;

c. Receive compensation tied directly to transactions in securities;

d. Provide "investment banking services," albeit to an affiliated entity; and

e. Have direct contact with outside investors, both in finding co-investors for the issuer and in finding purchasers for investments previously made by the issuer.

(iii) Notwithstanding the above, in a No-Action Letter to Mr. Paul Anka (dated July 24, 1991, "Paul Anka Letter"), SEC staff stated that it would not recommend enforcement action under Section 15(a) of the Exchange Act where an unregistered individual whose involvement in selling efforts was to be limited to providing an issuer with a list of potential investors and related contact information would receive transaction-based compensation (e.g., commissions) in connection with any resulting securities transactions.

[40] *See* Exchange Act rule 3a4-1(a)(2).

[41] *See* Exchange Act rule 3a4-1(a)(3).

[42] *See* Exchange Act rule 3a4-1(a)(4).

[43] *See* Exchange Act rule 3a4-1(a)(4)(ii).

(1) Importantly, Mr. Anka's proposed selling efforts were limited to providing the issuer with a list of potential investors. Mr. Anka would not, for instance, participate in any negotiations between the issuer and investors, nor would Mr. Anka solicit the investors or recommend purchasing the issuer's securities.

(d) M&A Broker No-Action Guidance

(i) In two 1985 cases, the Supreme Court determined that in situations where the sale of an entire business is effected by selling the target's securities (rather than its assets), these transactions are securities transactions subject to the federal securities laws.[44] In 2014, the SEC issued no-action relief to clarify the impact of these decisions on those involved in certain types of M&A transactions.[45]

(1) In the letter, the SEC Division of Trading and Markets stated that it would not recommend enforcement actions under Section 15(a) of the Exchange Act, where a person facilitates certain types securities transactions without first registering as a broker (such persons, "M&A Brokers").

a. M&A Brokers are those that are "engaged in the business of effecting securities transactions solely in connection with the transfer of ownership and control of a privately-held company…through the purchase, sale, exchange, issuance, repurchase, or redemption of, or a business combination involving, securities or assets of the company, to a buyer that will actively operate the company or the business conducted with the assets of the company."[46]

(ii) The letter notes that the buyer (or group of buyers) may choose to operate the company or business through the "power to elect executive officers and approve the annual budget or by service as an executive or other executive manager" and need not be the sole owner of the target company post-closing.[47]

(iii) The letter identified certain additional characteristics of a transaction necessary to fall within the M&A Broker relief, including:

(1) The privately-held company being sold must not have any class of securities registered or required to be registered with the SEC under Section 12, and it must itself be a going concern and not a "shell" company;

(2) The broker facilitating the transaction may not have power to bind any party to the transaction, and may not, either directly or indirectly, finance the transaction;

(3) The M&A Broker may not have custody of, or handle funds or securities issued or exchanged, in connection with the transaction;

(4) The transaction may not involve a public offering of securities;

(5) If the M&A Broker represents both buyer and seller, it must provide clear disclosures and obtain consent from both sides;

(6) If there is a group of buyers, that group must have been formed without involvement from the M&A Broker;

[44] *See Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985); *Gould v. Reufenach*, 471 U.S. 701 (1985).

[45] Division of Trading and Markets No-Action, Exemptive, and Interpretive Letter: M&A Brokers, Jan. 31, 2014.

[46] *Id.* at 2-3.

[47] *Id.* at 3, noting, among other things, that "control will be presumed to exist if, upon completion of the transaction, the buyer or group of buyers has the right to vote 25% or more of a class of voting securities … ."

(7) At the conclusion of the transaction, the buyer must actively control the company[48]; and

(8) The M&A Broker and all of its affiliated persons may not be barred or suspended from registration as a broker-dealer as a result of a disciplinary action.[49]

B. Broker-Dealer Registration

1. As noted above, any person that acts as a "broker" or "dealer" generally must register with the SEC pursuant to Section 15 of the Exchange Act. Additionally, such persons must, subject to certain very limited exceptions, become a member of FINRA.[50]

2. In 2017, new FINRA rules relating to capital acquisition brokers ("CAB Rules") became effective. These rules were adopted in hopes of providing certain regulatory relief to broker-dealers solely engaged in certain brokerage activities.[51] CAB Rules apply to FINRA members that meet the definition of capital acquisition broker ("CAB") under FINRA rule 016(c) and have been approved by FINRA to be regulated as CABs. CABs are subject to a more limited set of rules than other FINRA members.

(a) CAB is defined by FINRA as a broker that solely engages in certain delineated activities, including advising issuers regarding "securities offering or other capital raising activities" and acting as a placement agent in connection with the sale of newly-issued, unregistered securities to "institutional investors."[52]

(b) The term "institutional investor" has substantially the same meaning as that term is defined at FINRA Rule 2210, and includes any person meeting the definition of "qualified purchaser" under Section 2(a)(51) of the Investment Company Act of 1940. The term does not, however, include "accredited investors" (as defined at rule 501(a) of the Securities Act of 1933, as amended).

(c) FINRA noted that it did not believe it was necessary or appropriate to extend the definition of "institutional investor" to include "accredited investors" as accredited investors may not have the requisite investment acumen or financial means to understand or assume the risks associated with investments sold by CABs."[53]

IV. Section 13(d) and Section 16 Reporting Requirements under the Exchange Act

A. Section 13(d) Reporting Requirement Trigger

1. Upon becoming a greater than 5% "beneficial owner" of any voting, equity security registered under the Exchange Act ("Subject Securities").

(a) A beneficial owner of a security includes any person who, *directly or indirectly*, through any contract, arrangement, understanding, relationship or otherwise has or shares *voting power* and/or *investment power* with respect to such security. An Investment Manager's beneficial ownership should be calculated based on the aggregate positions of all entities it manages that are not disaggregated from each other for purposes of Section 13(d) and Section 16 reporting.

(i) Voting power includes the power to vote, or to direct the voting of, a security.

(ii) Investment power includes the power to dispose, or the power to direct the disposition, of a security.

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[48] *See* footnote 28, *supra*.

[49] See *Id.* at 2-4.

[50] FINRA is a "self-regulatory organization" that enforces its members' compliance with the federal securities laws and FINRA's own rules.

[51] *See* Exchange Act Release No. 34-78617, 81 Fed. Reg. 57948 (Aug. 24, 2016).

[52] *See* FINRA Rule 016(c).

[53] *See* 81 FR at 57957.

(b) Rule 13d-3(d)(1)(i) provides that a person is deemed to be the beneficial owner of a security if that person has the right to acquire beneficial ownership of that security within 60 days.[54]

(c) Rule 13d-5(b)(1) provides that when two or more persons agree (whether formal or informal, orally or in writing) to act together for the purpose of acquiring, holding, voting or disposing of Subject Securities, all members of the group formed thereby will be deemed to have beneficial ownership of all Subject Securities beneficially owned by the other members of the group.

(i) To be a member of a group, a person first must be the beneficial owner of Subject Securities.

(ii) If considered a group, the Subject Securities held by the group members must be aggregated when determining whether the 5% threshold has been crossed.

(iii) A group can also be formed with affiliated or unaffiliated entities or persons, if an agreement as to the acquisition, holding, voting or disposition of Subject Securities exists.

B. Type of Filing Required: Schedule 13D or the short form Schedule 13G?

1. Section 13(d) of the Exchange Act requires a beneficial owner that acquires more than 5% of a class of Subject Securities to file on Schedule 13D unless eligible to file on Schedule 13G.

(a) The initial Schedule 13D filing must be made within 10 calendar days of crossing 5%.

(b) Amendments must be made "promptly"[55] upon any material change in the information previously reported.

(i) An acquisition or disposition of 1% or more of the class of securities is deemed to be a material change requiring an amendment.

(ii) Another common amendment trigger is any material change to a filer's plans or proposals with respect to the issuer (under Item 4 of Schedule 13D).

2. Eligibility to File on Schedule 13G

(a) *13d-1(b) Qualified Institutional Investors*. Certain institutional investors (e.g., registered investment advisers, registered investment companies and registered brokers or dealers) may file on Schedule 13G as long as they have acquired the Subject Securities in the ordinary course of business and not with the purpose nor with the effect of changing or influencing the control of the issuer.

(i) The initial Schedule 13G is required to be filed within 45 days after the end of the calendar year if the beneficial ownership of the reporting person(s) exceeds 5% as of December 31; provided that, if the reporting person(s) beneficial ownership exceeds 10% prior to the end of the calendar year, the reporting person(s) initial Schedule 13G must be filed within 10 days after the end of the first month in which the reporting person(s) beneficial ownership exceeds 10% on the last day of the month.

(ii) Amendments are required:

(1) Within 45 days of the end of the calendar year if, as of December 31, there is any change in the information previously reported (unless the only change is a change in the percentage

[54] However, non-passive holdings confer beneficial ownership for a right to acquire at any time — even after 60 days. This important exception to the 60-day rule provides that any person who has a right to acquire beneficial ownership of a security with the purpose or effect of changing or influencing control of the issuer, or in connection with, or as a participant in, any transaction having such purpose or effect, is deemed to be a beneficial owner of the security immediately upon acquiring the right to acquire the security regardless of whether that right cannot be exercised within 60 days. Nonetheless, a person does not beneficially own Subject Securities underlying a derivative security if the right to acquire the underlying Subject Security is subject to material contingencies outside the control of such person that cannot be waived (e.g., the requirement to obtain a governmental approval or the effectiveness of a registration statement). Such a right does not create beneficial ownership until the contingency is met even where these material contingencies could be met within the 60-day period.

[55] "Promptly" is not defined in the rules, but has generally been interpreted by courts to mean not more than two business days.

beneficially owned and such change is a result of a change in the number of shares of the class outstanding);

(2) Within 10 calendar days after the end of any month in which beneficial ownership exceeds 10% as of the end of the month; and

(3) Once over 10%, within 10 calendar days of the end of any month in which beneficial ownership increases or decreases by more than 5% as of the end of the month.

(b) *13d-1(c) Passive Investors*. Investors that are not one of the types of institutional investors permitted to file under Rule 13d-1(b) may file under Rule 13d-1(c) as long as they have not acquired the Subject Securities with the purpose, or with the effect of, changing or influencing control of the issuer and their beneficial ownership does not constitute 20% or more of the class of Subject Securities.

(i) The initial Schedule 13G is required within 10 days of crossing 5% beneficial ownership.

(ii) Amendments are required:

(1) Within 45 days of the end of the calendar year if, as of December 31, there is any change in the information previously reported (unless the only change is a change in the percentage beneficially owned and such change is a result of a change in the number of shares of the class outstanding);

(2) "Promptly" upon crossing 10% beneficial ownership; and

(3) Once over 10%, "promptly" after beneficial ownership increases or decreases by more than 5%.

(c) *13d-1(d) Exempt Investors*. Investors who are or become the beneficial owner of more than 5% of a class of Subject Securities but who have not made an "acquisition" subject to Section 13(d) are permitted to file on Schedule 13G (for example those who become beneficial owners of more than 5% of a class of Subject Securities as a result of a stock buy-back, or those who owned the Subject Security prior to the Subject Security becoming registered under the Exchange Act) .[56] This provision is available regardless of control intent or ownership level. The ability to file under 13d-1(d) is lost if the investor acquires more than 2% of the class of Subject Securities within any 12-month period. For example, if the investor acquired 1.5% of the Subject Security two months prior the Exchange Act registration and one month following the registration acquired another 0.6% of the Subject Security, the ability to file under 13d-1(d) would be lost and instead of filing under Rule 13d-1(d) after the year-end, the investor would instead file under Rule 13d-1(b), 13d-1(c) or file a Schedule 13D, as appropriate.

(i) The initial Schedule 13G filing is required within 45 days of the end of the calendar year, if beneficial ownership exceeds 5% as of the end of the calendar year.

(ii) Amendments are required within 45 days of the end of the calendar year if, as of December 31, there is any change in the information previously reported (unless the only change is a change in the percentage beneficially owned and such change is a result of a change in the number of shares of the class outstanding).

C. Section 16 Reporting Requirement Trigger

1. Upon becoming an officer, director[57] or greater than 10% "beneficial owner" of any Subject Security.

(a) "Beneficial ownership" for determining who is subject to Section 16 is, for the most part, the same as

[56] This comes up most often where an issuer's securities are held, such as by a private equity or venture capital fund, prior to the issuer's initial public offering (concurrently with which the securities will become registered under the Exchange Act).

[57] It is possible for an entity to be treated as a director for purposes of Section 16 if it can be shown that the entity has deputized an individual to sit on the board of an issuer in order to represent the interests of the entity. If an entity is deemed to be a director-by-deputization, the entity will be treated as a director and subject to Section 16 as such regardless of whether the entity beneficially owns more than 10% of the issuer's securities.

the Section 13(d) beneficial ownership determination. Therefore, a Schedule 13D/G filer that is a greater than 10% beneficial owner separately will be subject to Section 16 reporting. Accordingly, reporting persons are typically the same as under the Section 13(d) analysis.

D. What is Reported and Subject to Matching Under Section 16(a)?

1. The beneficial ownership test used to determine whether a person is subject to Section 16 as a greater than 10% beneficial owner is different from the test used to determine what is reported under Section 16(a) and what is subject to matching for purposes of Section 16(b). Section 16(a) requires the disclosure of, and Section 16(b) subjects to profit disgorgement under Section 16, any equity securities of the issuer in which the reporting persons have a direct or indirect "pecuniary interest" (discussed below).

2. The use of different tests for determining greater than 10% beneficial ownership on the one hand, and what is included on Section 16 reports on the other hand, can result in a filer not reporting securities that were taken into account when determining whether the filer was subject to Section 16. It can also result in securities that are reported under Section 16 being excluded from Section 13(d) reporting and vice versa.

3. Pecuniary interest is defined as the "opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject securities." Rule 16a-1(a)(2)(i).

   (a) An indirect pecuniary interest is defined to include a general partner's proportionate interest in the portfolio securities held by a general or limited partnership to the extent of the greater of the partner's share of the partnership's profits or capital account. Rule 16a-1(a)(2)(ii)(B).

   (b) An Investment Manager will have an "indirect pecuniary interest" with respect to a class of an equity security if it receives a performance fee based, in part, on the security's performance unless, with respect to the performance fee:

      (i) The performance fee is calculated over a period of one year or more; and

      (ii) The equity securities of the issuer do not account for more than 10% of the market value of the portfolio of the applicable fund or account. Rule 16a-1(a)(2)(ii)(C).[58]

   (c) Asset based fees are excluded from the definition of indirect pecuniary interest. Rule 16a-1(a)(2)(ii)(C).

   (d) A Fund will be deemed to have a direct pecuniary interest in any securities directly held by it.

4. Forms Filed Under Section 16(a)

   (a) *Form 3 – Initial Statement of Beneficial Ownership of Securities*. Generally must be filed within 10 days of becoming an officer, director or greater than 10% "beneficial owner" to report all equity securities in which the filer has a pecuniary interest as of the time of crossing 10% (except that if the filing is a result of the initial registration of the issuer's securities under the Exchange Act (e.g., in connection with an IPO) the filing is required to be made on the date the issuer's registration statement is declared effective by the SEC).

   (b) *Form 4 – Statement of Change of Beneficial Ownership of Securities.* Must be filed within 2 business days after a change in pecuniary interest takes place to report such change.

   (c) *Form 5 – Annual Statement of Beneficial Ownership of Securities.* Must be filed within 45 days of the issuer's fiscal year end to report transactions that took place in the prior year that should have been reported but were not. It can also be used to report certain transactions exempt from 16(b). If there are no transactions required to be filed on a Form 5, no such filing is made for the year.

[58] The determination of "market value" is not defined. A factor that can be relevant to the determination includes how the Fund or account carries the position on its books.

5. Section 16(b) Short Swing Profit Liability

   (a) Section 16(b) imposes liability for short-swing profits from the issuer's equity securities (including derivative securities) upon all persons required to file reports under Section 16(a).

   (b) Section 16 insiders must disgorge to the issuer any profits realized as a result of a purchase and sale or sale and purchase of any equity securities of the issuer within a period of less than six months ("short swing profits").

   (c) With respect to 10% beneficial owners, the purchase that puts the beneficial owner over the 10% threshold does not qualify as a "purchase" subject to Section 16(b); only purchases made after becoming a greater than 10% beneficial owner will give rise to short swing profits when matched against sales occurring within six months, and while a Section 16 insider.

   (d) The "lowest-in, highest-out" method of calculating matching transactions is used to calculate profits under Section 16(b). Under this approach, "the highest sale price during the six month period is matched against the lowest purchase price in that period, followed by the next highest sale price and next lowest purchase price and so on, until all shares have been included," irrespective of the order in which the transactions were executed. Under this approach, it is possible for an insider to have an actual loss but a "realized" profit that is payable under Section 16(b).

Example

Transactions	Investment Status
Transaction 1 Buy 1,000,000 shares at $10 ($10M)	$10,000,000
Transaction 2 Buy 1,000,000 shares at $20 ($20M)	$30,000,000
Transaction 3 Sell 1,000,000 shares at $20 ($20M)	$10,000,000
Transaction 4 Sell 1,000,000 shares at $5 ($5M)	$5,000,000
Total Loss = $5,000,000	

Under §16(b)
Lowest price in = $10 = $10,000,000
Highest price out = $20 = $20,000,000
Total Realized Profit = $10,000,000

V. Rule 14e-4: The Short Tender Rule

A. Rule 14e-4 Generally

1. Rule 14e-4 prohibits a person from tendering shares into a partial tender offer unless the person is "net long" both at the time of tender and at the end of the proration period of the tender offer. Under Rule 14e-4(a)(1) a person's "net long position" is the excess, if any, of its "long position" over its "short position."

2. In adopting Rule 14e-4 (which at the time was Rule 10b-4. It was designated as Rule 14e-4 in 1990), Congress indicated that its intention was for each shareholder to receive equal treatment based upon the shareholder's interest in the securities that are the subject of a tender offer. By short tendering or hedging their tender, market professionals reduce their proration risk while increasing the proration risk of all those who cannot short or engage in hedged tendering, because the short or hedged tendering often leads to over tendering (i.e., the same shares being tendered more than once). The SEC has observed that short and hedged tendering often requires access to borrowed shares which market professionals have a clear advantage in obtaining access to. (See Release No. 34-26609 (March 8, 1989)).

B. Things to Note When Calculating a Person's Long and Short Positions

1. Rule 14e-4(a)(1)(i) defines a person's long position to include the amount of subject securities that such person:

   (a) Or his agent has title to or would have title to but for having lent such securities; or

   (b) Has purchased, or has entered into an unconditional contract, binding on both parties thereto, to purchase but has not yet received; or

   (c) Has exercised a standardized call option for; or

   (d) Has converted, exchanged or exercised an equivalent security for; or

   (e) Is entitled to receive upon conversion, exchange or exercise of an equivalent security.

C. Rule 14e-4(a)(1)(ii) defines a person's short position to include the amount of subject securities that such person:

1. Has sold, or has entered into an unconditional contract, binding on both parties thereto, to sell; or

2. Has borrowed; or

3. Has written a non-standardized call option, or granted any other right pursuant to which his shares may be tendered by another person; or

4. Is obligated to deliver upon exercise of a standardized call option sold on or after the date that a tender offer is first publicly announced or otherwise made known by the bidder to holders of the security to be acquired, if the exercise price of such option is lower than the highest tender offer price or stated amount of the consideration offered for the subject security. For the purpose of this paragraph, if one or more tender offers for the same security are ongoing on such date, the announcement date shall be that of the first announced offer.

D. Enforcement

1. On Dec. 18, 2019, the SEC announced settlements against two registered broker-dealers for violating SEC Rule 14e-4 by tendering more shares than their net long positions.[59] Disgorgement, prejudgment interest and fines for the violations exceeded $500,000.

2. Prior to this action, the SEC had not brought an SEC Rule 14e-4 case in over 20 years.

[59] *See* SEC Press Release, "SEC Charges Broker-Dealers With Illicitly Profiting in Partial Tender Offer," available here.

Developments in Private Equity Funds

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Stephanie R. Breslow

Stephanie R. Breslow is co-head of the Investment Management Group and a member of the firm's Executive Committee. She maintains a diverse practice that includes liquid funds, private equity funds and the structuring of investment management businesses. She focuses her practice on the formation of private equity funds (including LBO, mezzanine, distressed, real estate and venture) and liquid-securities funds (including hedge funds, hybrid funds, credit funds and activist funds) as well as providing regulatory advice to investment managers. She also represents fund sponsors and institutional investors in connection with seed-capital investments in fund managers and acquisitions of interests in investment management businesses and funds of funds and other institutional investors in connection with their investment activities, including blockchain technology and virtual currency offerings and transactions.

Recently serving as chair of the Private Investment Funds Subcommittee of the International Bar Association, Stephanie is a founding member and former chair of the Private Investment Fund Forum, a former member of the Advisory Board of Third Way's Capital Markets Initiative, a former member of the Board of Directors and a member of 100 Women in Finance, a member of the Board of Visitors of Columbia Law School and a member of the Board of Directors of the Girl Scouts of Greater New York. Stephanie has received the highest industry honors. She was named to the inaugural *Legal 500 US* Hall of Fame in the category of "Investment Fund Formation and Management: Alternative/Hedge Funds." Stephanie is also listed in *Chambers USA: America's Leading Lawyers, Chambers Global: The World's Leading Lawyers, Crain's Notable Women in Law, IFLR1000, Best Lawyers in America, Who's Who Legal: The International Who's Who of Business Lawyers*), *Who's Who Legal: The International Who's Who of Private Funds Lawyers*, *Who's Who Legal: Thought Leaders: Global Elite, Who's Who Legal: Thought Leaders: Private Funds, Expert Guide to the Best of the Best USA, Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers, Expert Guide to the World's Leading Women in Business Law and PLC Cross-border Private Equity Handbook*, among other leading directories. Stephanie was named the "Private Funds Lawyer of the Year" at the *Who's Who Legal Awards* and the *Euromoney Legal Media Group*'s "Best in Investment Funds" and "Outstanding Practitioner," both at the Americas Women in Business Law Awards. She is also recognized as one of *The Hedge Fund Journal*'s "50 Leading Women in Hedge Funds." Stephanie's representation of leading private investment funds has won numerous awards, including, most recently, *Law360*'s Asset Management Practice Group of the Year. She is a much sought-after speaker on fund formation and operation and compliance issues, and she regularly publishes articles on the latest trends in these areas. Stephanie co-authored *Private Equity Funds: Formation and Operation* and *Hedge Funds: Formation, Operation and Regulation*. Stephanie received her J.D. from Columbia Law School and her B.A., c*um laude*, from Harvard University.

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Peter G. Naismith focuses his practice on advising hedge funds, private equity funds, hybrid funds and investment advisers in connection with their structuring, formation and ongoing operational needs, as well as on certain regulatory and compliance matters. He represents a wide variety of institutional and entrepreneurial fund sponsors and asset managers. Peter also has extensive experience advising on mergers and acquisitions, including a range of complex, high-value public and private transactions across a number of industry sectors.

Prior to joining Schulte, Peter served as in-house counsel at a privately held investment firm, where he focused on fund formation, hedge fund and private equity fund seeding and family office matters. His broad expertise includes roles with firms based in New York, London and Adelaide, Australia. Peter received his LL.M., *magna cum laude*, from Duke University School of Law, his LL.M. (commercial), with honors, from The University of Melbourne, his Graduate Certificate in Legal Practice from The University of South Australia and his LL.B., with first class honors, from The Flinders University of South Australia.

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Phyllis A. Schwartz focuses her practice on the structuring, formation and operation of private equity funds, including buyout funds, venture capital funds, mezzanine funds, distressed funds, litigation financing funds and real estate funds. She represents both fund sponsors and investors in her practice. In addition to assisting fund sponsors with their internal management arrangements, succession planning, capital call borrowing facilities and formation of co-investment vehicles, she has extensive experience with institutional investors and regularly advises clients on market terms of investment funds. Phyllis also advises private equity funds in connection with their capital call credit lines and investments in, and dispositions of, portfolio companies.

Phyllis is listed in *The Legal 500 US*, *The Best Lawyers in America*, *New York Super Lawyers*, *Who's Who Legal: The International Who's Who of Private Funds Lawyers*, *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers* (Investment Funds, Private Equity) and the *Expert Guide to the World's Leading Women in Business Law* (Investment Funds). A member of New York's Private Investment Fund Forum, Phyllis frequently shares her insights on effective fund formation strategies at industry conferences and seminars. She recently discussed compliance concerns for co-investments and issues related to fund restructuring and secondary transactions. Interviewed by *Private Funds Management* in the article "Ringing the Changes," Phyllis is also the co-author of *Private Equity Funds: Formation and Operation* (Practising Law Institute), which is considered the leading treatise on the subject. In addition, she contributed to the *Fund Formation and Incentives Report* (Private Equity International in association with SRZ), as well as a chapter on "Advisers to Private Equity Funds — Practical Compliance Considerations" in *Mutual Funds and Exchange Traded Funds Regulation, Volume 2* (Practising Law Institute). Phyllis received her J.D. from Columbia Law School and her A.B. from Smith College.

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Joseph A. Smith

Joseph A. Smith represents private equity fund sponsors in connection with fund formation, the acquisition of portfolio investments and the implementation of exit strategies. In this capacity, Joe advises clients on securities, governance, ERISA, Investment Advisers Act and structural issues. He has extensive regulatory expertise, and wide-ranging experience with all alternative asset classes, including LBO funds, venture capital and later-stage growth equity funds, energy and infrastructure funds, credit funds, real estate funds and joint ventures, fund restructurings and other complex secondary transactions, and funds of funds. Joe has also represented many fund managers in connection with spinoffs and consolidations.

In addition to domestic representations, Joe has advised private equity clients in connection with the acquisition and structuring of portfolio investments throughout Europe, Latin America and Asia. His representation of asset managers in the real estate sector includes advice concerning REIT offerings and privatizations, partnership roll-ups and cross-border investments. Joe's clients include Arel Capital, Coller Capital, DRA Advisors, DuPont Capital Management, Fort Washington Investment Advisors, GE Asset Management (now State Street Global Advisors), Harbert Management Corporation, Hemisfério Sul Investimentos, Intel, Investors Diversified Realty, Kotak Mahindra Group, LCN Capital Partners, Mauá Capital, Ram Realty Services, REAL Infrastructure Partners, Royalton Partners, Value4Capital, VCFA Group, Vortus Investments and Westport Capital Partners. Joe has been recognized as a leading practitioner by *Chambers Global*, *Chambers USA*, *Expert Guide to the World's Leading Banking*, *Finance and Transactional Law Lawyers*, *The Legal 500 US* and *New York Super Lawyers*. Most recently, Joe was quoted by *Private Equity International* in the article "LPAs: Finding the Right Balance" and by *Private Funds Management* in the article "Ringing the Changes." Joe co-authored the "United States Fundraising" chapter in *The Private Equity Review* (Law Business Research Ltd.) and he contributed to the *Fund Formation and Incentives Report* (Private Equity International in association with SRZ). He received his J.D. from NYU School of Law and his A.B. from Columbia University.

Developments in Private Equity Funds

I. Introduction

A. With their proven ability to outperform the public markets in recent periods, private equity funds continue to attract new capital.[1] Although robust asset prices are making it more difficult to deploy that capital at comfortable valuations,[2] and despite a general concern about potential market downturns, the private equity industry remains a very attractive choice for fund sponsors and investors.

B. That said, particularly for new or smaller sponsors, or sponsors that have had poor returns, there is still significant pressure to delineate a clear strategy, provide terms that are compelling, and otherwise cater to investors that, generally, are more likely to favor the larger, more-established sponsors.[3]

II. Formation

A. Investment Programs

1. Obviously, conventional private equity strategies (e.g., leveraged buyout and real estate strategies) have continued to do well in 2019. We also continue to see sponsors doing well by positioning themselves in niche areas: healthcare, litigation finance, specialty finance and other fixed income alternatives, fintech and other technology strategies, emerging markets, distressed investing and impact investing (i.e., ESG, environmental and employment-focused investing), among others.

2. This trend toward niche strategies is the result of several factors. Investors may have a particular mandate, or may view a sponsor as more skilled in certain areas than others. In some cases, the personal goals of investment professionals, and talent retention issues, may be important drivers.

3. The proliferation of different investment strategies under a single parent company creates challenges, such as structuring compensation arrangements for investment professionals.

4. In addition, this trend requires PPMs, pitch books and other marketing documents that utilize hypothetical performance figures (by extracting the data linked to a single investment strategy from data covering multiple investment strategies) to be prepared with detailed legal disclosure.

B. Side Letter Requests

1. Side letter requests (including the most favored nations, or "MFN," election process) continue to play an important role in the fund formation process. Institutional investors continue to deliver extensive requests, among which are ESG topics, extensive notice requests and sponsor representations.

2. Considerable discipline remains a necessity if sponsors wish to avoid an explosion of differing side letter provisions.

3. Managers attempt to lessen side letter burdens by integrating overlapping side letter requests into their fund agreements. This approach does succeed in stemming the flow of requests in some cases. The downside of this approach, however, is that it will tend to lock these provisions into your documents for perpetuity, and may not prevent more granular or form-over-substance requests. Some sponsors include the MFN provision in their LPAs.

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[1] Surveys published separately in 2019 by Ernst & Young (2019 Global Private Equity Survey) and *Preqin* (2019 Global Private Equity and Venture Capital Report) indicated that around two-fifths of respondents planned to increase their exposure to private equity in 2019.

[2] Witness the record levels of dry powder currently sitting on the sidelines. *Preqin* estimates $1.7 trillion across the private equity fund space, up from $1.5 trillion in 2018. Bain & Company (Global Private Equity Report 2019) pegs the figure even higher, calculating that this dry powder increased by almost two-thirds in the five years through year-end 2018. About half of the dry powder cited by Bain is attributed to the 2017 and 2018 vintage years.

[3] *Preqin* found that 24% of total capital raised by the industry in 2018 was secured by the 10 largest funds closed.

4. In our view, the approach of integrating side letter requests into fund documents makes the most sense in those cases where the failure to afford the same treatment to all investors would create selective disclosure or other basic fairness issues (e.g., a provision requiring notice of a material event).

5. The erosion of MFN rights has continued. Most investors now accept that MFN rights are available on the relative size of investors' commitments. However, we see investors focusing intently on how one will measure size (e.g., do you look across the sponsor's suite of products, do you credit investors with the investments made by other clients of the same gatekeeper, if so, does the credit extend to all clients of that gatekeeper or only clients for whom the gatekeeper exercising investment discretion, etc.) We also now see a broader list of topics excluded from MFN rights, regardless of the size of an investor's commitment to a fund. These excluded rights often cover rights to serve on investor committees, co-investment rights, agreements regarding the investor's right to receive or the obligation to provide information, transfer rights and modifications to investor representations.

C. Compensation for Investment Professionals

1. Clients are best served by focusing on their general partner and management company documents as early as possible, including the governing agreements of the entities themselves and any grant-related agreements for individual team members, to ensure that such documents are finalized in advance of significant economics accruing to top tier entities from the underlying funds.

2. The many reasons for prioritizing these documents include:

(a) These documents provide the framework for managing the multiple cash flow streams that may result from sponsoring multiple products under the same firm (the proliferation of products referenced earlier).

(b) As a talent retention matter, these documents are key to ensuring that the best performers are directly incentivized, while also ensuring that the firm can effectively restrain leavers from competing and protect its intellectual property.

(c) From a risk management perspective, particularly for founders, these documents can be critical in times of stress. For example, in a clawback scenario, having had the forethought to establish holdbacks at the level of your general partner or carry vehicle may mean that a sponsor does not have to chase its people to return distributions received in earlier years.

(d) There are a host of tax-related considerations raised by granting equity or phantom equity interests to team members.

III. Economics

A. Management Fees

1. Generally, the traditional model, including a management fee based on commitments during the investment period and a management fee based on invested capital thereafter, remains the most common approach.

2. Likewise, headline management fee rates remain stable, with most funds still charging fees in the 1.75%-2% range. Smaller funds need to earn enough fee revenue to build teams and achieve their potential — investors generally understand that. For the larger and more-established sponsors, however, it is harder to establish that a full 2% rate is appropriate.

3. Of course, only a portion of investors actually pay the highest management fee rate. Many sponsors have adopted a tiered approach, with larger investors receiving some fee break. "Early bird discounts" also remain a relatively common means of encouraging investors to commit at an early stage in the fundraising process.

4. Less commonly (albeit logically, given that many investors are repeat customers), investors have started to request credit for their aggregate capital invested across a sponsor's affiliated funds, rather than the amount invested in the particular fund at hand.

5. Access to co-investment opportunities remains a means for investors to achieve a lower blended management fee rate and therefore, has been a topic for negotiation in fund raising.

B. Carried Interest

1. We continue to see "American" or "deal-by-deal" waterfalls less frequently than the "European" or "whole fund" model, especially for funds launched by newer or smaller sponsors. While there is some innovation to be found on the carried interest structures, as a general matter, investors seem to remain comfortable with the 20% carry over a 8% preferred return hurdle with a full catch up.[4]

2. While the basic model is stable, more and more sponsors are questioning the sense of retaining a preferred return hurdle in the 8% range. Long seen as a proxy for a risk-free rate and therefore a reasonable means of incentivizing a sponsor to put capital to work quickly (particularly if the sponsor told investors it had a robust pipeline and was targeting mid-teens returns or higher), an 8% hurdle is viewed as harder to justify when real interest rates have remained so low for several years, and presents particular challenges in more niche areas (e.g., for funds pursuing fixed income-related strategies, which have been popular in the prevailing low-interest rate environment). Some degradation of the 8% standard is therefore becoming evident.

C. Recycling

1. Provisions permitting reinvestment or "recycling" of investment proceeds (and distributions followed by recalls of permitted reinvestment amounts) remain standard features of private equity funds. However, we continue to see broader reinvestment rights, such as the right to recycle investment proceeds after the investment period, the right to recycle all deal proceeds (as opposed to only the cost of an investment), subject to an overall investment limit of 120% of commitments, and the right to recycle investment proceeds in an amount equal to capital contributions utilized for fund expenses.

IV. Operations

A. Expenses

1. The SEC has been focused on expense allocations for several years now, and as a result the industry has collectively moved toward more extensive permitted expense litanies and expense allocation requirements within fund documents, including significantly more detailed expense allocation policies and procedures.

2. Developments of note in this area have included:

(a) *Broken-Deal Expenses*. In recent years, sponsors have been warning investors in their main funds that prospective co-investors may not agree to bear their share of broken-deal expenses as a condition to participating in a co-investment. In response to such disclosures, we are starting to see investors seeking to negotiate caps on broken-deal expenses, raising the prospect that some portion of such expenses will need to be borne by the sponsor.

(b) *Organizational Expenses*. "Org caps" continue to increase, particularly for funds with complex structures, and newer funds, where significant expenses can be incurred in structuring and building documents and negotiating with investors over what might be an extensive marketing period.[5]

(i) Whether expenses incurred in handling an MFN process are organizational expenses (i.e., counting toward any cap) or operating expenses (i.e., an uncapped, permitted expense) is becoming an important consideration.

(ii) In addition, parallel funds established for particular investors or groups of investors may add significant organizational expenses and the approach to treating those organizational expenses as

[4] One 2019 survey (MJ Hudson's Private Equity Fund Terms Research) found that, of funds surveyed, over four-fifths included a 20% carried interest, over two-thirds included an 8% preferred return hurdle, and over three-quarters included a full catchup.

[5] *Preqin* (cited above) found that the average launch timeline for a private equity fund in 2019 was around 15 months to final close, slightly down from 16 months in 2018.

shared expenses across the complex or expenses allocable only to those investors requires consideration.

(c) *Affiliated Service Providers*. For the more-established sponsors that have affiliates that service portfolio companies, extensive disclosures are becoming a common feature. Investors are very focused on the use of affiliated servicers by sponsors and will demand comfort that any related charges are at rates that match or better market rates; but in our experience, investors are generally willing to permit the use of affiliated servicers if it is evident that the services cannot be readily sourced at a lower cost. For sponsors that maintain internal legal and other professional staff, it is possible to treat a portion of the related expenses as permitted fund expenses, but again, investors pay close attention to this issue and clear disclosure must be made.

(d) *Regulatory Compliance.* The expense of regulatory compliance is another area where granularity in fund documents continues to expand. To ensure no disconnect with investors, sponsors must think about where their offering and investing activity will occur and which regimes will apply. Documents should clearly record the types of expense that will be borne by investors and provide the basis for that allocation.

B. Advisory Boards

1. Nearly all private equity funds have a committee of investor representatives ("LPAC" or "advisory board").

2. Advisory board provisions in fund documents are, however, another area where the level of detail has expanded in fund documents. For example, we have seen broader provisions describing the scope of the advisory board's role and specific functions, including provisions that specifically exclude certain transactions from requiring advisory board-level reporting or voting.

3. Provisions spelling out how to deal with conflicts that arise for individual advisory board members are receiving greater attention (e.g., the scenario — becoming more common — where an advisory board member sits on several advisory boards and the relevant funds hold investments at different levels of the same issuer's structure; whether members can or must abstain from voting; how the quorum and voting majority is determined in such a case; and whether the advisory board has a right to seek advice from legal counsel at expense of the fund, among others).

4. Investors are, in some cases, seeking observer rights instead of voting membership on an advisory board. This status provides investors with access to materials provided to, and minutes of, advisory board meetings.

5. There has been an increasing level of concern on the part of investors as to their potential exposures as advisory board members. Such concerns appear widespread notwithstanding that regulators and courts appears to be generally respectful of provisions purporting to relieve advisory board members of responsibility for other investors. Consequently, investors regularly negotiate for the right to obtain separate counsel for advisory boards at the expense of the fund.

C. Subscription Facilities

1. Managers have been generally able to persuade investors that subscription facilities are a good means of bridging calls and ensuring no loss of access to opportunities. The period for repayment of a facility is growing longer — frequently up to one year. The effects of a facility on IRR need to be considered and should be addressed in marketing materials, risk factors and fund reporting.

2. In the case of longer-term subscription facilities, UBTI can be another issue that your tax lawyers and accountants will want to focus on.

3. The overall limit on borrowings under such facilities remains in the vicinity of 20-25% of committed capital (aligned with the maximum amount that a fund can invest in a single company).

4. In side letters, expect to see investors wanting to limit their obligation to deliver commitment letters or financial information to lenders; the best practice here is to determine at an early stage what the lenders will

want to see in the fund documents, and make sure that lenders are reviewing any relevant side letter provisions before they are finalized.

D. Co-Investments

1. As referenced earlier, co-investments remain a draw by sponsors for raising funds and are important for funds to pursue investments that are larger than permitted under fund documents. However, perhaps somewhat surprisingly, investors have become more tolerant of co-investments where co-investors buy and sell at different times and on different terms than the fund.

2. Fees and carry charged to co-investors are not uniform, but they are expected to be lower than fund rates.

V. End-of-Life

A. Clawbacks

1. There remains little chance of avoiding the inclusion of a general partner giveback or "clawback" provision,[6] albeit that sponsors sometimes try, usually by pointing to the "European" waterfall in their fund documents and the likely pace of calls and distributions.

2. Variations in this area arise more often in respect of when the sponsor will be calculating any clawback obligation. Notwithstanding efforts by ILPA to encourage the use of interim clawbacks, they are still far from universal (albeit somewhat more prevalent in buyout funds).

3. Carried interest escrow provisions are rare, with clawback guarantees from founders or entities with significant assets generally regarded as acceptable alternatives (particular for funds with "European" waterfalls).

B. Term Extensions

1. In seeking consent to an extension to a fund's term, it can be tempting to offer a reduced management fee to investors as an inducement, but sponsors should beware of doing this without carefully running the models — it can be expensive to operate a fund that has only a small number of remaining investments.

2. In addition, a sponsor's willingness to agree to reduce fees in return for an extension can set a precedent that is difficult to depart from.

C. Secondary Transactions

1. GP-Led Transactions

(a) As the industry matures, it is still frequently the case that funds reach the end of their term with assets that they have been unable to sell. Generally, we see sponsors having some difficulty persuading investors in successor funds of the merits of acquiring such assets, due to the perception that such assets must be impaired.

(b) Sponsor-led secondary transactions can provide an effective solution, but usually a relatively expensive one, and some of that expense typically lands on the sponsor. For example, the sponsor may find itself building and populating a data room for bidders, which can be a time-consuming and expensive exercise.

(c) Sponsor-led secondary transactions also give rise to a host of tax, ERISA and securities law issues which need to be appropriately managed.

2. *Investor-Led Transactions*. Investors have sought to exit positions across multiple funds to meet their own liquidity needs. These transactions can be extremely burdensome for the parties, including sponsors, but they have also become important transactions in which sponsors can build investor relationships.

[6] The MJ Hudson study (cited above) found that 97% of the surveyed funds had a carried interest clawback mechanism.

VI. ILPA

A. The Institutional Limited Partners Association ("ILPA") had a very busy 2019, delivering on a number of initiatives.

B. *Sponsor-Led Secondary Fund Restructurings*. In April, ILPA released its report on sponsor–led secondary fund restructurings,[7] which we believe provides a framework and guidance that sponsors and investors alike will find useful.

C. *ESG*. In June, ILPA published the latest edition of its ESG principles, which we also generally view as a useful tool for the industry.[8]

D. *Model LPA*. In October, ILPA released a form of model LPA with a stated aim of strengthening investor-sponsor alignment in the private equity industry. The industry is still digesting this document at the time of writing. On initial review, we are concerned that it is off-market in a number of respects.[9] However, like the 2009 ILPA private equity principles and other ILPA initiatives, it will almost certainly inform the comments that sponsors receive from investors.

VII. Conclusion

A. Private equity has had another banner year, and should 2020 see any economic downturn, the industry seems well positioned to negotiate it successfully.

B. However, staying abreast of developments in private equity fund terms can prove the difference for sponsors seeking to raise capital in a more challenging environment.

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[7] ILPA, "GP-led Secondary Fund Restructurings — Considerations for Limited and General Partners," April 2019 (publicly available at www.ilpa.org).

[8] ILPA, "ILPA Principles 3.0: Fostering Transparency, Governance and Alignment of Interests for General and Limited Partners," (publicly available at www.ilpa.org).

[9] Among the recommendations reflected in the model LPA that we consider off-market are its adoption of ERISA-like prudent person standards in describing general partner duties; certain burdensome provisions regarding the approval of conflicts, which are in certain respects at odds with the prevailing SEC guidance; the grant of significant decision making authority to the advisory board; departure from a full general partner catchup within the carry waterfall; carried interest escrows and interim clawbacks; certain provisions relating to management fees, when they start and when they step down; provisions whereby the preferred return starts to accrue immediately on a drawing under a subline; a 100% haircut on removal of the general partner for cause; and a haircut even if the general partner is removed without cause.

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Recently serving as chair of the Private Investment Funds Subcommittee of the International Bar Association, Stephanie is a founding member and former chair of the Private Investment Fund Forum, a former member of the Advisory Board of Third Way's Capital Markets Initiative, a former member of the Board of Directors and a member of 100 Women in Finance, a member of the Board of Visitors of Columbia Law School and a member of the Board of Directors of the Girl Scouts of Greater New York. Stephanie has received the highest industry honors. She was named to the inaugural *Legal 500 US* Hall of Fame in the category of "Investment Fund Formation and Management: Alternative/Hedge Funds." Stephanie is also listed in *Chambers USA: America's Leading Lawyers, Chambers Global: The World's Leading Lawyers, Crain's Notable Women in Law, IFLR1000, Best Lawyers in America, Who's Who Legal: The International Who's Who of Business Lawyers*), *Who's Who Legal: The International Who's Who of Private Funds Lawyers*, *Who's Who Legal: Thought Leaders: Global Elite, Who's Who Legal: Thought Leaders: Private Funds, Expert Guide to the Best of the Best USA, Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers, Expert Guide to the World's Leading Women in Business Law and PLC Cross-border Private Equity Handbook*, among other leading directories. Stephanie was named the "Private Funds Lawyer of the Year" at the *Who's Who Legal Awards* and the *Euromoney Legal Media Group*'s "Best in Investment Funds" and "Outstanding Practitioner," both at the Americas Women in Business Law Awards. She is also recognized as one of *The Hedge Fund Journal*'s "50 Leading Women in Hedge Funds." Stephanie's representation of leading private investment funds has won numerous awards, including, most recently, *Law360*'s Asset Management Practice Group of the Year. She is a much sought-after speaker on fund formation and operation and compliance issues, and she regularly publishes articles on the latest trends in these areas. Stephanie co-authored *Private Equity Funds: Formation and Operation* and *Hedge Funds: Formation, Operation and Regulation*. Stephanie received her J.D. from Columbia Law School and her B.A., c*um laude*, from Harvard University.

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Aneliya has been recognized as a “Recommended Lawyer” in *The Legal 500 US* in M&A/Corporate and Commercial: Shareholder Activism — Advice to Shareholders for 2019. The leading industry publication noted how the ‘hardworking and creative’ Aneliya Crawford advised Trian Fund Management on its successful campaign to appoint the manager’s co-founder Ed Garden to the board of General Electric.” *The Legal 500* highlighted also her work advising “Sports Direct on its campaign at Iconix Brand Group, securing two board seats in a cooperation agreement” and “UBS, as financial advisor to Elliott Management, in relation to its campaign at NXP Semiconductors.” A recognized thought leader, Aneliya has become a leading source for business journalists and business news organizations and a much sought-after speaker. She has served as a moderator and speaker at numerous conferences and events addressing shareholder activism, M&A and corporate governance. She contributed to *The Activist Investing Annual Review 2019* (produced by Activist Insight in association with SRZ) and the *2018 Shareholder Activism Insight* report (published by SRZ in association with Activist Insight and Okapi Partners) and has authored articles published in the *Harvard Law School Forum on Corporate Governance and Financial Regulation*, *Forbes*, *HFMWeek* and others. Aneliya was named to *Crain’s* 40 Under 40 Class of 2018 and has been named a New York “Rising Star” by *Super Lawyers* magazine each year since 2014 for her shareholder activism and M&A practice. Aneliya received her M.L.A., *magna cum laude*, from Harvard University, her J.D. from Benjamin N. Cardozo School of Law and her B.A. from American University in Bulgaria.

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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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Jennifer was named among the world's "50 Leading Women in Hedge Funds" by *The Hedge Fund Journal*. A member of the board of directors of 100 Women in Finance, Jennifer is recognized by *The Legal 500 US, Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers* (Investment Funds), *Expert Guide to the World's Leading Women in Business Law* (Investment Funds) and has been named an *IFLR1000* "Rising Star" (Investment Funds). She co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and presented at conferences on topics including attracting and retaining capital, operational due diligence, compliance issues, hedge funds and management company structures and considerations for emerging hedge fund managers. Jennifer earned her J.D. from Columbia Law School and her B.A., *cum laude*, from the University of Pennsylvania.

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David J. Efron is co-managing partner of the firm. He serves as co-head of the Investment Management Group and as a member of the Executive Committee. With more than 25 years of experience, David has a broad practice advising private fund managers that employ a wide range of investment strategies. He represents many of the world's largest private fund managers on formation, structuring, organization, compensation, operations, seed capital and joint venture arrangements and restructurings, among other types of matters related to their funds and management companies. Notably, David has advised on many of the largest start-up hedge fund launches in the industry over the past few years. Additionally, David also represents private fund managers in connection with SEC regulatory issues and compliance-related matters.

Schulte's Investment Management Group, which David co-heads, has been described as the "preeminent name in this area" and at "the forefront of this industry" by *Chambers*, a prominent industry publication that ranks firms and lawyers. David is listed in *Chambers Global*, *Chambers USA*, *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*, *The Legal 500 US* and *Who's Who Legal: The International Who's Who of Private Funds Lawyers*. In particular, *The Legal 500 US* has praised his "superb judgment and deep expertise" and recognized him as "an extraordinarily capable attorney. He has a mastery of the pertinent matters, but he also brings a pragmatic approach." *Chambers Global* and *Chambers USA* noted that David is "an outstanding lawyer, with excellent judgment and the necessary soft touch during the delicate negotiations that occur during a start-up/launch" and that "he is attuned to the business considerations and provides measured, reasoned advice that reflects his deep experience and industry knowledge." A published author on subjects relating to investment management, he is a sought-after speaker for hedge fund industry conferences and seminars and a frequent guest lecturer at New York-area law schools and business schools. David received his LL.M. degree in securities regulation, with distinction, from the Georgetown University Law Center, his J.D., *cum laude*, from Syracuse University College of Law and his B.A. from Vassar College.

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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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Dr. Farmer holds an M.D. and Ph.D. from Harvard University, where he is the Kolokotrones University Professor and the chair of the Department of Global Health and Social Medicine at Harvard Medical School; he is also chief of the Division of Global Health Equity at Brigham and Women's Hospital, Boston. Additionally, Dr. Farmer serves as the United Nations Special Adviser to the Secretary-General on Community Based Medicine and Lessons from Haiti. Dr. Farmer has written extensively on health, human rights, and the consequences of social inequality. He is the recipient of numerous honors, including the Bronislaw Malinowski Award and the Margaret Mead Award from the American Anthropological Association, the Outstanding International Physician (Nathan Davis) Award from the American Medical Association, a John D. and Catherine T. MacArthur Foundation Fellowship, and, with his PIH colleagues, the Hilton Humanitarian Prize. He is a member of the American Academy of Arts and Sciences and the Institute of Medicine of the National Academy of Sciences, from which he was awarded the 2018 Public Welfare Medal.

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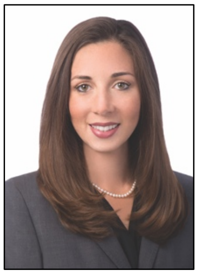

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In recognition of her significant accomplishments during her Treasury career, Melissa received the Secretary's Meritorious Service Award, which honors individuals whose achievements are substantial and significantly advance the Treasury Department's 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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Dan has been ranked by *Chambers USA* in the Investment Funds: Hedge Funds – Nationwide category as well as *The Legal 500 US* in its Investment Fund Formation and Management – Alternative/Hedge Funds category. *Chambers* notes that clients praised him as "outstanding to work with," adding that "he is very smart, very experienced and very responsive." A sought-after speaker, Dan has spoken at the Goldman Sachs Annual Hedge Fund conference on "Succession Planning" and the Wells Fargo Prime Services conference on "Assessing Your Fund for Institutional Growth." He also presented at the AIMA Seminar: Navigating the Landscape of Side Letter Terms and was recently quoted in the *HFMWeek* article "Don't Play Favourites With Your Investors." Dan received his J.D. from the University of Michigan Law School and his A.B., *cum laude*, from the University of Michigan.

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Taleah has been recognized as a leading lawyer by *The Legal 500 US, Benchmark Litigation: The Definitive Guide to America's Leading Litigation Firms and Attorneys* and by *New York Super Lawyers*. She received the Burton Award for Distinguished Legal Writing for the *New York Law Journal* article "Options When a Competitor Raids the Company," was honored with the Excellence in Pro Bono Advocacy Award by Sanctuary for Families and was named among *Savoy* magazine's Most Influential Black Lawyers. Taleah holds a J.D. from Rutgers Law School and a B.S. from the University of Maryland.

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Jason's recent speaking engagements include discussing "Insurance Dedicated Funds and Related Strategies" and leading "A Conversation with Jason Dillow, Bardin Hill Investment Partners LP" at SRZ's 28th Annual Private Investment Funds Seminar. He also discussed "Shareholder Activism" at SRZ's 27th Annual Private Investment Funds Seminar and "Credit and Hybrid Funds" at SRZ's 26th Annual Private Investment Funds Seminar. Jason's publications include co-authoring "Information Security: Obligations and Expectations," an *SRZ White Paper*. Jason earned his J.D. from Fordham University School of Law, where he was a member of the *Fordham Law Review*, and his B.S. from the University of Michigan.

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Ele is recognized as a leading lawyer in *Chambers USA*, *The Legal 500 US*, *New York Super Lawyers – New York Metro Top 100* and *Super Lawyers Business Edition*. He has served as a moderator and speaker at numerous conferences and events addressing Shareholder Activism, regulatory and reporting issues, PIPEs, M&A deals, capital markets and other topics of interest to the alternative investment industry. He contributed to *The Activist Investing Annual Review 2019* (produced by Activist Insight in association with SRZ) and the 2018 *Shareholder Activism Insight* report (published by SRZ in association with Activist Insight and Okapi Partners). Ele received his J.D. from Yale Law School where he was senior editor of *The Yale Law Journal*. He received his B.S., *summa cum laude*, from Brooklyn College, CUNY.

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Blockchain Technology & Digital Assets

Finance

Mergers & Acquisitions

PIPEs

Private Equity

F. Xavier Kowalski

F. Xavier Kowalski represents issuers, sponsors and investment banks in initial public offerings, high-yield financings, equity-linked financings, and other domestic and international capital markets transactions. He also counsels clients in general corporate and securities law matters. His practice includes a broad range of cross-border transactions across a number of targeted industries, including health care, media and entertainment, and technology. He also brings significant experience in private equity and leveraged finance transactions. Xavier received his J.D. from the University of Virginia School of Law and his B.A. from the University of Florida.

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John J. Mahon

John J. Mahon represents private equity firms and other financial sector participants in a wide range of capital markets and securities law matters. He regularly assists clients in connection with the establishment and operation of business development companies (BDCs), registered closed-end funds and other similar public and private vehicles that comply with complex regulatory structures, including the Investment Company Act of 1940, the Investment Advisers Act of 1940 and the Dodd-Frank Act. With more than a decade and a half of experience, John has been involved with more than 100 debt and equity offerings, including over 20 initial public offerings (IPOs), reflecting an aggregate of over $10 billion in total proceeds. His work in securities law and mergers and acquisitions includes providing guidance to many New York Stock Exchange (NYSE) and Nasdaq-listed companies in connection with ongoing corporate governance and U.S. Securities and Exchange Commission (SEC) reporting and compliance matters. John routinely handles issues involving tender offers, proxy solicitations, going-private transactions and beneficial ownership reporting obligations.

John is listed in *The Legal 500 US* and *Washington, DC Super Lawyers*. A recipient of the SEC Capital Markets Award, he serves as an adjunct professor at The George Washington University Law School and is the former chair of the Corporate Finance Committee of the Corporation, Finance and Securities Law Section of the District of Columbia Bar. He speaks and writes on topics ranging from SEC regulations and disclosure obligations to public and private capital raising structures, 1940 Act regulated funds and M&A issues. John was interviewed for *The Hedge Fund Journal* article “BDC and RIC Research and Issuance Proliferating” and he was quoted in the *S&P Global Market Intelligence* article “BDCs Step Into Spotlight With Moves on Leverage, Fees.” John recently spoke on “Specialty Activism: REITs, Banking, Litigation and ‘40 Act Funds” at SRZ’s 9th Annual Shareholder Activism Conference. John received his J.D. from the Georgetown University Law Center and his B.S.B.A., *cum laude*, from the University of Richmond.

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Anna Maleva-Otto

Anna Maleva-Otto concentrates her practice on advising asset managers on a range of UK financial services regulatory matters, including the impact of EU directives and regulations. She advises clients on all aspects of the establishment and operation of regulated businesses in the United Kingdom, as well as trading on UK and EU markets. Anna frequently participates in industry working groups in connection with new and emerging regulatory initiatives, and has advised asset managers on several key pieces of recent EU legislation (including GDPR, Short Selling Regulation, Alternative Investment Fund Managers Directive, MiFID II, MAR, EMIR and SFTR). Anna began her career as a regulatory consultant assisting clients in the financial services sector with the design and implementation of compliance procedures, conduct of internal compliance investigations, compliance audits and remediation exercises.

Anna is listed in *The Legal 500 UK* as a “Recommended” lawyer in Financial Services: Non-Contentious Regulatory. An interviewee described her as “excellent — highly responsive, well informed and pragmatic in her advice, and a pleasure to work with.” She has also been named among the world’s “50 Leading Women in Hedge Funds” by *The Hedge Fund Journal*. Anna frequently speaks and writes on topics related to her areas of expertise. She recently co-authored the UK chapter in the *Chambers Alternative Funds Guide 2019* — a guide examining key industry trends and regulatory and tax matters impacting funds, managers and investors. Anna has also worked with AIMA to produce *MiFID2 – A Guide for Investment Managers* and authored the “Insider Trading Law in the United Kingdom” chapter in the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute). Her recent speaking engagements have addressed topics such as market abuse, insider dealing, monitoring electronic communications, and payments for research under MiFID II. Anna is admitted to practice in England and Wales, and New York. Anna received her J.D. from Emory University School of Law and her M.A. from Saint Petersburg State University.

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Peter G. Naismith focuses his practice on advising hedge funds, private equity funds, hybrid funds and investment advisers in connection with their structuring, formation and ongoing operational needs, as well as on certain regulatory and compliance matters. He represents a wide variety of institutional and entrepreneurial fund sponsors and asset managers. Peter also has extensive experience advising on mergers and acquisitions, including a range of complex, high-value public and private transactions across a number of industry sectors.

Prior to joining Schulte, Peter served as in-house counsel at a privately held investment firm, where he focused on fund formation, hedge fund and private equity fund seeding and family office matters. His broad expertise includes roles with firms based in New York, London and Adelaide, Australia. Peter received his LL.M., *magna cum laude*, from Duke University School of Law, his LL.M. (commercial), with honors, from The University of Melbourne, his Graduate Certificate in Legal Practice from The University of South Australia and his LL.B., with first class honors, from The Flinders University of South Australia.

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David Nissenbaum

David Nissenbaum is co-head of the Investment Management Group. He primarily represents institutional and entrepreneurial investment managers, financial services firms and private investment funds in all aspects of their businesses. He structures investment management and financial services firms along with credit, hedge, private equity, hybrid, distressed investing, activist and energy funds, co-investments, funds of funds and scalable platforms for fund sponsors. David also advises on fundraising, management company partnerships, compensation plans, succession plans, seed and strategic investments and spinoffs of investment teams. His work includes counseling clients on finding practical solutions to regulatory and compliance requirements, including the Volcker Rule, and managing conflicts of interest with an emphasis on reducing legal risk to the business.

Clients often seek David's advice on business matters and strategy and to assist on difficult negotiations. For many years, he has been named a "Leader in His Field" by *Chambers Global* and *Chambers USA* and has been recognized by *The International Who's Who of Private Funds Lawyers*, *PLC Cross-border Private Equity Handbook*, *The Legal 500 US* and *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*. A past member of the Advisory Board of The Financial Executives Alliance and the Banking Law Committee of the New York City Bar Association, David is a sought-after writer and speaker. Works he has authored or co-authored include the chapter "Management Company Structures and Terms" in *Hedge Funds: Formation, Operation and Regulation*, published by *ALM Law Journal Press*; "Just Like Starting Over: A Blueprint for the New Wall Street Firm," published by *The Deal*; and "Succession Planning," published by SRZ. He has spoken at conferences and seminars on a range of topics, including fundraising, merchant bank structures, liquidity events, credit and lending funds and co-investment vehicles. David received his J.D. from Brooklyn Law School and his B.A. from the State University of New York at Albany.

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Paul N. Roth

Paul N. Roth is a founding partner of the firm and chair of the Investment Management Group. Throughout his career, Paul has acted as counsel to leading public and private companies in financial services and to their boards of directors. His extensive private investment funds practice, an area in which he has more than 50 years of experience, includes the representation of hedge funds, private equity funds, offshore funds, investment advisers and broker-dealers in connection with fund formations and compliance, securities regulation, mergers and acquisitions (domestic and cross-border) and other financial transactions. Considered the "dean of the hedge fund bar," Paul serves as a special adviser to the board of directors of the Managed Funds Association (MFA). He is the former chair of the Subcommittee on Hedge Funds of the ABA's Committee on Federal Securities Regulation and the New York City Bar Association's Committee on Securities Regulation.

Paul has been recognized as a leading funds lawyer by *The Best Lawyers in America,* which also named him New York City Private Funds/Hedge Funds Law Lawyer of the Year; *Chambers Global*, *Chambers USA*, *IFLR1000*, *Expert Guide to the Best of the Best USA*, *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*, *Lawdragon 500 Leading Lawyers in America*, *The Legal 500 US*, *New York Super Lawyers*, *PLC Cross-border Investment Funds Handbook*, *Who's Who in American Law*, *Who's Who in America* and *Who's Who Legal: The International Who's Who of Private Funds Lawyers*. Paul was recently honored at *The Hedge Fund Journal* Awards for his outstanding achievement in the hedge fund industry. He also received a Lifetime Achievement Award from Hedge Funds Care in recognition of his prominence in the hedge funds industry and his extraordinary commitment to philanthropy. He was named to *HFMWeek's* 2010 list of the 50 most influential people in hedge funds. Paul is a former lecturer at the University of Pennsylvania's Wharton School, where he taught "Responsibility in Professional Services." of Business. He is currently an Adjunct Professor of Law at NYU School of Law, where he is teaching "Law and Management of Financial Services Businesses." Paul graduated *magna cum laude* from Harvard College, *cum laude* from Harvard Law School and was awarded a Fulbright Fellowship to study law in the Netherlands. He served on the Advisory Board of Harvard Law School's Center on Lawyers and the Professional Services Industry and formerly served as president and a trustee of the Harvard Law School Alumni Association of New York City. In addition, he is a senior director of the Legal Defense Fund of the NAACP and a member of the advisory board of the RAND Center for Corporate Ethics and Governance, and he is a fellow of the New York Bar Foundation and the Phi Beta Kappa Society.

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Gary Stein

Gary Stein focuses on white collar criminal defense and securities regulatory matters, complex commercial litigation, internal investigations, anti-money laundering issues, civil and criminal forfeiture proceedings and appellate litigation. He represents public companies, financial institutions, hedge funds, other entities and individuals as subjects, victims and witnesses in federal and state criminal investigations and regulatory investigations by the SEC, SROs and state attorneys general. He has conducted numerous internal investigations involving potential violations of the Foreign Corrupt Practices Act, financial statement fraud, money laundering and other matters, and advises companies on compliance with the FCPA and anti-money laundering and OFAC regulations. As a former Assistant U.S. Attorney and chief appellate attorney in the Southern District of New York, Gary investigated, prosecuted, tried and represented the government on appeal in numerous white-collar criminal cases involving money laundering, fraudulent investment schemes, bank fraud, insider trading, art theft, illegal kickbacks, terrorist financing and other financial crimes. His civil litigation experience includes claims of fraud and breach of contract, securities class actions and derivative actions, contests over corporate control, and disputes arising from the sale of a business. He has handled more than 150 appeals in federal and state courts involving issues of both criminal law and procedure and complex commercial law. He has successfully argued 17 appeals in the U.S. Court of Appeals for the Second Circuit.

Gary has been recognized as a leading litigation attorney by *The Legal 500 US, Benchmark Litigation: The Definitive Guide to America's Leading Litigation, New York Super Lawyers, Firm & Attorneys* and *Who's Who Legal: Business Crime Defence.* An accomplished public speaker and writer, he has presented on FCPA, insider trading, risk management and crisis management issues at a number of conferences. Gary has been presented with Burton Awards for Distinguished Legal Writing. In 2008, he won for co-authoring "The Foreign Corrupt Practices Act: Recent Cases and Enforcement Trends," which appeared in the *Journal of Investment Compliance* and in 2015, he won for authoring "Pension Forfeiture and Prosecutorial Policy-Making," which appeared in the *NYU Journal of Legislation and Public Policy Quorum*. Additionally, he co-authors the "Scienter: Trading 'On the Basis Of'" chapter in the *Insider Trading Law and Compliance Answer Book.* Gary serves on the Board of Editors of the *Business Crimes* Bulletin. He received his J.D. from NYU School of Law and his B.A. from NYU.

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

Craig is recognized as a leading litigation lawyer in *Benchmark Litigation: The Definitive Guide to America's Leading Litigation Firms and Attorneys*, *The Legal 500 US* and *New York Super Lawyers*. He is a former law clerk to the Hon. Lawrence M. McKenna of the U.S. District Court for the Southern District of New York. Craig has written and spoken about enforcement trends in the private fund space and other industry-related topics. Most recently, he was interviewed for the article "Execution Enforcement Actions Escalate," published in *The Hedge Fund Journal*. Craig earned his J.D., *cum laude*, from the Benjamin N. Cardozo School of Law and his B.A. from the University of Michigan.

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

Recognized as a leading lawyer in the industry, Boris is ranked in *Chambers USA*, *Chambers Global* and *The Legal 500 US* for his work in structured finance. He serves as outside general counsel to the Institutional Longevity Markets Association (ILMA) and is a member of the Structured Finance Committee of the New York City Bar Association, the New York State Bar Association and the Esoteric Assets Committee and Risk Retention Task Force of the Structured Finance Industry Group. A frequent speaker at securitization industry conferences, Boris has conducted various securitization, litigation funding and life settlement seminars in the United States and abroad. Most recently, Boris was interviewed for the article “Attorneys Must Tread Carefully in Litigation Funding’s Next Stage,” published in *Law360* and the articles “SRZ’s Leading Litigation Finance Practice: Holistic Expertise for a Booming Asset Class” and “Life Settlements and Longevity Swaps: Opportunities for Investors, Individuals, Insurers and Pension Funds,” both published in *The Hedge Fund Journal*. His speaking engagements have included “Flash Briefings on Alternative & Emerging Asset Classes — Structured Settlements” at SFIG and IMN Vegas 2018 and “Insurance Dedicated Funds and Related Strategies” and “Credit and Specialty Finance,” both at SRZ’s 28th Annual Private Investment Funds Seminar. Boris received his J.D. from NYU School of Law and his B.A., with honors, from Oberlin College.

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A published author, Elie recently contributed to "United States Fundraising" in *The Private Equity Review*, published by Law Business Research and he co-authored "PATH Act: Recently Enacted Legislation Modifies the FIRPTA and REIT Rules," an *SRZ Alert*. Elie received his LL.M. in taxation from NYU School of Law, his J.D. from Osgoode Hall Law School and his B.A., with distinction, from York University.

Credit

I. Trends in Funds and Strategies

A. *Market Highlights.* The rapid growth of private credit has slowed in 2019. Fewer funds were raised in 2019 than 2018.

1. According to recent surveys, investors are investing proportionally more in private investment strategies. Allocations to private credit and infrastructure decreased while allocations to PE and real estate grew.

   (a) According to *Preqin*'s Q3 2019 report on private debt, however, investors are looking to commit more to private debt strategies as compared to 2018.

   (b) A significant portion of investors are targeting direct lending strategies (47%).

2. The overall market view is that we are currently at the peak of the credit cycle. Investors are starting to think about distressed debt, despite recent lackluster performance in that space.

3. Managers are beginning to bet on Europe for increased distressed opportunities while the U.S. market remains less active. Companies such as Thomas Cook Group PLC and Galapagos SA represent the type of distressed opportunity that managers are not currently seeing in the United States.

   (a) According to *Preqin*, half of active private debt investors are targeting Europe. European funds bounced back from a slow Q2 to show strong fundraising in Q3 2019.

      (i) Investors similarly remain interested in Europe-focused funds, with 60% of investor mandates reviewed by *Preqin* in Q1 2019 seeking investment in Europe.

4. A recent 60-fund review of hedge funds conducted by *The Wall Street Journal* found that structured credit was the best-performing strategy of the funds reviewed.

5. Investors remain interested in litigation funding opportunities, as returns are uncorrelated to the equity and debt markets. Managers have responded to the demand but some managers believe the litigation finance market is becoming overcrowded.

B. *Strategies and Programs*. The "credit fund" marketplace contains a wide variety of strategies and investment programs.

1. Leveraged loan funds buy or originate bank loans and then lever the portfolio.

2. Special situations funds tend to have a broad focus and will buy a wide range of "unique" fixed-income opportunities.

   (a) Special situation funds often seek higher yields; frequently with "equity-like" returns.

3. Direct lending funds typically originate loans rather than purchase loans in the secondary market.

   (a) Direct lending funds represent a large portion of all capital raised by credit funds.

   (b) Direct lending funds typically focus on senior secured loans with floating rate interest and "unitranche" loans.

   (c) Cash flow distributions and lower yields than private equity funds are the norm for these types of funds.

   (d) Direct lending funds are often unlevered.

   (e) Often, loans are made to buyout fund borrowers as part of a leveraged buyout.

4. Multi-Strategy Credit Funds

   (a) These funds purchase assets in private or public credit markets.

(b) Multi-strategy credit fund structures can vary widely.

5. Distressed Debt Funds

   (a) For the past six years, industry experts have been waiting for the distressed credit market to arrive.

   (b) Fundraising efforts have slowed after a number of distressed debt fund managers launched funds between 2015 and 2018, only to find capital was not put to work or put to work at lower returns than expected.

      (i) Fewer funds were raised in 2019 than in 2018.

   (c) Distressed managers have a substantial amount of dry powder, more than in recent years.

6. *Specialty Finance Funds*. Specialty finance covers a wide range of strategies and deal types.

   (a) Investments in litigation finance funds continued to increase in 2019. The size of the financing transactions also increased from previous years.

   (b) Other esoteric asset classes are discussed below.

C. *Fund Structures.* A variety of structures and terms are used.

1. Many credit fund managers use a closed-end or "private equity-style" structure.

   (a) The benefits of this structure are:

      (i) Less pressure on valuations, which can be a complex task, especially in light of the shift to private credit.

      (ii) No withdrawal rights by investors, so certainty of capital for the credit fund manager.

      (iii) Capital call feature to reduce cash drag on the fund's returns.

   (b) The difficulties inherent with this structure:

      (i) Need to go to market with a new fund launch once capital has been called to a certain level.

      (ii) Need to liquidate all assets before the end of the term.

      (iii) Compensation can be delayed. When using a back-ended waterfall (or "European-Style Waterfall") for carried interest, the credit fund manager's employees must wait years for carried interest distributions.

2. Many credit funds have also moved to "hybrid terms" that combine open-end fund terms and closed end fund terms tailored to the characteristics of the fund's assets. For example:

   (a) Capital commitments added to an open-end fund.

   (b) Withdrawal rights and investor-level gates after a long lockup.

   (c) "Fast pay-slow pay" redemption feature.

      (i) These types of hybrid funds have built-in liquidating withdrawal accounts (the "slow pay" feature) which allow the credit fund manager to sell semi-liquid assets in the portfolio over a period of years, while the more liquid assets in the portfolio are sold more quickly to fulfill a portion of each investor's withdrawal requests (the "fast pay" feature).

      (ii) Despite the "slow pay" feature, these funds are open-ended and rely on capital contributions, valuations, incentive allocations or sometimes private-equity style distribution waterfalls.

   (d) The benefits of the hybrid structure are several, but the two key benefits are:

      (i) For investors, there is some level of liquidity during the life of the fund; and

(ii) For the credit fund manager, there is one ongoing fund offering rather than subsequent funds and periodic fundraises every few years, and asking each investor to make a new decision to invest in the next fund.

3. Business development companies ("BDCs") have become more popular.

(a) BDCs are regulated funds under the Investment Company Act but with a generally lighter regulatory burden than typical registered investment companies (closed-end funds or mutual funds). In recent years, BDCs have often been first launched privately to establish a track record before a public offering.

(b) BDCs are sometimes used for direct lending strategies as the loan-originating activities do not create the same tax concerns for non-U.S. and tax-exempt investors as do other structures.

(c) BDCs can elect to be treated as regulated investment companies ("RICs") for federal income tax purposes, which allows a manager to give investors access to direct origination strategies while at the same time avoiding negative tax consequences its ECI and UBTI sensitive investors.

(i) Specifically, RICs are corporations for tax purposes, so they block ECI and UBTI in most cases. A RIC, though, can usually eliminate its corporate tax liability by paying dividends, and in many cases foreign shareholders in a BDC can receive those dividends free and clear of the usual 30% withholding tax on dividend income.

(d) With those tax advantages in mind, SRZ recently helped launch the first BDC structured exclusively for ERISA benefit plan investors that normally face challenges investing in direct lending funds.

(e) While publicly-traded BDCs have historically targeted true retail investors, newer models, including the "private BDC" structure, have increasingly targeted the high net worth accredited investor space through existing distribution channels, while other examples have sought to leverage the tax advantages of the BDC structure to target offshore and tax-exempt investors that would normally invest in a more traditional private fund structure.

(f) Investment Company Act of 1940 restrictions on things like co-investments and cross trades come into play when a manager invests private funds side-by-side with regulated funds (e.g., BDCs).

D. *Tax Considerations*. Tax planning is critical for most credit funds.

1. *ECI.* Funds that lend or lead workouts may generate effectively connected income, which requires special structuring for non-U.S. investors.

2. *Clean Energy Funds.* Funds that invest in clean energy have additional tax-planning requirements in order to take advantage of tax credits, which can have a significant impact on fund structuring and investor composition.

E. *Conflicts of Interest.* Resolving conflicts of interest with sister businesses and funds can be a significant issue and requires thoughtful planning.

1. Credit fund managers must decide in advance in their compliance policies and procedures how they will allocate trades among their various funds.

2. They must also decide how to resolve conflicts when investing in different parts of the capital structure of a given portfolio company.

F. *Focus on Valuation*. Valuations are a persistent concern for credit funds.

1. Valuing illiquid, thinly-traded or private investments can be difficult.

(a) Models using discounted cash flow analysis must include reasonable and supportable assumptions.

2. Undervaluing in order to sell at a profit has been an area of SEC concern, as has overvaluing to obtain higher fees.

3. Managers must decide when to use in-house valuations or when to assign this task to third-party valuation firms, as well as how often a third-party firm will conduct the valuation of the portfolio.

4. Given recent increased SEC interest in valuations, managers are seeking third-party valuations on a more frequent basis.

   (a) Managers should review reports provided by third-party valuation agents for areas of SEC scrutiny, such as the availability and use or exclusion of "outlier" or exceptional market trades in determining valuations.

G. *Credit Fund Terms*. Terms and conditions for closed-end credit funds continue to evolve.

1. *Length of Investment Period*. The market is often three years from the final closing date (or, in some cases, the initial investment date), but managers are starting to push for four-year investment periods.

2. *Terms*. The average term length we have seen is 6.5 years, and we have seen a push for even longer terms.

3. *Carried Interest Waterfall*. In closed-end funds, the market is still for a back-ended waterfall ("European-Style Waterfall"), however, some credit fund managers that seek higher returns (e.g., high teens) have tested the market and offered a deal-by-deal waterfall ("American Waterfall").

   (a) With the American Waterfall, the credit fund manager must still recoup prior realized losses and permanent write-downs.

   (b) In addition, investors who agree to an American Waterfall will often require the general partner to make interim clawbacks, if warranted.

   (c) The market for the carried interest rate varies mainly from 15-20%. In general, the higher the expected return, the more likely it is that the manager will ask for and receive the higher carried interest rate.

4. *Preferred Return*. The market for higher-yielding credit funds is 8 percent, and the market for direct lending funds ranges from 5-8%. In general, the lower the yield of the credit fund, the easier it is to ask investors for lower preferred return.

5. *Management Fees*. The management fee rate and what the management fee is calculated on are hotly negotiated. We are seeing rates that range from 1-2%; however the 2% rate is often for smaller investors — institutions tend to pay closer to 1.25%.

   (a) The basis for the management fee most often continues to be invested capital (i.e., cost basis of the assets being managed) or NAV, but a few managers have pushed investors to accept a management fee based on capital commitments.

      (i) Valuation becomes more important when net asset value is the management fee base.

   (b) Early bird discounts for investors who arrive for the first closing remain popular in the market, and we see discounts ranging from 25 to 50 basis points.

6. *Subscription Lines*. Subscription lines have been more popular than ever.

   (a) Managers should be adding the proper disclosure to their fund documents if use of subscription lines could alter internal rates of return.

   (b) In master-feeder fund structures, cascading pledges may need to be used if your credit fund is hardwired for ERISA purposes because the feeder funds should not be borrowing under these types of structures.

7. *Fund-Level Leverage*. Some credit fund managers negotiate for the right to lever the portfolio at the fund level or at special purpose vehicles below the fund level. Fund-level debt ratios vary but market for funds that use

leverage is less than 1 to 1 (debt to equity). Managers should remember to carve out subscription lines from any borrowing limits.

8. *Distribution of Current Income*. More investors in credit funds are insisting on some type of periodic distributions of cash. How much cash should be distributed and when it should be distributed varies widely in our experience. Some funds distribute current income, while others distribute an interest equivalent amount.

H. *The LIBOR Transition*. Replacement of LIBOR poses new challenges for credit fund managers.

1. LIBOR will be replaced with a new benchmark rate and will not be published after 2021.

2. In July 2019, the SEC Staff issued a statement encouraging market participants to begin managing the transition from LIBOR. The SEC's Division of Investment Management suggested that funds and advisers consider the following:

(a) The impact the LIBOR transition will have on the functioning, liquidity and value of investments, and on the effectiveness of liquidity risk management programs;

(b) The effects on legacy contracts and operating agreements;

(c) Whether the impacts and other consequences of the discontinuation of LIBOR are risks that should be disclosed to investors.

3. Managers should prepare for the discontinuation of LIBOR by doing the following:

(a) Establishing a point of contact for coordination of organization-wide approach.

(b) Working with counsel to identify investments and contracts that will be affected.

(c) Identifying and measuring risks of transition.

(d) Assessing remediation possibilities and planning for implementation.

(e) Considering potential effects on operations and technology, potential accounting and reporting issues, and potential tax and regulatory issues.

II. Bankruptcy Risks for Credit Strategies

A. *Liquidity Crunch.* Private funds seeking to provide liquidity, whether by taking advantage of short-term debt trading strategies or long-term strategies like loan-to-own, must be cognizant that the current liquidity crunch creates the very real risk of bankruptcy.

B. *Cram–Up*. A "cram-up" plan of reorganization is when junior classes of creditors impose a cramdown on senior classes of creditors. In such circumstances, senior classes of creditors can be forced to accept the terms of a proposed restructuring, even if they are not as good as the original deal, including, for example, take back paper with a below market interest rate. The "cram-up" risk is heightened when a junior lender holds the fulcrum security or can influence the restructuring path based on its significant holdings across the capital stack.

1. There are two primary cram-up methods: reinstatement and indubitable equivalent.

2. In a reinstatement cram-up, the maturity of debt is restored at the pre-bankruptcy level, collection on debt due as a result of defaults are decelerated, defaults are "cured" and lenders are compensated for damages, thereby continuing the terms of the pre-bankruptcy financing. Debtors may favor this approach in a market where interest rates have risen significantly or where debtors enjoy a favorable covenant package (as would be the case in many of the existing "covenant lite" financings).

3. In the alternative, debt can be crammed up by either providing the secured lender with deferred cash payments with a present value equal to the debt (assuming the lender is fully secured by its collateral package) or by providing the secured lender with the "indubitable equivalent" of its secured claim. Debtors may utilize this approach where the pre-bankruptcy maturity date is an issue or to compel lenders to involuntarily refinance using interest rates that may be lower than an existing facility.

(a) Courts have applied two methodologies for determining the appropriate interest rate to calculate present value: the formula approach and the market approach. The "formula approach" starts with a risk-free base rate (such as the Treasury rate or prime rate) and is adjusted by the court to account for risks based on the circumstances of the case, the nature of the collateral, the terms of the take back paper and feasibility of the plan. The "market approach" refers to the prevailing rate of interest the debtor would be required to pay for the same financing in an efficient market.

C. *Disallowance of OID*. Original Issue Discount ("OID") is the difference between the value of the proceeds of a debt instrument at the time it is issued and the face amount of the same at its maturity. In addition to OID created at the time of issuance, OID can also arise in debt-for-debt exchanges (including face value exchanges and fair value exchanges).

1. OID is paid only when the debt matures and is amortized over the life of the debt from an accounting and tax perspective (like regular interest accrual). As such, bankruptcy courts have held that OID constitutes interest for purposes of treatment under the Bankruptcy Code.

2. In bankruptcy, the allowed amount of a creditor's claim is determined as of the date the bankruptcy case is commenced. Consistent with this rule, claims for unmatured interest, and unamortized OID, are disallowed.

D. *Lien Avoidance*. In bankruptcy, a debtor may seek to unwind certain transfers or obligations it believes were fraudulently made. An LBO transaction that goes bad can be a prime target for fraudulent conveyance claims because lenders, management and shareholders may benefit greatly, while the debt used to finance the deal can render the company insolvent.

1. In general, an LBO or functionally similar transaction involves substituting debt for equity. Often, loan proceeds are obtained by the acquiring entity, secured by the target entity's assets and used by the acquiring entity to buy-out the existing equity holders of the target entity. With respect to lender risks, parties may initiate fraudulent transfer litigation to avoid the liens granted to the third-party lenders that financed the LBO.

2. There are two types of fraud for purposes of fraudulent transfers: actual fraud and constructive fraud. Actual fraud exists where a transfer was made with actual intent to hinder, delay or defraud investors. Because direct evidence of fraudulent intent is often unavailable, courts rarely find actual fraud in the case of an LBO. Constructive fraud does not require fraudulent intent, but, instead, seeks to unwind transfers that were not in the best interests of the transferor.

3. In order to avoid the liens under a theory of constructive fraud, the debtor must have been (i) insolvent or (ii) undercapitalized at the time of (or as a result of) the transaction. This is a fact-intensive inquiry and often requires expert analysis, but courts frequently look to three data points as a start:

   (a) *Equity Market Cap*. With respect to solvency, courts prefer market evidence and have frequently relied on a public company's positive equity capitalization as dispositive proof of solvency in the absence of fraud.

   (b) *Balance Sheet*. Another solvency data point, albeit not dispositive, is the balance sheet. If the assets of the company exceed liabilities by a meaningful cushion after the LBO transaction, courts may consider that to be evidence of solvency.

   (c) *Adequate Capital*. If solvency is a snapshot at a particular point in time, a determination of "adequate capitalization" is forward-looking based on projections. If the company's projections show a sufficient operating income to deal with its operating liabilities based on reasonable assumptions, courts may consider that to be evidence of adequate capitalization.

4. *Risk Mitigants*. Lenders should be cognizant that a failed LBO will likely be subject to litigation. To mitigate risks, lenders should be prepared to conduct a thorough, independent solvency analysis of the potential borrower at time of transaction (both on an individual and post-LBO consolidated basis). When performing a solvency analysis and valuation, lenders should expect that courts will "collapse" the transaction and look at the net value received by the borrower, rather than consideration exchanged in any individual/incremental

transaction. Lenders may also require a third-party solvency opinion and representations in the loan agreement (and transaction agreement) and an officers' certificate on solvency.

(a) These steps would *not eliminate* the fraudulent transfer risk, but would be helpful to mitigate them in the event of a future bankruptcy filing.

III. Certain Material Provisions of a Typical Credit Agreement

A. Credit Facility

1. *Mechanics*. The facility section of the credit agreement sets forth the mechanics of making a loan, the payment of the principal of, and interest on, each loan, and the maximum amounts, sublimits, borrowing bases and other basic terms that relate to the facility.

2. Interest Rate

(a) Loan pricing may be divided into two categories: interest rates based on (x) an all-inclusive calculation of the bank's costs in extending credit, such as the bank's prime rate, and (y) the bank's "cost of funds." In each case, the lender may add a margin or spread to the foregoing base interest rates, based upon the lender's perceived risk of the credit. The most common cost of funds rate is LIBOR. Note that the Financial Conduct Authority of the United Kingdom plans to phase out LIBOR by the end of 2021. Discussions are underway to determine the new benchmark rate to replace LIBOR, which may include a benchmark rate based on the Secured Overnight Financing Rate ("SOFR").

(b) Most states have laws that limit the rate of interest a lender may charge on a loan. Most of these limitations do not apply to large commercial loans. For example, in New York, commercial loans in excess of $2,500,000 are not subject to usury restrictions. Some states, however, still have usury laws that are of concern to commercial lenders. Note that fees and equity kickers may be included as interest when calculating the interest rate for determining whether a loan is usurious.

3. *Incremental Facilities*. Credit agreements may have provisions that allow for (i) incremental facilities to increase the existing loans on same terms or different terms, and/or (ii) sidecar loan facilities that permit additional loans on same terms or different terms. The terms of the incremental facilities, the amounts, the economics and rights of existing lenders to participate or provide such facilities are all negotiated on a deal-by-deal basis.

B. Letters of Credit

1. A letter of credit facility is usually part of the revolving facility (i.e., reduces the amount available under the revolving facility) with a sublimit on the letter of credit facility.

C. Application of Payments

1. *Waterfall*. Governs how the proceeds from collateral or other payments are allocated among the lenders after the occurrence of an event of default.

D. Conditions Precedent

1. Conditions precedent establish the conditions to the lender's obligation to extend credit to the borrower.

2. Many credit agreements entered into in connection with an acquisition financing require "SunGard" closing conditions. SunGard provisions replace the customary conditions precedent to initial funding that require the perfection of security interest on the collateral and that all representations and warranties are true and correct, in each case, as of the closing date. The purpose of SunGard provisions is to reduce the number and scope of conditions precedent so there is more certainty for the seller that the financing will be available and the acquisition will close as expected.

E. Representations and Warranties

1. The representations and warranties of a credit agreement, together with the disclosure schedules that are attached to the credit agreement, provide a "snapshot" of the borrower at a particular point in time, and, if there is a gap between signing and closing of any funding, the representations and warranties are "brought down" (i.e., re-made) on the closing date and each funding date.

2. There are two broad categories of representations and warranties. The first category deals with standard issues, such as the borrower's due organization and compliance with laws. The second category deals with issues specific to the particular credit and borrower. These include such items as compliance with specific regulations applicable to the borrower's business and ownership of assets by the borrower.

F. Covenants

1. Through the covenants of a credit agreement, the lender seeks to maintain the "snapshot" of the borrower. If a covenant is violated, a lender may reevaluate the credit and declare an event of default. There are many types of covenants found in credit agreements. Covenants are generally divided into affirmative covenants (setting forth actions the borrower should affirmatively take), negative covenants (setting forth prohibitions on certain actions by the borrower) and financial covenants.

2. Examples of affirmative covenants: financial reporting, compliance with laws, maintenance of existence, maintenance of insurance, inspections/lender calls, maintenance of books and records and further assurances.

3. Examples of negative covenants: limitations on debt, liens, investments, dispositions, fundamental changes, dividends/distributions, change in the nature of business, payment on other debt and transactions with affiliates.

   (a) These covenants typically include certain exceptions and thresholds. Borrowers will often push to expand the threshold baskets by (i) setting the basket as the "greater of a fixed amount and a certain percentage of EBITDA" as opposed to a fixed amount; and (ii) using the "Available Amount/Builder Basket." All of the covenant baskets should be reviewed collectively – especially given the prevalence of EBITDA grower baskets and available amount baskets.

   (b) The "Limited Condition Acquisition" concept is fairly prevalent in large cap and upper middle-market transactions. Limited Condition Acquisition provisions were originally introduced so that a buyer in an acquisition could bolster its position by stating its offer to purchase is not conditional on obtaining third-party debt. Credit agreements that permit Limited Condition Acquisitions will allow a borrower to elect to test availability under debt incurrence baskets and/or conditions such as "no default or event of default" on the date of the execution of the acquisition documents rather than at its completion.

   (c) Some credit agreements also differentiate between "Restricted Subsidiaries" and "Unrestricted Subsidiaries." Restricted Subsidiaries are subject to the representations and warranties and the covenants of the credit agreement. Unrestricted Subsidiaries would not be subject to such provisions. If a credit agreement permits the borrower to have Unrestricted Subsidiaries, it is important to review all of the negative covenants for any potential issues.

   (d) Credit agreements should reflect the assumptions used to underwrite the deal. Credit agreements should prohibit transfers of assets that are material to the business of the borrower, and if certain baskets are expected to be utilized solely with cash (e.g., cash investments and cash restricted payments), the credit agreement should be drafted clearly to state such expectations.

4. Financial Covenants

   (a) *Weakening of Financial Covenants*. "Covenant-lite" approach, speculative EBITDA addbacks and increased cushion to sponsor models — all may affect recovery prospects for lenders.

   (b) Financial covenants should be tight enough to detect a financial problem in advance of a default. If the financial covenants are sufficiently sensitive and the credit is being monitored properly, the lenders should be able to exercise rights and remedies before a payment default occurs.

G. Events of Default and Remedies

1. Events of default are the triggers that allow the lender to exercise its rights and remedies, including acceleration of the loans and termination of commitments.

2. May include an equity cure provision to permit the borrower to cure its financial covenant defaults.

IV. Specialty Finance, Esoteric Deals and Yields Uncorrelated to Capital Markets

A. Uncorrelated investment opportunities continue to be in high demand.

B. *Specialty Finance*. This includes all areas that traditional banks can't fund.

1. *Consumer Credit*. Debt incurred by consumers when purchasing goods or services. Examples include rent-to-own and motorcycle leases. Other types of consumer funding are expanding, e.g., income-sharing agreements.

2. *Commercial Credit*. Examples include merchant cash advances and insurance-related receivables.

3. *Insurance Companies.* Are these the new banks? Insurance companies have begun to offer direct credit.

(a) Can be an additional source of leverage to funds.

(b) Sometimes need a rating.

C. "Esoteric" Deals

1. Litigation finance.

2. Income-sharing agreements.

3. Purchase of lottery winnings.

4. Medical liens.

Private Investments

I. Introduction

A. *Basic Trend*. A number of managers who have historically been focused either primarily or exclusively on public investments ("public investments") are investing in private equity-type investments ("private investments"), and not just by suspending redemptions.[1] Expansion to private investments can add complexities to structures and terms that managers would otherwise use.

B. *Reasons for Why this Trend Is Occurring*. This trend is occurring because it is becoming more challenging to invest in the public investment markets because of:

1. Fully priced and oversaturated public markets

2. Low interest rates in the public markets

C. *Structuring Approaches*. There are two general approaches to structure private investments within an existing fund complex otherwise focused on public investments.

1. Single fund structures (i.e., side pockets, hybrid fund structures)

2. Separate fund structures (i.e., co-investment vehicles, side-by-side structures)

II. Single Fund Structures

A. Development of Trends of Investor Interest in Single Fund Structures

1. Side pockets and other single fund structures were unpopular after the financial crisis. New funds were launched without them unless the investment program was something like distressed debt where they were unavoidable, and even existing funds often promised to stop using side pockets going forward.[2]

2. Recently, however, side pockets are becoming increasingly more acceptable again as part of the toolbox to maximize returns in a strategy rather than an emergency measure to address unintended illiquidity.

3. Examples of investment program sectors where side pockets are becoming more acceptable:[3]

(a) Credit funds[4]

(b) Emerging markets

(c) Litigation finance

(d) Insurance products

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[1] *See e.g.*, "2019 EY Global Alternative Fund Survey", page 13 (available for download at: https://www.ey.com/en_gl/wealth-asset-management/when-focusing-on-the-future-where-do-you-look) (reporting that "more than a quarter of hedge fund managers indicated they have either a private equity or venture capital offering" and that hedge fund's offering of co-investment vehicles or "best idea portfolios" has increased by 18% since 2018); Idzelis, Christine, "Hedge Fund Firms Ramp Up Private Investing", *Institutional Investor* (April 26, 2019) (available at: https://www.institutionalinvestor.com/article/b1f4r997t0wgtr/Hedge-Fund-Firms-Ramp-Up-Private-Investing); Whyte, Amy, "Two Sigma is Getting Into Private Equity", *Institutional Investor* (November 19, 2019) (available at: https://www.institutionalinvestor.com/article/b1j394r56c8336/Two-Sigma-Is-Getting-Into-Private-Equity); Karsh, Melissa "Hedge Funds Turn to Private Capital Playbook in Search of Assets", *Bloomberg* (Jan. 3, 2019) (available at: https://www.bloomberg.com/news/articles/2019-01-03/hedge-funds-turn-to-private-capital-playbook-in-search-of-assets).

[2] *See* Lovell, Hamlin, "Credit Funds: Evolving Hybrid and Other Structures — Insights from SRZ's Leading Investment Management Practice," *The Hedge Fund Journal* (December 2019); *see also* Shadab, Houman, "Financial Crisis to Slow Convergence of Hedge Funds and Private Equity Funds, But not For Long," *Hedge Fund Law Report* (March 4, 2019).

[3] *Id*.

[4] *Id*.

B. Considerations Regarding Exposure Limitations on Private Investments in Single Fund Structures

1. *Setting Fixed Allocation Amounts on a Fund-Level v. Investor-Level Basis*. When setting fixed allocations for side pocket exposure, managers should consider whether to set this on a fund-level basis (*e.g.*, the fund as a whole will not allocate more than 25% of its assets to side pockets) or on an investor-level basis (*e.g.*, no more than 25% of an investor's capital account(s) will be allocated to side pockets). Benefits to allocating it based on an investor-level basis are that it helps ensure that all investors get side pocket exposure and that the fund does not run of side pocket capacity because of partial redeemers.

2. *Investor Optionality in Allocations*. Traditionally, fund managers set fixed percentages for side pocket allocations (whether on a fund-level or investor-level basis). We are now seeing managers offering optionality to investors in terms of how much exposure they want to the side pockets within a portfolio (this optionality will only work if the side pocket allocations are set on an investor-level basis).

   (a) This can seem attractive from a marketing perspective.

   (b) However, managers need to think about the complexities that will arise if different people have different levels of side pocket cap and an investment needs to be moved into the side pocked midstream.

   (c) Also, if a manager gives investors a choice as to the amounts of side pockets investors will accept, managers may find that too many investors opt out of side pockets, giving managers less ability to pursue privates investments.

C. General Issues to Consider[5]

1. *Structure of Legal Entity.* While traditional fund legal entities can be used for single fund structures pursuing both public and private investments (e.g., Delaware limited partnerships, Cayman Islands companies or partnerships), the usage of Delaware series LLCs, Delaware series partnerships or Cayman Islands segregated portfolio companies can help facilitate a hybrid investment structure, as one series/portfolio can be used for the public investment portfolio while another series/portfolio can be used for the private investment portfolio.[6]

2. *Fund Terms.* Managers should consider various fund terms when incorporating private investments into funds otherwise focused on public investments.

   (a) Subscriptions

      (i) Managers using hybrid fund structures may consider accepting subscriptions through capital commitments they draw down over time (as opposed to capital contributions that are fully funded at the time of subscription).

      (ii) This can facilitate the ability to invest opportunistically in more illiquid assets.

      (iii) When using a drawdown mechanism, managers should generally include typical terms that funds use for drawdown mechanics (e.g., default provisions, a single capital account tracks the entire capital commitment amount; consider whether investor's voting rights should be based off of the total amount committed vs. the total amount contributed).[7]

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[5] While certain of these issues may be applicable to public and private investments pursued through separate investment fund structures, they have been included in the discussion of this outline regarding public and private investments pursued through single investment structures as they may more frequently or acutely arise in that context.

[6] *See* Braunstein, Yehuda M. and Warren, Todd K., "Understanding the Benefits and Uses of Series LLCs for Hedge Fund Managers," *The Hedge Fund Law Report* (Nov. 15, 2012).

[7] *See* Griffith Cara, "Can a Capital on Call Funding Structure Fit the Hedge Fund Mismatch," *Hedge Fund Law Report* (Nov. 5, 2019).

(b) Liquidity

(i) Some managers may consider creating more illiquid terms for the funds as a whole with lock-ups and gates.

(ii) Managers may also consider more liquid terms for the public investment portion of the portfolio and more illiquid terms for the private investments.[8]

(c) Management Fees

(i) Hedge fund management fees are often based on a certain percentage of the NAV of its investments. Private equity funds, though, often set management fees based on the amount of invested or committed capital. Managers should consider which approach is appropriate for a hybrid fund, or consider applying separate management fee terms for the private investments and public investments.

(ii) Private equity funds often offer management fee offset terms, whereby any transaction fees, consulting fees or similar fees the manager collects as part of managing the private investment, will offset the management fees the fund owes to the manager. Hybrid fund managers should consider adding such terms (to the extent they don't already exist) at least for the private investment portion of the portfolio.

(d) Incentive Compensation

(i) Incentive compensation on private investments is generally collected in a more back-ended manner once the investment proceeds are realized. Incentive compensation on public investments, though, is generally collected on an annual basis on both realized and unrealized gains.

(ii) Managers using a hybrid structure should consider whether to:

(1) Apply a private equity-type/waterfall incentive compensation structure for all investments;

(2) Apply a hedge-fund style incentive compensation on the entire portfolio (e.g., annually, based on realized and unrealized gains) — note this will often require the use of an "internal rate of return" valuation mechanism to value the illiquid portions of the portfolio; or

(3) Apply a private equity type incentive compensation term only to the private investment portfolio, and annual hedge-fund style incentive compensation term to the public investment portfolio.[9]

(e) *Participation of Incoming Investors in Current Private Investments*. Private equity funds often allow investors admitted to the fund at subsequent closings to participate in the fund's initial private investments (typically requiring them to pay interest and make-up management fees to put them in the same economic position as the initial investors). Hybrid funds may consider this strategy, though if a fund has an evergreen structure with investors being admitted and withdrawing frequently, it may be easier for the fund to only allow incoming investors to participate in future private investments.

3. Certain Tax Considerations

(a) One of the tax concerns with private investments is structuring around "effectively-connected income." Blockers can be used to create tax efficiency.

(b) If a manager is using blockers in its fund complex, the manager needs to consider the particular point in which the blockers are placed. Blockers can be inserted into a fund complex in a way that enables you to

[8] *See* Banzaca, Jennifer, "Hedge Fund Managers Turn to Hybrid Fund Structures to Reconcile Liquidity Terms and Duration of Assets," *Hedge Fund Law Report* (Feb. 4, 2009).

[9] *See generally Id*.

collect carried interest on a pre-tax basis. It might seem that this hurts the investor. In fact, taking the carry pre-tax is neutral for investors. Only the IRS loses.

4. *Certain ERISA Considerations*. If a fund decides to have a private investment portfolio and public investment portfolio in the same fund, it is possible to structure them such that the testing as to whether the fund has 25% or more of ERISA investors is done on a separate basis for the portfolio that holds the private investments. This is especially true if the private investments are held through different series of a Delaware series partnership or series LLC or a different portfolio of a Cayman segregated portfolio company.

III. Separate Fund Structures

A. General Benefits

1. Sometimes it makes more sense, either from a marketing perspective or because of the amount of private investments a manager wants to make, to run private investments in a separate vehicle rather than attempting to manage them through side pockets.

2. The separate structure might be attractive to investors who are not otherwise interested in the public market part of your strategy or who want a closed end fund with classic private equity terms.

3. Using a separate vehicle also provides a manager with more flexibility in creating structures and terms that are appropriate for these types of investments.

B. Types of Separate Fund Structures

1. *Co-investment Vehicles.* A manager can insert its more illiquid investments in a co-investment vehicle. These are generally used for single investments.[10]

2. Side-by-Side

(a) A manager may set up a dedicated separate vehicle for multiple private investment opportunities that invests alongside a separate vehicle used for public investments.

(b) A manager may initially set up multiple co-investment vehicles and then combine them into a dedicated private equity fund that it manages alongside its hedge fund.

C. General Issues to Consider[11]

1. Investor Protections in Private Investment Funds

(a) Fund sponsors who are used to running evergreen funds that invest in public investments may be surprised by the level of additional investor protections that investors in closed end private equity funds expect. Those can include: hurdles, clawbacks, investor rights to remove the general partner, and far more expansive investment restrictions and side letter requests.

(b) Sometimes, these requests can leak across from those investors to the manager's public equity products, such as with respect to fee terms:

(c) Fee Terms:

(i) Investors may seek MFN treatment, taking into consideration the assets they have across multiple funds, including both the funds that are focused on public and private investments.

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[10] *See* e.g., Lovell, Hamlin, "Co-Investments go Mainstream: Thoughts from the co-head of SRZ's leading investment management group," *The Hedge Fund Journal* (Aug. 2019); Kustin, Ira P., "Beyond the Master-Feeder: Managing Liquidity Demands in More Flexible Fund Structures, *Hedge Fund Law Report* (May 25, 2017).

[11] While certain of these issues may be applicable to public and private investments pursued through single fund structures, they have been included in the discussion of this outline regarding public and private investments pursued through separate fund structures as they may more frequently or acutely arise in that context.

(ii) Managers may want to offer common fee terms for public and private investments – when doing so, managers should consider the differences between terms used for public and private investments and whether this will work, *e.g.*,:

(1) It may be appropriate for management fees to be based off of NAV for public investments, but invested or committed capital for private investments.

(2) Incentive compensation may be more appropriately structured as a back-ended waterfall for private investments, while an annual incentive allocation on realized and unrealized gains may be more appropriate for the public investments.

2. Allocation of Investment Opportunities

(a) Managers need to be careful to fairly allocate investment opportunities between their funds focused on public and private investments. This can be challenging in some situations, e.g.:

(i) An investment is not easy to classify as being totally public vs. private.

(ii) If the public and private investments that will be made are not obviously distinct from one another. For instance, some managers use private equity structures for investments in which they are seeking control and a long-term hold, while using evergreen structures for passive investments. If the manager changes its thesis midstream towards taking control of an investment previously expected to be passive, the investment may become more appropriate for its private investment fund. In that case it will be important to have set clear expectations as to whether the evergreen fund will continue to invest in the same company, stand-still, or possibly sell its position to the private investment fund.

(b) The allocation of investment opportunities may create certain inherent conflicts of interest when different funds invest in a different portions of an issuer's capital structure (e.g., the public-investment-focused fund invests in publicly traded securities of an issuer, while the private equity fund invests in certain privately issued debt of the issuer or a new class of privately offered equity).[12]

(c) If the public and private investment fund invest in the same type of an investment, they should consider any conflicts related to entering and/or exiting the investment, e.g., it might be fair for each fund to exit an investment at the same time unless there's a specific reason to justify the difference in exiting the same opportunity.

(d) If the managers lures investors into a co-investment vehicle away from the main fund, particularly when the co-investment vehicle charges lower fees, the manager needs to be able to take the position that it wasn't taking opportunities away from the main fund.

(e) Managers may consider buying excess capacity in certain investments in order to allocate it to a co-investment vehicle that it intends to form (e.g., because the investment is too illiquid to be entirely held in a fund that is primarily focused on liquid investments).

(i) In these scenarios, managers should be able to defend this approach why it was fair to the more liquid fund to make the investment in this manner (e.g., the more liquid fund was able to buy the investment at a cheaper price because it bought the capacity it intends to eventually allocate to the co-investment vehicle).

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[12] *See* e.g., Breslow, Stephanie, "Recent Trends in Credit Funds," *Expert Guides Women in Business Law*, pages 81-82 (Aug. 2019) (available at: https://www.srz.com/images/content/1/6/v2/165769/082319-SRZ-Expert-Guides-Credit-Funds.pdf) ("*Credit fund general partners must decide in advance how they will allocate trades among their various funds, as well as how to resolve conflicts when investing in different parts of the capital structure of a given portfolio company.*"); Banzaca, Jen, "Don't Play Favourites With Your Investors: How are firms managing a range of conflicts of interest when running different types of investment vehicles," *HFM Week.Com*, pages 17-18 (April 19-25, 2018) (available at: https://www.srz.com/images/content/1/5/v2/156833/HFMWeek-Don-t-Play-Favourites-With-Your-Investors.pdf).

(ii) Managers must also consider issues involving cross-trades in this situation, once the investment is eventually allocated to the co-investment vehicle.

(iii) Managers should realize that this arrangement may have adverse implications from a tax perspective if the fund takes the position that it is an "investor" vs. a "trader."

3. Allocation of Expenses

(a) The different funds need to fairly allocate common expenses amongst each other. This can be complicated in many situations.

(b) If the private investment-focused fund invests in an investment at a later date than the main fund, it may be appropriate for the private investment fund to pay its proportionate share of the expenses incurred by the other investment fund in the initial stages of the investments.

(c) Managers should particularly pay attention to how to allocate expenses among main funds and co-investment vehicles. The SEC has scrutinized such arrangements.[13]

(d) The SEC has also scrutinized whether "broken-deal expenses" are allocated fairly among funds.[14]

(e) Managers must clearly disclose their expense allocation disclosure to investors and follow it.

4. Cross-Defaults

(a) Assuming the private investment-focused fund in the structure accepts contributions through capital commitments (as opposed to capital contributions), managers may consider implementing terms whereby if an investor defaults on its capital commitment to the private investment-focused fund, the manager may deduct capital from the investor's capital account in the public fund to cover the shortfall in the private investment-fund created by the default (e.g., where the investor does not otherwise have capital in the private investment-focused fund from which to collect capital).

(b) Managers should note this arrangement may have adverse tax consequences to the extent either fund in the structure seeks to avoid being taxable as a "publicly-traded partnership."

5. *Certain Tax Considerations.* Using a separate structure focused solely on private investments allows you more flexibility. That said, the tools used by traditional private equity funds that have maybe a dozen investments aren't always the best for hybrid strategies with a more diverse portfolio mix. For example, the typical private equity model involves starting with a single partnership and rolling out alternative investment vehicles if a manager wants to block things. This could be expensive if a manager finds that a lot of investments need blocking. You have to weigh this against the tax drag of blocking everything for non-U.S. and tax-exempt investors and your marketing team's desire to have a fund that looks like a classic private equity fund.

6. *Certain ERISA Considerations*. The fund focused on private investments may qualify as a "VCOC" or "REOC" for ERISA purposes, thus allowing it to admit 25% or more of ERISA investors.

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[13] *See* e.g., Lees, Hena, "SEC Fines Fund Manager for Failing to Equitably Allocate Fees and Expenses to Its Affiliate Funds and Co-Investors," *Hedge Fund Law Report* (June 6, 2019).

[14] *See In the Matter of Platinum Equity Advisors, LLC* (Investment Advisers Act of 1940 Release No. 4772) (Sept. 21, 2017 (same); *see also* Pitaro, Vincent, "SEC Enforcement Action Involving 'Broken Deal' Expenses Emphasizes the Importance of Proper Allocation and Disclosure," *Hedge Fund Law Report* (July 9, 2015).

IV. Other Issues to Consider in Single or Separate Fund Structures

A. Team Compensation

1. Investment personnel of hedge funds focused on only public investments are generally paid annually based on the fund's realized and unrealized gains. This compensation structure may not be appropriate for private investments where carried interest is typically only paid once investments are realized. For example:

   (a) Managers of pure private equity funds typically grant the investment team slices of carry that are locked in subject to vesting and forfeiture so that a person working on the fund day one, knows they can receive carry in future years, even if they leave in the meantime. This type of issue does not arise in evergreen public funds, although it is relevant to side pockets. Fund firms that are expanding into private investments need to think about whether their compensation model need to be modified to deal with this issue.

   (b) A lot of you have gotten used to annual bonuses that are made in the manager's discretion. This becomes less tolerable when carry will not be earned for years after the work is done.

2. If managers have different teams running the private equity and public market investments, managers need to decide whether each team is being paid in the usual way for that asset class, or whether everybody is sharing in the common pool. It can be attractive to private equity investment team members to get a portion of their compensation based on annual mark to market performance on the public side. Correlatively, having private equity carry dangling in the future can be a good retention tool for public side investment professionals.

3. If managers decide to combine your public and private investments in a single hybrid fund, managers may need to limit investor liquidity. This can cause investors to demand that a manager's carry only be collected at the end of a multi-year lock-up. This can create complexities from a tax perspective, particularly when an investor has a managed account.

B. Performance Results and Advertising

1. Presentation of Performance Results

   (a) Performance results are often presented differently by funds focusing on private investments v. funds focusing on public investments:

      (i) Performance results attributable to private investments typically present more detailed performance information that includes deal-by-deal gross returns, projections and IRR calculations.

      (ii) Performance results attributable to public investments (e.g., in the hedge fund context) typically:

         (1) Are only based on NAV and annual performance information;

         (2) Are more limited because investors can act on this information to subscribe and redeem; and

         (3) Reflect "cash drag" as a result of holding more in cash reserves than a private equity fund run side by side.

   (b) As a result of the differences in presentation, performance numbers attributable to funds or portfolios focused on private investments vs. those focused on public investments may differ, even when their investment portfolios are substantially similar.

   (c) Furthermore, different structuring for tax issues between the public and private investments can also cause differences in performances due to "tax drag."

   (d) Investors who invest in both public and private investments may seek to receive more extensive information regarding the private investments than is generally available with respect to public investments. This could present selective disclosure issues since the investors could act on this information by withdrawing from the hedge fund in a side-by-side structure, or limiting their allocation to side pockets in a hybrid structure, to the detriment of other investors.

2. Performance Advertising

(a) Because of the foregoing differences, managers need to also be mindful about adapting performance results from a structure that pursues public and private investments and applying it to a structure that only pursues public or private investments, or similarly adapting performance results from a fund complex that pursues a different investment strategy than the one a manager currently pursues. Such advertising might potentially be too misleading in certain instances and, even where permitted, must also contain disclosures regarding the differences in investment strategies used between public and private investments.[15]

[15] *See* e.g., *Clover Capital Management, Inc.*, SEC No-Action Letter (available Oct. 28, 1986) ("In the staff's view, Rule 206(4)-1(a)(5) prohibits an advertisement that [with respect to model and actual results] . . . fails to disclose any material conditions, objectives, or investment strategies used to obtain the results portrayed.").

Regulatory

I. Standard of Conduct for Investment Advisers

A. On June 5, 2019, the U.S. Securities and Exchange Commission 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")[1];

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

3. Regulation Best Interest; and[3]

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

B. Fiduciary Interpretations

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

(a) Federal Fiduciary Duty

(i) 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.[5]

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

(b) Conflicts of Interest Waivers

(i) 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."[6]

(ii) 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."[7]

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[1] Commission Interpretation Regarding the Standard of Conduct for Investment Advisers, Advisers Act Release No. IA 5248 (July 12, 2019) (hereinafter "Fiduciary Interpretation"), available here.

[2] Form CRS Relationship Summary; Amendments to Form ADV, Advisers Act Release No. IA-5247 (June 5, 2019) (hereinafter "Form CRS Release"), available here.

[3] Regulation Best Interest: The Broker-Dealer Standard of Conduct, Release No. 34-86031 (June 5, 2019) (hereinafter "Regulation Best Interest"), available here.

[4] 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 here.

[5] Fiduciary Interpretation *supra* note 1, at 6.

[6] *Id.* at 23.

[7] *Id.* at 8.

(iii) The SEC, in the fiduciary interpretation:

(1) 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[8]; and

(2) validates an "informed consent" concept for conflict of interest disclosures by an adviser.[9]

(c) Contractual Limits

(i) The Fiduciary Interpretation expressly acknowledged 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."[10]

(ii) 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."[11]

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

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

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

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

(4) A waiver of a specific obligation under the Investment Advisers Act.[12]

(d) Guidance on the Duty of Care

(i) The SEC stated that an advisers fiduciary duties encompass a duty of care as well as a duty of loyalty.[13]

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

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

(2) An obligation to seek best execution;

(3) A requirement to monitor performance over the course of a relationship.[14]

(e) Use of Contingent Language in Disclosures

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

(1) the adviser, in fact, has a particular conflict; or

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[8] *Id.* at 23, n. 57.

[9] *Id.* at 9.

[10] *Id.* at 28, n. 70.

[11] *Id.* at 10.

[12] *Id.* at 10-11.

[13] *Id.* at 2.

[14] *Id.* at 12.

(2) has such a conflict with respect to some, but not all, of the adviser's clients.[15]

(ii) 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.[16]

(f) Specific Guidance on Allocation Policies

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

(ii) 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 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."[17]

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."[18] As the DC Circuit held in Goldstein v. SEC[19], 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.[20]

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.[21] 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.[22]

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[15] *Id.* at 25.

[16] *Id.*

[17] *Id.* at 26.

[18] Form CRS Release *supra* note 2, at 234.

[19] 451 F.3d 873 (DC Cir. 2006).

[20] 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 here.

[21] 17 CFR 275.204-5(d)(2).

[22] Form CRS Release *supra* note 2, at 239.

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.[23]

3. 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 Advisers Act) when it "is provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions."[24]

4. 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:

   (a) 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;"[25] and

   (b) 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."[26]

II. Advertising Rule Proposal

A. Overview

1. On Nov. 4, 2019, the SEC issued proposed amendments to the "Advertising Rule" under the Investment Advisers Act of 1940 ("Advisers Act"),[27] 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[28]

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[23] Regulation Best Interest *supra* note 3, at 1.

[24] Solely Incidental Interpretation *supra* note 4, at 12.

[25] *Id.* at 16.

[26] *Id.* at 19.

[27] Investment Adviser Advertisements; Compensation for Solicitations, Advisers Act Release No. IA-5407 (Nov. 4, 2019) (hereinafter "Advertising Rule Proposal"), available here.

[28] *See* https://www.govinfo.gov/content/pkg/FR-2019-12-10/pdf/2019-24651.pdf.

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."[29]

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.[30]

C. Case Studies

1. The proposed rule incorporated a "fair and balanced" principle to evaluate the use of case studies and other past specific recommendations.[31]

2. The SEC noted 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.

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.[32]

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, offer to provide) similar information addressing the risks and limitations of the use of hypothetical performance in making investment decisions.[33]

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.[34]

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.

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[29] Advertising Rule Proposal *supra* note 27, 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.

[30] *Id.* at 109.

[31] *Id.* at 63.

[32] *Id.* at 58-59.

[33] *Id.* at 158-160.

[34] *Id.* at 352.

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.[35]

G. Compliance

1. The proposed rule would generally require review and pre-approval of advertisements by a designated employee.[36]

2. This review and approval requirement also applies to updates to previously-reviewed advertisements.[37]

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.[38]

H. 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, such as 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.[39]

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.[40]

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[41];

   (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[42];

   (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[43];

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[35] *Id.* at 145.

[36] *Id.* at 190.

[37] *Id.*

[38] *Id.* at 108.

[39] *Id.* at 19-20.

[40] *Id.* at 24-25.

[41] *Id.* at 56.

[42] *Id.* at 57.

[43] *Id.* at 59.

(d) Include or exclude performance results, or contain presentations of performance time periods, in a manner that is not fair and balanced[44]; and

(e) Are otherwise materially misleading.[45]

K. Comment Period, Transition Period and Existing No-Action Letters

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

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

III. Cash Solicitation Rule Proposal

A. 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.[46]

B. 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).[47]

C. 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.[48]

D. 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.[49]

E. 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.[50]

F. 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 amended rules during the period after the effective date but before the compliance date.

3. 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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[44] *Id.* at 68.

[45] *Id.* at 72.

[46] *Id.* at 200.

[47] *Id.* at 201-202.

[48] *Id.* at 245-246.

[49] *Id.* at 205.

[50] *Id.* at 18.

IV. 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").[51]

B. The Fiduciary Interpretation[52] specified that voting decisions fall within the (fiduciary) duties of care and loyalty owed to clients by investment advisers.

C. 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.

D. 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.[53]

2. The SEC noted that such a review allows the adviser to confirm that its voting policies and procedures have been:

(a) Reasonably formulated (both in the abstract and in actual operation); and

(b) Effectively implemented.

E. 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."[54]

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.[55]

F. Multiple Clients

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

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."[56]

G. 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."[57]

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

[51] Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Advisers Act Release No. IA-5325 (Sept. 10, 2019) (hereinafter "Proxy Guidance"), available here.

[52] Fiduciary Interpretation *supra* note 1, at 12, n. 32.

[53] Proxy Guidance *supra* note 51, at 16.

[54] *Id.* at 15.

[55] *Id.*

[56] *Id.* at 15, n. 40.

[57] *Id.* at 13.

3. The SEC also indicated that a “reasonable investigation” should consider whether particular votes request a more detailed analysis (e.g., mergers and acquisitions).[58]

H. 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[59]:

   (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; and

   (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.

I. Mangers 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[60]:

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

   (b) And in the client’s best interest; and

   (c) Before the votes are cast.

4. Examples of “additional steps” steps to evaluate whether the investment adviser’s voting determinations are consistent with its voting policies and procedures proposed in the Proxy Guidance include[61]:

   (a) Reviews of the proposed voting slates

   (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

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.”[62]

   (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

[58] *Id.* at 14.

[59] *Id.* at 10-11.

[60] *Id.* at 15.

[61] *Id.* at 15-16.

[62] *Id.* at 17.

clients"[63] 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.[64]

(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.[65]

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."[66]

V. Alternative Data and Webscraping

A. Background

1. Private investment firms are increasingly utilizing "alternative data" obtained from a variety of sources, including via so-called web scraping. Regulators are focused on the policies and procedures firms have in place to vet the source and types of data fund managers are using.

2. Alternative data can be acquired from a variety of sources including, social media, credit card panels, price and payment information, geolocation information and satellite imagery. Investment managers use a variety of tools to analyze this data and incorporate it into their investment process (often relying both on internal resources and third party vendors).

3. Web scraping, also referred to as data scraping, spidering or crawling, among other names, can use various methods to collect information from across the Internet but generally relies on software that simulates human Web browsing. Web-scraped data can include product pricing, search trends, web traffic or insights from expert network sites.

[63] *Id.*

[64] *Id.* at 21.

[65] *Id.* at 21-22.

[66] *Id.* at 21.

4. *Web-Scraped Data*. Data harvested from online sources using automated software — carries the risk that firms may unwittingly be in receipt of material non-pubic information, personally identifiable information, information improperly obtained in breach of confidentiality obligations or privacy laws, or information that the provider is prohibited from disclosing.

B. Potential Issues

1. Insider Trading

(a) Where data aggregators purchase data that is not public from the source or data is scraped that was not intended to be public (such as from behind a login or paywall or from the dark web), it may be considered MNPI.

(b) Exclusivity agreements with a web scraper who may have a proprietary tool not available to others in the market could also give rise to a claim that the collected information is MNPI.

(c) There is potentially a low threshold for establishing materiality where Big Data is concerned:

(i) In *SEC v. Huang*[67], the defendant, a data analyst at Capital One, misappropriated non-public credit card transaction data to trade various retailers' stock.

(ii) The Third Circuit upheld the $13 million jury verdict against the defendant, rejecting his argument that the data was not material because Capital One data on average represented only about 2.4% of transactions in the market.[68]

(d) If data is collected in a manner that is deceptive — e.g., disguising or failing to reveal the scrapers' identity or circumventing technological controls (such as the "I am not a robot" tests), it would be deemed a "deceptive device" for 10b-5 purposes (dispensing with the requirement of a breach of duty).

(i) In *SEC v. Dorozhko*[69], the Second Circuit held that the defendant's hacking to obtain confidential earnings data in advance of a public announcement was a deceptive act because the hack involved affirmatively misrepresenting himself.

(ii) Computer Fraud And Abuse Act Of 1984 ("CFAA")

(1) The CFAA prohibits accessing a computer without authorization or in excess of authorization[70]

(2) Thus far, efforts to stop scrapers using the CFAA have mostly be unsuccessful:

a. In September, the Ninth Circuit held that LinkedIn could not use the CFAA to block a web scrapers' access to its public data.[71]

(iii) Breach of Contract And Other Common Law Claims

(1) Data harvesting can take place in a manner contrary to, or inconsistent with, the terms of use and privacy statement of the websites from which the data is collected.

(2) Sources selling their own data could potentially be in violation of their customer agreements.

(3) Although the Ninth Circuit rejected CFAA claims in a case brought by LinkedIn (in *HiQ Labs v. LinkedIn*), it noted that other common law remedies are potentially available in response to web

[67] 684 Fed. Appx. 167 (2017).

[68] *Id.*

[69] 574 F.3d 42 (2009).

[70] 18 U.S.C. § 1030 (2019).

[71] *HiQ Labs v. LinkedIn*, DC No.3:17-cv-03301-EMC (9th Cir. Sept. 9, 2019).

scraping, including trespass to chattels, copyright infringement, misappropriation, unjust enrichment, conversion, and breaches of contract or privacy.[72]

C. Recent SEC Exam Focus

1. The Office of Compliance Inspections and Examinations ("OCIE") has recently engaged in examinations focused primarily on web scraping and the use of alternative data.

2. Requests in these examinations address:

(a) Web-scraped data obtained via third party vendors, and how it is used in the research and investment process;

(b) Due diligence surrounding vendors providing web-scraped data;

(c) Data that firms may scrape and aggregate themselves; and

(d) How data is allocated or made available across a firm.

VI. California Consumer Privacy Act

A. Jan. 1, 2020 is the effective date of the California Consumer Privacy Act ("CCPA"), the country's first comprehensive privacy law.

B. Entities and Individuals Required to Comply:

1. The Act defines a "consumer" as any "natural person who is a California resident."[73]

2. The law applies to any business with at least $25 million in gross annual revenue[74] 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.[75]

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.[76]

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."[77]

(a) This is much broader than other privacy laws and expressly includes items such as email addresses, internet protocol addresses and biometric information.[78]

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[72] *Id.*

[73] California Consumer Privacy Act, CAL. CIV. CODE § 1798.140(g).

[74] *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.

[75] *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.

[76] *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).

[77] *Id.* § 1798.140(o)(1).

[78] *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[79] 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. Because final regulations are unlikely to be published before Jan. 1, 2020, the CCPA precludes the commencement of any enforcement actions prior to July 1, 2020.[80]

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,"[81] although the California Attorney General has stated some violations may not be capable of being cured after the fact.

4. Private Right of Action in the CCPA

   (a) Limited solely to consumers whose personal information (defined more narrowly for these purposes)[82] has been subject to unauthorized access or disclosure as a result of the covered business' failure to maintain reasonable security procedures.[83]

   (b) 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.[84]

   (c) 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.[85]

E. *Private Fund Manager Implications*. 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:

1. Existing Individual Investors

[79] "Sale" is defined broadly to include any disclosure or dissemination of personal information "for monetary or other valuable consideration." *Id.* § 1798.140(t).

[80] *Id.* § 1798.185(c).

[81] *Id.* § 1798.155(b).

[82] 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)

[83] *Id.* § 1798.150(a)(1).

[84] *Id.* § 1798.150(b).

[85] *Id.* § 1798.150(a)(1).

(a) The most pertinent CCPA provision for private fund managers is the exemption for any information collected "pursuant to" the Gramm-Leach-Bliley Act ("GLBA").[86]

(b) 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.

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

(d) 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 should be CCPA exempt.

2. Prospective Individual Investors

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

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

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

(ii) 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.

3. B2B Contacts

(a) 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.

(b) 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.

(c) 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.[87]

F. 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.

(a) This can be accomplished by adding notices in job applications, employee handbooks and independent contractor agreements.

[86] *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.

[87] *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.

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.

4. Absent an extension to the moratorium or amendment, the CCPA's more extensive disclosure requirements will apply commencing Jan. 1, 2021.[88]

G. *Alternative Data.* Such data in which personal information has been "deidentified" or "aggregated" is excluded from the CCPA.[89]

H. Sharing Personal Information with Service Providers

1. A business must disclose to consumers the purposes for which it shares personal information.[90]

   (a) This can be accomplished by adding language in an online privacy policy or similar disclosure.

2. The contains certain more burdensome obligations with respect to the "sale" or use for a "commercial purpose"[91] 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.[92]

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.[93]

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.[94]

   (h) 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.[95]

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[88] *Id.* § 1798.145(h).

[89] *See*, e.g., *Id.* §§ 1798.140(o)(2); 1798.145(a)(5).

[90] *Id.* § 1798.100(b), 1798.140(t)(2)(C)(i).

[91] "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).

[92] *Id.* § 1798.140(t)(2)(C); 1798.140(v).

[93] *Id.* § 1798.140(t)(2).

[94] *Id.* § 1798.140(d).

[95] *Id.* § 1798.140(v).

5. CCPA and GDPR Compliance

   (a) GDPR compliance does not ensure CCPA compliance because there are significant differences in requirements, definitions and scope.[96]

   (b) 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.

VII. Insider Trading Law Passed in Congress

A. On Dec. 5, 2019, the U.S. House of Representatives passed the Insider Trading Prohibition Act, which seeks to amend the Securities Exchange Act of 1934 to provide an explicit definition or insider trading.[97]

B. The bill would prohibit the purchase or sale of securities by someone while aware of material nonpublic information regarding such securities "if such person knows, or recklessly disregards, that such information has been obtained wrongfully, or that such purchase or sale would constitute a wrongful use of such information."[98]

C. Knowledge Requirement and Newman

   1. The bill states that a person need not "know[] the specific means by which the [material nonpublic] information was obtained or communicated, or whether any personal benefit was paid or promised by or to any person in the chain of communication, so long as the person trading while in the possession of such information or making the communication, as the case may be was aware, consciously avoided being aware, or recklessly disregarded that that such information was wrongfully obtained or communicated."[99]

   2. The language in the bill would legislatively overturn the decision of the Court of Appeals for the Second Circuit in *Newman*,[100] that a tippee (a recipient of inside information) must have actual knowledge that the tipper (the provider of inside information) received a specific personal benefit from passing along the material nonpublic information, to prove that a tippee is liable for insider trading.

D. The House of Representatives passed the bill in a near-unanimous vote, 410-13.[101] The bill currently sits with the Senate Committee on Banking, Housing and Urban Affairs.

VIII. United Kingdom and European Union Updates

A. AIFMD — Cross-Border Distribution Directive

   1. The Cross-Border Distribution Directive (Directive (EU) 2019/1160)[102] amends the EU Alternative Investment Fund Managers Directive ("AIFMD") by introducing the concept of "pre-marketing."

      (a) The new rules are due to take effect from Aug. 2, 2021.

      (b) Pre-marketing is defined as: "provision of information or communications, direct or indirect, on investment strategies or investment ideas in order to test their interest in a fund which is not yet established, or established but not yet notified for marketing."

[96] 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.

[97] Insider Trading Prohibition Act of 2019, H.R. 2534, 116th Cong. § 16A (2019).

[98] *Id.* § 16A(a).

[99] *Id.* § 16A(c)(2).

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

[101] 165 Cong. Rec. H9278 (daily ed. Dec. 5, 2019) (vote total).

[102] Directive (EU) 2019/1160 of the European Parliament (June 20, 2019), available here.

2. Under the new rules, pre-marketing of an alternative investment fund ("AIF") will be permissible without first notifying the regulator, subject to the following requirements being met:
   (a) The information cannot be sufficient to commit an investor to an investment;
   (b) The information cannot include subscription forms in draft or final form, or constitutional documents, prospectus, or offering documents in final form;
   (c) Any subscription within 18 months of pre-marketing is considered the result of marketing and requires a marketing notification to the supervisory authority.
3. As drafted, the new pre-marketing provisions only apply to EU-domiciled AIFs (e.g. Irish or Luxembourg funds).
   (a) However, Recital (12) of the Cross-Border Distribution Directive confirms that the legislative intent was not to disadvantage EU funds vis-à-vis non-EU funds.
   (b) It is also widely expected that a similar provision will be applied to non-EU funds and their managers in the proposal to revise AIFMD (known as "AIFMD II") which is expected to be published in the first half of 2020.
4. In the meanwhile, it is expected that the new concept of pre-marketing will inform the supervisory approaches of EU regulators to marketing and reverse solicitation offers made by non-EU managers with non-EU funds.

B. Switzerland — Marketing of Funds

1. Federal Act on Financial Services ("FINSA") and its implementing ordinance enter into force on 1 Jan. 2020, subject to a transitional period of 24 months for some of the new requirements.[103]
2. Among other things, FINSA modifies the current distribution rules under the Swiss Collective Investment Schemes Act ("CISA"), so that the requirements to appoint a Swiss representative and paying agent are largely lifted, except in the case of marketing to high net worth individuals (e.g. private clients who meet the specific net asset and knowledge/experience requirements and who request to be treated as professional clients).
3. The new rules will also introduce obligations for fund managers/distributors to implement a code of conduct, certain organizational requirements and maintain an affiliation with a Swiss financial ombudsman scheme subject to a two-year transitional period.
4. During the transitional period or until the manager can demonstrate that they comply with FINSA obligations, non-Swiss fund managers and distributors may be required to maintain the distribution agreements they have entered into with the Swiss representative.

C. Self-Reporting to the FCA

1. The FCA Principle for Business 11 requires an FCA-regulated firm to deal with its regulators in an open and cooperative way, and disclose to the FCA appropriately anything relating to the firm of which the FCA would reasonably expect notice.[104]
2. The FCA generally considers that matters such as material regulatory breaches, or notices of investigations or enforcement by an overseas regulator have a serious regulatory impact, and must, accordingly, be notified to the FCA as soon as possible.

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[103] Federal Act on Financial Services, Federal Assembly of the Swiss Confederation, available here.

[104] PRIN 2.1 The Principles, Financial Conduct Authority (March 1, 2018), available here.

3. In addition, a self-reporting regime applies under the EU Market Abuse Regulation with regards to any suspicions of insider trading or market manipulation (this is known as Suspicious Transactions and Orders reporting, or STOR).[105]

D. UK Senior Managers and Certification Regime

1. The Senior Managers and Certification Regime ("SMCR") replaced the Approved Persons Regime for FCA-regulated firms on Dec. 9, 2019.[106]

2. The new regime applies to almost all UK firms authorized by the FCA, as well as branches of non-UK firms with permission to carry out regulated activities in the UK.

3. The regime aims to reduce harm to consumers and strengthen market integrity. It sets a new standard of personal conduct for everyone working in financial services. The key elements of the regime are:

   (a) *The Conduct Rules*. The Conduct Rules set minimum standards of individual behavior in financial services firms and apply to employees who carry out financial services activities, or linked activities. Some Conduct Rules apply to all employees, while others only apply to Senior Managers.

   (b) *The Senior Managers Regime*. The most senior individuals within the firm ("Senior Managers") who perform key roles ("Senior Management Functions") require the FCA approval before starting their roles (subject to grandfathering arrangements for existing Senior Managers). Every Senior Manager will need to have a "Statement of Responsibilities" which clearly sets out their responsibilities and accountabilities.

   (c) Statutory Duty of Responsibility for Senior Managers which requires Senior Managers to take reasonable steps to prevent regulatory breaches.

   (d) The Certification Regime applies to employees whose role means it is possible for them to cause significant harm to the firm, its customers, or the market more generally. These roles are called "Certification Functions". Unlike under the Approved Persons regime, the FCA will no longer approve individuals in Certification Functions; instead, the firms will need to check and certify that they are fit and proper to perform their role at least once a year.

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[105] Market Abuse Regulation (EU) 596/2014 of The European Parliament (April 16, 2014), available here.

[106] Senior Managers and Certification Regime, Financial Conduct Authority (Sept. 12, 2019), available here.

Terms and Trends

I. U.S. Trends

A. Performance and Investor Outlook

1. Performance is good.

(a) Hedge Funds

(i) Hedge funds on average were up 12.19% through Dec. 31, 2019.[1]

(ii) Best performing hedge funds, through Dec. 31, 2019, were macro (23.36%) and long equity (21.85%) strategies; worst performing were market neutral (4.23%) and relative value (5.30%) strategies.[2]

(b) Private Equity

(i) Meanwhile, *Preqin* reports that private equity returns (IRR) globally continue to be strong over one-year (16.3%), three-year (17%), five-year (14.4%) and 10-year (15.6%) time horizons to June 2019.

(ii) *Preqin* also reports that buyout funds have outperformed all other private equity strategies, with IRRs of 18.9%, 18.3%, 15.7% and 16.9%, respectively, over the same time horizons.[3]

2. Current fundraising environment is challenging for some.

(a) Hedge Funds

(i) $3.25 trillion assets under management by hedge fund managers at end of June 2019, up from $3.1 trillion at the end of 2018.[4]

(ii) *Eurekahedge* reports that net flow since 2013 has been in — not out — for a total of $98.4 billion new assets invested in hedge funds.

(iii) *Eurekahedge* reports that the largest funds have been the drivers of growth. Funds with $1 billion in assets under management or more have accounted for more than half of the gains of the industry, and nearly half of the net asset inflow.

(b) Private Equity

(i) *Preqin* reports that:

(1) 1,319 private equity funds were raised in 2019, compared to 1,794 in 2018; and

(2) $595 billion aggregate capital raised by private equity funds in 2019, down from $628 billion raised in 2018.[5]

(ii) Mega-funds are raising capital (*Private Equity International* reports that in Q4 2019, nine funds were seeking $10bn or more from investors, with U.S., European and Asian funds all featuring).[6]

3. Investor Outlook

(a) Hedge Funds

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[1] *See https://pro.preqin.com/analysis/hedgeFundPerformance/marketBenchmarks/benchmarkReturns/1.*
[2] *See https://pro.preqin.com/analysis/hedgeFundPerformance/marketBenchmarks/benchmarkReturns/1.*
[3] *See https://pro.preqin.com/analysis/horizonIRRs.*
[4] *The Wall Street Journal,* Oct. 6, 2019.
[5] *See https://pro.preqin.com/analysis/historicalFundraising.*
[6] *See http://docs.preqin.com/reports/Preqin-Private-Capital-Fundraising-Update-Q4-2018.pdf.*

(i) Bifurcation of fundraising market

(1) Well-known and large managers can go without a seed investor, and rely on two or more early anchor investors.

(2) Other managers use a seed deal or try to grow organically, which requires patience and fee discipline.

a. Managed accounts grow capital, but the cost here is liquidity.

b. Build in MFN and common side letter terms to fund documents.

c. Offering a founders' class of interests, which often includes capacity rights.

(b) Private Equity

(i) *Preqin* reports that large proportions of investors expect to commit more capital in 2020 than they did in 2019.[7]

(ii) Rise of the "one and done" closing, offering investors a volume discount based on size.

(iii) Rise of dry closings, with no management fee payable until fund begins sourcing investments, i.e., once the prior fund reaches the end of its investment period.

B. Private Fund Strategies

1. Popular Hedge Fund Strategies (based on the number of funds launched)[8]

(a) Equity

(b) Event-Driven Strategies

(c) Credit

(d) Relative Value

(e) Managed Futures/CTA

2. Popular Private Equity Fund Strategies (based on number of funds launched)

(a) Venture

(b) Real Estate

(c) Growth

(d) Buyout

C. Fund Structuring and Conflicts

1. Due to cost cutting, more managers want complex funds built out in advance rather than multiple AIVs (e.g., dual master fund structures).

2. Conflicts inherent to fund structure (e.g., warehousing, structuring and servicing of loans) built in from day one. Advisory board use is becoming common from day one.

3. More REIT subsidiaries than we have seen in the past. Conflicts exist on exit and no pro rata sales could happen.

4. Co-investments — almost every large private equity deal is underwritten by manager and syndicated to limited partners or co-investments.

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[7] *See http://docs.preqin.com/reports/Preqin-Private-Capital-Fundraising-Update-Q4-2018.pdf.*

[8] Preqin Quarterly Update: Hedge Funds Q3 2019, p. 7.

5. SEC fiduciary duty interpretation is driving more robust conflicts disclosure.

6. Multi-strategy private equity fund managers establishing allocation committees and written allocation policies to address potential conflicts of interest in allocating investments between funds.

D. Other Trends

1. Hedge Fund Trends

(a) Increasing interest in long-only funds due to market success.

(b) Some experimentation with hurdle rates, either against a fixed rate or against an index.

(c) Stabilization of the management fee rate around 1.5%.

(d) Stabilization of the incentive around 17.5%.

(e) Making accommodations for consulting firms and bank platforms (e.g., liquidity and/or fee breaks on a consultant-wide basis), with proper disclosure.

(f) Venture investing by hedge funds increasing as search for alpha widens.

(g) Increasing use of Insurance Dedicated Funds ("IDFs").

2. Private Equity Trends

(a) The two-track fundraising market continues to develop, with LPs looking to place ever more capital with GPs they know and trust. These GPs in turn are establishing new strategies in order to soak up this latent demand (e.g., buyout GPs moving into credit, infrastructure, etc.).

(b) The private equity market is maturing, with secondary fund investments and co-investments becoming standard parts of LPs' portfolios and large increases in the numbers of GP-led secondaries and funds established solely to invest in GPs.

(c) Top European GPs are seeking to compete for talent with their U.S. peers by moving to deal-by-deal or hybrid waterfalls.

(d) ESG is becoming an essential area for GPs, as LPs increasingly focus their due diligence on the double bottom line.

(e) Succession planning is becoming an issue as founders reach retirement age.

(f) Expense granularity.

(g) Allocation of broken deal expenses.

II. U.K. and EU Trends

A. Hedge Fund Trends

1. London remains the core hedge fund center in Europe, both for European-based firms and for European offices of non-European firms. Some firms have looked to establish a presence in Ireland, Luxembourg or Malta as well.

2. The downward pressure on management fees is causing a number of managers problems given the high capital costs of running a European-based fund manager and the need to maintain regulatory capital.

3. The vast majority of funds established by London-based managers continues to be Cayman funds. However, there is a small trend towards Irish and Luxembourg funds, especially where the cornerstone investor is European or European investors are the primary target. In some cases, Irish or Luxembourg funds are part of a master-feeder structure including Cayman funds and, in other cases, they run in parallel to a Cayman flagship fund.

B. Private Equity Fund Trends

1. Brexit has led to the effective end of the English limited partnership (“ELP”) as a private equity fund vehicle for GPs investing outside of the UK. Managers who would formerly have used ELPs are moving back and middle-office operations to either Luxembourg or the Channel Islands.
2. Tightening of substance rules in Luxembourg and offshore jurisdictions means that Luxembourg and offshore funds must now have “real” operations in the host country.

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