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# Regulatory Developments and Annual Compliance Obligations Applicable to Private Fund Sponsors

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Over the course of the last year, there have been a number of regulatory developments affecting private funds and their investment advisers that private equity sponsors should be aware of. We would also like to remind our private equity clients of important upcoming regulatory filings and compliance obligations in 2020.[1]

## CURRENT AREAS OF SEC FOCUS AND OTHER REGULATORY DEVELOPMENTS

### OCIE Announces 2020 Examination Priorities

On January 7, 2020, the Securities and Exchange Commission's (SEC) Office of Compliance Inspections and Examinations (OCIE) issued its examination priorities for 2020[2] principally focused around seven themes:

1. Matters of importance to retail investors, including issues related to intermediaries that serve and interact with retail investors and disclosures relating to fees, expenses and conflicts of interest.

2. Market infrastructure, including entities that provide services critical to the functioning of capital markets, such as clearing agencies, national securities exchanges, alternative trading systems and transfer agents.

3. Cybersecurity (with an emphasis on the protection of clients' personal financial information). Areas of focus will include: (i) governance and risk management; (ii) access controls; (iii) data loss prevention; (iv) vendor management; (v) training; and (vi) incident response and resiliency.

4. Risk-based examinations for registered entities. In particular, examinations of registered investment advisers will focus on advisers that have never been examined, including new registrants.

5. Anti-money laundering programs for those registrants subject to AML requirements.

6. Financial technology (Fintech) and innovation, including digital assets/cryptocurrencies and electronic investment advice (*e.g.*, "robo-advisers").

7. Oversight of the Financial Industry Regulatory Authority and the Municipal Securities Rulemaking Board in connection with those bodies' examination and regulation of broker-dealers and municipal advisors.

While private fund sponsors were not a named target of the 2020 priorities, OCIE noted that it will continue to focus on advisers to private funds that have a greater impact on retail investors, such as firms that provide management to registered investment companies or separately managed accounts side-by-side with private funds. Moreover, OCIE will review advisers 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 affiliates to provide services to clients. OCIE also noted that it has a particular interest in the accuracy and adequacy of disclosures provided by advisers offering clients new types or emerging investment strategies, such as strategies focused on sustainable and responsible investing, which incorporate environmental, social, and governance (ESG) criteria.

**Proposed Amendment of "Accredited Investor" Definition**

In December 2019, the SEC proposed amendments to the definition of "accredited investor" in Regulation D under the Securities Act of 1933 (Regulation D) to add new categories of qualifying natural persons and entities and to make certain other modifications to the existing definition.[3] The SEC stated that the proposed amendments are intended to update and improve the definition in order to identify more effectively institutional and individual investors that have the knowledge and expertise to participate in private securities offerings. If adopted, the amendments would broaden the number of potential investors eligible to participate in a Regulation D offering by a private fund[4] or other issuer.

*Knowledgeable Employees of Private Funds* – The proposal would allow "knowledgeable employees" of a private fund to qualify as accredited investors for purposes of investing in that fund.[5] The SEC stated that such employees, through their knowledge of and active participation in the investment activities of the private fund, are likely to be financially sophisticated and capable of fending for themselves in evaluating investments in such private funds.

*Professional Certifications and Designations and Other Credentials* – The SEC proposed to add a category for natural persons to qualify as accredited investors based on certain professional certifications and designations or other credentials that the SEC by order finds demonstrate an individual's background and understanding in the areas of securities and investing even if such persons do not meet the current financial thresholds in the accredited investor definition.[6] The SEC stated that it preliminarily expects that individuals holding the following certifications or designations would be deemed accredited investors: (i) licensed general securities representative (Series 7); (ii) licensed investment adviser representative (Series 65); and (iii) licensed private securities offerings representative (Series 82). The SEC would consider other categories of certifications or designations as eligible for accredited investor status based on public comment and market developments.

*Adding Categories of Entities that Qualify as Accredited Investors* – The current accredited investor definition includes specific categories of entities, and any entity not covered by one of the enumerated categories is not an accredited investor under the rule. The SEC noted that this has resulted in uncertainty for legal entities of a type similar, but not identical, to those listed entities. Therefore, the following categories of entities are among those proposed to be added to the definition: (i) registered investment advisers; (ii) limited liability companies with total assets in excess of $5 million that were not formed for the specific purpose of acquiring the securities being offered; (iii) any entity owning investments in excess of $5 million that is not formed for the specific purpose of acquiring the securities being offered; and (iv) "family offices" with at least $5 million in assets under management and its "family clients," each as defined in Rule 202(a)(11)(G)-1 under the Investment Advisers Act of 1940 (Advisers Act).

*Permit Spousal Equivalents to Pool Finances for the Purposes of Qualifying as Accredited Investors* – To provide certainty, the proposal would allow natural persons to include joint income and assets from spousal equivalents when calculating joint income and net worth under the Individual Financial Tests. The proposed amendments would define spousal equivalent as a cohabitant occupying a relationship generally equivalent to that of a spouse.

*Request for Additional Comment on Modifying Income and Net Worth Tests* – The SEC did not propose revising the income and net worth thresholds in the Individual Financial Tests. However, it requested further comment on possible approaches to adjusting these thresholds.

**Proposed Amendments to Advisers Act Advertisement Rule**

In November 2019 the SEC proposed to significantly amend Rule 206(4)-1 under the Advisers Act (the so-called "advertising rule").[7] The proposal would replace the current rule's broadly drawn limitations with principles-based provisions and contains general prohibitions of certain advertising practices, as well as more tailored restrictions and requirements that are reasonably designed to prevent fraud with respect to certain specific types of advertisements. The proposal would allow the use of testimonials and endorsements, and permits the presentation of performance with tailored requirements based on an advertisement's intended audience. The following is a summary of the more material provisions of the proposed amendments.

*Definition of "Advertisement"* – The proposed rule would define "advertisement" as "any communication, disseminated by any means, by or on behalf of an investment adviser, that offers or promotes the investment adviser's investment 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." The proposed definition generally would not include: (i) live oral communications that are not broadcast on radio, television, the internet, or any other similar medium; (ii) a communication by an investment adviser that does no more than respond to an unsolicited request for specified information about the investment adviser or its services, other than (A) any communication to a Retail Person[8] that includes performance results or (B) any communication that includes hypothetical performance; or (iii) any information required to be contained in a statutory or regulatory notice, filing, or other communication.

*General Prohibitions* – The proposal contains general prohibitions of certain advertising practices as a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts. These provisions would replace elements of the current rule, such as the prohibition on testimonials and profitable past recommendations. To establish a violation of the proposed rule, the SEC would not need to demonstrate that an investment adviser acted with scienter; negligence is sufficient. The prohibitions include:

1. Advertisements that include any untrue statements of a material fact, or that omit a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading.

2. Advertisements that include any material claim or statement that is unsubstantiated. The SEC stated that this provision would prohibit as misleading, for example, statements about guaranteed returns and claims about the adviser's skills or experience that the adviser cannot substantiate.

3. Advertisements that include an untrue or misleading implication about, or are reasonably likely to cause an untrue or misleading inference to be drawn concerning, a material fact relating to an investment adviser.[9]

4. Advertisements that discuss or imply any potential benefits connected with or resulting from the investment adviser's services or methods of operation without clearly and prominently discussing associated material risks or other limitations associated with the potential benefits.

5. Advertisements that include a reference to specific investment advice where such investment advice is not presented in a manner that is fair and balanced. This provision replaces the existing rule's prohibition on advertising past recommendations (*i.e.*, cherry-picking) with a principles-based approach that requires the presentation to be fair and balanced based on all surrounding facts and circumstances.

6. Any advertisement that is otherwise materially misleading.

*Testimonials, Endorsements, and Third Party Ratings* - The proposed rule specifically addresses the use of testimonials, endorsements, and third-party ratings in advertisements. The proposed rule would define "testimonial," "endorsement," and "third-party rating," and would permit advisers to use them in advertisements, subject to the rule's general prohibitions of certain practices and additional conditions.

*Presentation of Performance Results* – The proposed rule would prohibit any investment adviser from including or excluding performance results, or presenting time periods for performance, in a manner that is not fair and balanced. **Of special note to private fund sponsors is that while the proposal requires advisers to include net performance results with equal prominence in any Retail Advertisements that include gross performance[10] results, no similar requirement exists for Non-Retail Advertisements. Therefore, an advertisement sent only to Non-Retail Persons would not have to include net performance or comply with other performance-related requirements of the rule applicable to Retail Advertisements.** The SEC stated that it believes Non-Retail Persons do not need net performance because they have access to analytical and other resources, and therefore the capacity to evaluate gross performance as advertised. An adviser would be required to adopt and implement policies and procedures reasonably designed to ensure that the Non-Retail Advertisement is disseminated solely to Non-Retail Persons.[11]

The proposed rule would condition the presentation in any advertisement of "related performance" on the inclusion of all related portfolios. However, the proposed rule would generally allow related performance to exclude related portfolios as long as the advertised performance results are no higher than if all related portfolios had been included. "Related performance" is defined as "the performance results of one or more related portfolios, either on a portfolio-by-portfolio basis or as one or more composite aggregations of all portfolios falling within stated criteria." "Related portfolio" in turn is defined as "a portfolio, managed by the investment adviser, with substantially similar investment policies, objectives, and strategies as those of the services being offered or promoted in the advertisement."

The proposed rule would allow an adviser to provide hypothetical performance (*e.g.*, targets or projections) in an advertisement, provided that the adviser takes certain steps to address the misleading nature of hypothetical performance if its underlying assumptions are not subjected to further analysis. First, the adviser must adopt and implement policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the financial situation and investment objectives of the person to whom the advertisement is disseminated (the Recipient). Second, the adviser must provide sufficient information to enable the Recipient to understand the criteria used and assumptions made in calculating such hypothetical performance. Third, the adviser must provide (or, when the recipient is a Non-Retail Person, offer to provide promptly) sufficient information to enable the Recipient to understand the risks and limitations of using hypothetical performance in making investment decisions.

*Portability of Performance, Testimonials, Third Party Ratings, and Specific Investment Advice* – Advisers often seek to advertise investment performance for which the adviser, its personnel, or its predecessor firm have provided advice in the past as or at a different entity. The SEC acknowledged that these predecessor performance results may be relevant when an advertisement offers services to be provided by the personnel responsible for the predecessor performance, even when the personnel did not work during the period for which performance is being advertised for the adviser disseminating the advertisement. However, the SEC also noted that predecessor performance results achieved by another investment adviser, or by personnel of another investment adviser, run the risk of being presented in a false or misleading manner. While some circumstances under which predecessor performance results are misleading may be addressed through specific provisions included in the proposed rule (*e.g.,* predecessor performance results may be misleading where they exclude any accounts that were managed in a substantially similar manner, or where they include any accounts that were not managed in a substantially similar manner, at the predecessor firm), the SEC requested comment on whether it would be appropriate to include in the proposed rule additional provisions to address specifically the presentation of predecessor performance results.

The proposed rule would permit the use of testimonials and references to specific investment advice given by an investment adviser, unlike the blanket ban on their use under the current rule. However, advisers would have to use the general anti-fraud considerations required by the proposed rule to determine whether testimonials and endorsements referring to a predecessor entity, past third-party ratings, or specific investment advice given at a previous firm could be used by an adviser in advertisements.

*Review and Approval of Advertisements* – The proposed rule would require an adviser to have an advertisement reviewed and approved for consistency with the requirements of the proposed rule by a designated employee before, directly or indirectly, disseminating the advertisement, except for advertisements that are: (i) communications that are disseminated only to a single person or household or to a single investor in a pooled investment vehicle; or (ii) live oral communications that are broadcast on radio, television, the internet, or any other similar medium.

*Proposed Amendments to Form ADV* – In connection with the proposed amendments to the advertising rule, the SEC also proposed amendments to Item 5 of Part 1A of Form ADV to improve information available to the SEC and the public about advisers' advertising practices. Specifically, an adviser would be required to state whether any of its advertisements contain (i) performance results, and if so, whether all of the performance results were verified or reviewed by a person who is not a related person, (ii) testimonials or endorsements, or includes a third-party rating, and if so, whether the adviser pays or otherwise provides compensation or anything of value, directly or indirectly, in connection with their use and (iii) a reference to specific investment advice provided by the adviser.

**Cayman Islands Private Funds Bill, 2020**

The Cayman Islands recently published a draft Private Funds Bill, 2020, which provides for the registration of closed-ended funds formed in the Cayman Islands with the Cayman Islands Monetary Authority. While the new law contains limited exceptions, most closed-ended pooled investment vehicles will be required to register. Registration will entail the filing (and annual update) of a registration form and payment of an initial and annual fee. In addition, managers to registered funds will have to comply with certain ongoing substantive requirements regarding, *e.g.*, the preparation of fund audits, valuation of investments and custody of fund assets. While it is expected that the compliance burden for most SEC-registered investment advisers will be relatively light, managers should contact their Cayman Islands counsel to discuss the applicability and implications of this legislation. The legislation is expected to go into effect by the end of January 2020.

**California Consumer Privacy Act**

The California Consumer Privacy Act (CCPA) took effect on January 1, 2020. The CCPA will generally impact firms (including private fund sponsors and portfolio companies) (i) doing business in California regardless of their physical location, (ii) that have gross annual revenue in excess of $25 million and (iii) that collect "personal information" (which includes any information that identifies, relates to, describes, is capable of being associated with, or could reasonably be linked, directly or indirectly, with a particular consumer or household) from natural persons who are California residents (Consumers). While there is very little guidance regarding what constitutes "doing business," it is likely that California will take a broad approach and therefore, *e.g.*, soliciting individual California investors or entering into contracts with California entities will suffice to trigger the CCPA. The CCPA requires disclosures to Consumers regarding the collection and use of their personal information and gives Consumers the right to request that such information be deleted.

The CCPA grants Consumers a private right of action in certain instances of data breach involving unauthorized access to a Consumer's personal information. Statutory damages for such incidents are the greater of either actual damages or between $100 and $750 per Consumer per incident. The CCPA also gives the California Attorney General the discretion to seek injunctive relief or civil penalties for alleged violations of the CCPA that are not cured within 30 days following notification of such alleged violations. Civil penalties are limited to $2,500 per violation or up to $7,500 per violation if such violation is intentional.

The CCPA contains an exemption that excludes businesses that are expressly subject to other privacy-related laws, including the Gramm-Leach-Bliley Act (GLBA), to which registered investment advisers (but not exempt reporting advisers) are subject. However, because the CCPA is broader than the GLBA in some ways, it is possible that a firm that complies with the GLBA would still have obligations under the CCPA.

In addition to the CCPA, Nevada's privacy law became effective on October 1, 2019. It covers any business that collects or uses the personal information of Nevada residents who engage in a commercial manner with that business online. Covered businesses must maintain web privacy policies that are transparent about their uses of personal information, and allow Nevada consumers to opt out of the sale of their personal information.

**SEC Adopts Rules and Interpretations Regarding Duties of Investment Advisers and Broker-Dealers**

In June 2019, the SEC adopted several new rules and interpretations designed to protect retail investors in their relationships with registered investment advisers and broker-dealers. While private fund managers are not the primary focus of the rules, they should be aware of these developments.

*SEC Interpretation Regarding Standard of Conduct for Investment Advisers*

Most relevant for private fund managers is the SEC's guidance regarding the fiduciary duty investment advisers owe to their clients.[12] The U.S. Supreme Court has found that the Advisers Act imposes a fiduciary obligation on an investment adviser, and therefore the adviser must always act in the best interest of its clients.[13] As a fiduciary, an adviser owes its clients a duty of care and a duty of loyalty, which duties are enforceable pursuant to the anti-fraud provisions of the Advisers Act, primarily Section 206 and the rules thereunder.

In its interpretation, the SEC stated that the duty of care includes, among other things, the duty to: (i) provide advice that is in the best interest of the client, (ii) seek best execution of a client's transactions and (iii) provide advice and monitoring over the course of the relationship. The SEC also provided guidance regarding an investment adviser's obligations in connection with its duty of care, including, among other things, the duty to: (i) make a reasonable inquiry into a client's financial situation, level of financial sophistication, investment experience and investment objectives (collectively, a client's investment profile), (ii) provide personalized advice that is suitable for and in the best interest of the client based on the client's investment profile, (iii) update a client's investment profile in order to adjust its advice to reflect any changed circumstances and (iv) take into account the costs of an investment strategy, including the cost of fees or compensation, when considering whether such investment strategy is in the best interest of the client.

The SEC stated that the duty of loyalty requires an investment adviser to: (i) put its client's interests first, (ii) not favor its own interests over those of a client or unfairly favor one client over another, (iii) make full and fair disclosure to its clients of all material facts relating to the advisory relationship and (iv) seek to avoid conflicts of interest with its clients and make full and fair disclosure of all conflicts of interest that could affect the advisory relationship. The guidance emphasized that with respect to conflicts of interest, disclosure must be sufficiently specific and clear so that a client has sufficient facts to provide informed consent to a conflicted transaction or arrangement.[14]

Importantly, the SEC acknowledged that the duty owed to a client *"… must be viewed in the context of the agreed-upon scope of the relationship between the adviser and the client…. For example, the obligations of an adviser providing comprehensive, discretionary advice in an ongoing relationship with a retail client… will be significantly different from the obligations of an adviser to a registered investment company or private fund where the contract defines the scope of the adviser's services and limitations on its authority with substantial specificity...."* However, the fiduciary obligation always applies, and may not be waived or modified by contract.

*Form CRS Relationship Summary and Related Disclosure Requirements*

In an attempt to reduce what the SEC sees as confusion among retail investors regarding the nature of their relationships with registered investment advisers[15] and broker-dealers, the SEC adopted a new disclosure document for those firms (Form CRS Relationship Summary).[16] This short (two pages maximum for advisers and broker-dealers and four pages for dual registrants) summary will inform retail investors about the relationships and services the investment adviser or broker-dealer offers, the standard of conduct and the fees and costs associated with those services, specified conflicts of interest, and whether the firm and its financial professionals currently have reportable legal or disciplinary events. Retail investors will receive a summary at the beginning of a relationship with a firm, and updated information following a material change. The relationship summary will be in addition to the existing obligation of a registered adviser to deliver a Form ADV Part 2A brochure and will be subject to SEC filing and recordkeeping requirements. Advisers will have to file their initial relationship summary with the SEC between May 1, 2020 and June 30, 2020.

Of note to private fund sponsors, the relationship summary must only be delivered to a "retail investor," which 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. While this definition does not include an exemption based on net worth or investor sophistication, it does not seem to cover investors in private funds. Therefore, it appears that a private fund sponsor will not be required to comply with the Form CRS requirement with respect to natural person limited partners in its funds.

*Regulation Best Interest*

After many years of study and internal debate, the SEC adopted Regulation Best Interest, which establishes a standard of conduct for broker-dealers when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer.[17] Under new Rule 15l-1 under the Securities Exchange Act of 1934, a broker-dealer must act in the best interest of the retail customer at the time a recommendation is made without placing the financial or other interest of the broker-dealer ahead of the interest of the retail customer. The SEC stated that this obligation would be satisfied if the broker-dealer, among other things: (i) before or at the time of such recommendation, reasonably discloses to the retail customer, in writing, the material facts relating to the scope and terms of the relationship, and all material conflicts of interest associated with the recommendation, (ii) exercises reasonable diligence, care and skill, (iii) establishes, maintains, and enforces written policies and procedures reasonably designed to identify and at a minimum disclose, or eliminate, all conflicts of interest that are associated with such recommendation and (iv) establishes, maintains, and enforces written policies and procedures reasonably designed to comply with Regulation Best Interest as a whole. Broker-dealers must comply with Regulation Best Interest by June 30, 2020.

Regulation Best Interest will apply to all relevant transactions between a broker-dealer and a "retail customer." A retail customer is defined as a natural person, or the legal representative of such natural person, who (i) receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer, or a natural person who is an associated person of a broker or dealer and (ii) uses the recommendation primarily for personal, family, or household purposes. Based on this definition, the sale of private fund interests by placement agents and other registered broker-dealers to institutional investors (such as corporations and pension plans) generally would not be covered by Regulation Best Interest. However, sales to high net worth individuals and their estate planning and related vehicles generally would be covered.

**SEC Charges Accounting Firm to Private Funds with Violating Auditor Independence Rules**

In August 2019, the SEC charged a large public accounting firm (Accounting Firm) with violations of its auditor independence rules (Independence Rules) in connection with more than 100 audit reports involving at least 15 audit clients, including several private funds.[18] According to the SEC's order, the Accounting Firm represented that it was "independent" in audit reports issued on the clients' financial statements. However, the SEC found that the Accounting Firm or its affiliates provided prohibited non-audit services to affiliates of those audit clients (including to portfolio companies of the private funds), which violated the Independence Rules. The prohibited non-audit services included corporate secretarial services, payment facilitation, payroll outsourcing, loaned staff, financial information system design or implementation, bookkeeping, internal audit outsourcing, and investment adviser services. The SEC also found that certain of the Accounting Firm's independence controls were inadequate, resulting in its failure to identify and avoid these prohibited non-audit services.

Among the Accounting Firm's clients impacted by its breach of the Independence Rules were several private funds, which engaged the Accounting Firm to audit their financial statements in order to satisfy the requirements of Rule 206(4)-2 (Custody Rule)[19] under the Advisers Act. However, consulting personnel of the Accounting Firm or its affiliates were also separately engaged to provide prohibited non-audit services to several portfolio companies of the funds in violation of the Independence Rules. The SEC found that the Accounting Firm failed to implement sufficient procedures to detect and prevent these types of violations of the Independence Rules, and that Accounting Firm personnel failed to correctly follow the procedures that were in place.[20] As a result, the Accounting Firm not only violated the Independence Rules (and other federal securities laws), but also caused multiple registered investment advisers to violate Section 206(4) of the Advisers Act and the Custody Rule.

As part of its settlement with the SEC, the Accounting Firm (i) agreed to pay a $950,000 penalty, (ii) was censured and (iii) agreed to engage an independent consultant to evaluate its current quality controls for complying with the Independence Rules.

In light of this settlement, private fund sponsors (especially those who rely on the audit provision of the Custody Rule) may want to speak with their funds' auditors to seek to ensure that such firms have procedures in place to ensure compliance with the Independence Rules.[21]

## COMPLIANCE OBLIGATIONS FOR PRIVATE EQUITY FUND ADVISERS[22]

FORM ADV
***(Annual** Amendment **due by March 30, 2020)***

Investment advisers that are registered with the SEC under the Advisers Act, and advisers filing as exempt reporting advisers with the SEC, must file an annual amendment to Form ADV within 90 days of the end of their fiscal year (*i.e.*, by March 30, 2020 for advisers with a fiscal year-end of December 31).[23]

Registered investment advisers must file an updated Part 1 and Part 2A brochure of such adviser's Form ADV, while exempt reporting advisers must file an updated Part 1. Registered investment advisers are also required to update, but are not required to file with the SEC, Part 2B brochure supplements of their Form ADV. In addition, registered investment advisers are required to provide a copy of the updated Form ADV Part 2A brochure (or a summary of changes with an offer to provide the complete brochure) and, in certain cases, an updated Part 2B brochure supplement to each client.

### FORM PF
***(Annual Filing due by April 29, 2020)***

Registered investment advisers to private equity funds with more than $150 million of assets under management attributable to those funds (as of the last day of their most recent fiscal year) are required to file Form PF with the SEC within 120 days after such adviser's fiscal year-end (*i.e.*, by April 29, 2020 for advisers with a fiscal year-end of December 31).[24] Form PF requires disclosure of the adviser's assets under management and information on each private fund it advises.

### CFTC FILINGS
***(Annual Affirmation of De Minimis and Commodity Trading Advisor Exemptions due by February 28, 2020)***

Many private equity fund sponsors are able to rely on the exemption from registration with the National Futures Association (NFA) that is available under Commodity Futures Trading Commission (CFTC) Rule 4.13(a)(3) (the *de minimis* exemption) and have claimed such exemption.[25] The *de minimis* exemption is subject to an annual affirmation which must be completed within 60 days after the end of each calendar year. Failure to affirm the exemption is deemed a withdrawal of the exemption once the 60 day period has elapsed. Private fund sponsors that do not qualify for the *de minimis* exemption may be subject to registration with the NFA as commodity pool operators and commodity trading advisors.

In addition, many fund managers rely on the "solely incidental" exemption from registering as a commodity trading advisor pursuant to CFTC Rule 4.14(a)(8). An annual affirmation of this exemption is also required to be filed within 60 days after the end of each calendar year.

### FORM BE-10 BENCHMARK SURVEY OF U.S. DIRECT INVESTMENT ABROAD
***(BE-10 Reports are due May 29, 2020 for a U.S. Reporter with fewer than 50 qualifying investments and June 30, 2020 for a U.S. Reporter with 50 or more qualifying investments)***

The Bureau of Economic Analysis (BEA) requires all U.S. persons (including private funds) that own, directly or indirectly, 10% or more of the voting securities of an incorporated foreign business enterprise or an equivalent interest in an unincorporated foreign business enterprise to submit various reports regarding those holdings. The BE-10 survey is the BEA's most comprehensive survey and is conducted every five years. A response is required from entities subject to the reporting requirements whether or not they are contacted by the BEA. Therefore, generally all private funds domiciled in the U.S. with stakes of 10% or more in one or more non-U.S. portfolio companies must file. The BE-10 should be submitted on a consolidated basis, meaning a U.S-based private fund manager would submit one survey on behalf of all its U.S.-domiciled funds.

### CUSTODY RULE

Registered investment advisers to private funds must comply with certain custody procedures, including generally maintaining client funds and securities with a qualified custodian and either (i) undergoing an annual surprise examination of client assets conducted by an independent public accountant or (ii) obtaining an audit of each private fund by an independent public accountant and delivering the audited financial statements, prepared in accordance with generally accepted accounting principles, to fund investors within 120 days of the fund's fiscal year-end. Private fund sponsors should review their custody procedures to ensure compliance with these rules.

## ANNUAL REVIEW OF COMPLIANCE POLICIES AND PROCEDURES

Registered investment advisers are required to perform a review to assess the adequacy of the adviser's compliance policies and the effectiveness of their implementation and, if necessary, to update their compliance policies and procedures on an annual basis. In determining the adequacy of an annual review, the SEC has indicated that it will consider a number of factors, including the persons conducting the review, the scope and duration of the review and the adviser's findings and recommendations resulting from the review. Written evidence of the results of the annual review should be kept and reviewed by the adviser's chief compliance officer, senior management and, if applicable, outside counsel. Employee compliance training should be conducted at least annually based on the results of the compliance review.

## REVIEW OF OFFERING MATERIALS

As a general disclosure matter, and for purposes of U.S. federal and state anti-fraud laws, an investment adviser must continually ensure that each of its fund offering documents is kept up to date, is consistent with its other fund offering documents and its Form ADV and contains all material disclosures that may be required in order for investors to be able to make an informed investment decision.

Accordingly, it may be an appropriate time for an investment adviser to review its offering materials (including investor newsletters and pitch books) and confirm whether any updates or amendments are necessary. In particular, an investment adviser should take into account the impact of recent market conditions on its funds and review its current disclosure regarding: investment objectives and strategies; valuation practices; performance and related disclaimers; any mention of specific investments to confirm that there are no "cherry picking" issues; conflicts of interests; risk factors; personnel; service providers; "bad actor" disclosures; and any relevant legal or regulatory developments. In light of the SEC's continuing focus on the allocation of private fund fees and expenses and conflicts of interest, advisers must take special care in reviewing their practices and disclosure in these areas.

## CERTAIN FILINGS REQUIRED UNDER THE SECURITIES EXCHANGE ACT OF 1934

### Form 13F

The Securities Exchange Act of 1934 requires investment advisers (whether or not registered) to submit a report on Schedule 13F to the SEC, within 45 days after the last day of any calendar year and within 45 days after the last day of each of the next three calendar quarters following such calendar year, if on the last day of any month of such calendar year the investment adviser exercised discretion with respect to accounts holding Section 13(f) securities (generally, publicly traded securities) having an aggregate fair market value of at least $100 million.

### Form 13H

An investment adviser that is a "large trader" (*i.e.*, it engages in transactions in National Market System securities equal to or in excess of two million shares or $20 million during any calendar day, or 20 million shares or $200 million during any calendar month) must promptly (within 10 days) file an initial Form 13H after effecting aggregate transactions equal to, or greater than, the applicable activity level. Following this initial filing, all large traders must make an amended filing to update any previously-disclosed information that becomes inaccurate no later than promptly (within 10 days) following calendar quarter end and must separately file an annual amendment within 45 days after calendar year-end.

## PRIVACY POLICY NOTICE

Investment advisers and private funds are subject to SEC, CFTC and Federal Trade Commission regulations governing the privacy of certain confidential information. Under such privacy rules, investment advisers and private funds are required to provide notice to individual investors regarding their privacy policies and procedures at the start of the relationship with such individual investor (although they are no longer required to provide an annual privacy notice to such investors unless material changes have been made to the policy).

## FORM D AND BLUE SKY FILINGS

Form D filings for private funds with ongoing offerings lasting longer than one year need to be amended on an annual basis, on or before the first anniversary of the initial Form D filing. Potential investors can obtain copies of Form D via the SEC's website. On an annual basis, private fund sponsors should also review their blue sky filings for each state to make sure they meet any renewal requirements. In some states fees apply for late blue sky filings.

## BAD ACTOR RULES

Rule 506(d) of Regulation D under the Securities Act of 1933 prohibits a private fund from relying on the safe harbor private placement exemption contained in Regulation D if the fund, or certain specified persons or entities associated with the fund, are subject to disqualifying events as a result of bad acts. It is imperative for private fund sponsors that intend to rely on Regulation D to identify all persons and entities subject to the rule and conduct appropriate due diligence (including receiving written certifications) to ensure that none are subject to disqualification. In addition, for funds that are engaging in continuous and/or long-term offerings, the diligence should be periodically refreshed.

## STATE LOBBYIST REGISTRATIONS

Private fund sponsors should look at each state in which a public entity or a public employee retirement plan is an investor or a potential investor to determine if the investment adviser or its personnel are required to register as lobbyists. This may require engaging local counsel with knowledge of state and municipal laws and regulations.

## ANNUAL VCOC/PLAN ASSETS CERTIFICATIONS

Many private equity funds limit "benefit plan investors" to less than 25% of any class of equity interest in a fund (the 25% test) so that such fund's assets are not deemed "plan assets" subject to the U.S. Employee Retirement Income Security Act of 1974 (ERISA), and some private equity fund sponsors have agreed to provide an annual certification to that effect. Such certification generally can be made at any time during the year, but typically investors wish to have a certification made as of a specified annual date, often as of the end of the year, for convenience. Such certifications must take into account the impact of transfers and withdrawals of fund interests during the applicable period, as well as the impact of different ownership percentages of any alternative investment vehicle, or investments, due to excuse and exclusion.

Other private equity funds operate as "venture capital operating companies" (VCOCs), and may have agreed to deliver an annual certification or opinion as to the fund's VCOC status. Such certification or opinion will require a determination as to whether at least 50% (based on cost) of the fund's total investments (excluding cash and other temporary investments) constitute "good" venture capital investments during the 90-day valuation period applicable to the fund. Information regarding the cost of each investment held by the fund on one day during the applicable 90-day period, and confirmation of the management rights required for any "good" investment, should be gathered in preparation for such certification or opinion. Usually the 90-day valuation period is established by the fund in connection with its initial investment. The timing of providing the certification is usually tied to the end of the 90-day period, often 60 days following the end of such period. Fund sponsors should conduct the VCOC or 25% test analysis, as applicable, and deliver the applicable certification to their limited partners.

If a "feeder fund" for investors with a particular tax profile was established to invest in a "master fund," it is possible that the feeder fund might be designed to hold plan assets of ERISA investors. In such case, it may be necessary to update any mandatory disclosure pursuant to Section 408(b)(2) of ERISA (if applicable) regarding direct and indirect compensation for services, if any, relating to the feeder fund. In the case of a new master fund that intends to operate as a VCOC but has not yet made its first investment, updated disclosure to comply with Section 408(b)(2) of ERISA (and possibly other reporting requirements applicable to ERISA investors) may be required, particularly if expenses or management fees were paid by any ERISA investors before the first investment has been made. The circumstances pertaining to each master and feeder fund differ, and counsel should be consulted regarding compliance with any applicable disclosure requirements.

## TIC REPORTING

U.S. private fund sponsors (and non-U.S. private fund sponsors that manage U.S.-domiciled funds) that have portfolio investments in foreign issuers, have issued interests in their funds to foreign residents or have claims on or liabilities to foreign residents may be required to report those transactions to the Federal Reserve Bank of New York on the Treasury International Capital (TIC) system.

TIC Form SLT generally requires U.S. resident entities to report investments in foreign long-term securities (*i.e.*, securities with a maturity of more than one year) and long-term securities issued by such U.S. resident entities to foreign persons equal to $1 billion or more. A private fund adviser is required to consolidate its reportable long-term securities across all funds to determine whether it meets the reporting threshold. The acquisition of 10% or more of the voting securities of an entity is considered a “direct investment” under the form and is excluded for purposes of determining the $1 billion threshold. Form SLT must be filed monthly. Note that sales of U.S.-domiciled fund interests to foreign investors, and sales of foreign-domiciled fund interests to U.S. investors, may count towards the $1 billion reporting threshold.

TIC Form B generally requires (subject to certain thresholds) the reporting of information on certain claims and liabilities (including loans and short-term debt instruments) of U.S. financial institutions with non-U.S. persons. Filing obligations generally may result from private funds that invest directly in non-U.S. debt instruments, provide credit to non-U.S. entities, directly hold non-U.S. short-term securities or maintain credit facilities with non-U.S. financial institutions. However, any claims or liabilities that are serviced by a U.S. entity, or any claims or liabilities for which a U.S. custodian or U.S. sub-custodian is used, do not need to be reported by the private fund adviser. Form B must be filed monthly, with a separate quarterly filing.

TIC Form S generally requires U.S. resident entities to report purchases and sales of long-term securities with foreign entities if, during any month, such transactions equaled $350 million or more in the aggregate. A private fund adviser is required to consolidate its reportable long-term securities transactions across all funds to determine whether it meets or exceeds the reporting threshold. Once the reporting threshold is met in a given month, Form S must be filed monthly for the remainder of the calendar year. Note that sales of U.S.-domiciled fund interests to foreign investors, and sales of foreign-domiciled fund interests to U.S. investors, may count towards the $350 million reporting threshold.

## FORM BE-13

The BEA requires a U.S. entity, including a private fund domiciled in the U.S., to make a filing on Form BE-13 if a non-U.S. person acquires ownership of 10% or more of its voting securities and the cost of acquiring such securities is more than $3 million.[26] The BEA generally does not consider limited partner interests or non-managing member limited liability company interests to be voting securities, so most U.S. funds with foreign investors would not have to file. However, general partner/managing member interests generally are considered voting securities for purposes of Form BE-13. Therefore, a fund domiciled in the U.S. that has a general partner domiciled outside the U.S. generally would be required to file. In addition, if a non-U.S. fund owns 10% or more of the voting securities of a U.S.-domiciled portfolio company, the portfolio company generally would have to file. Reports are required to be filed within 45 days of a reportable transaction. After an initial BE-13 filing is made, the BEA requires quarterly, annual, and five-year benchmark filings. A U.S. person must file a Form BE-13 for a reportable transaction even if not directly requested to do so by the BEA.

## EUROPEAN UNION REGULATION OF THE PRIVATE EQUITY INDUSTRY

The Directive on Alternative Investment Fund Managers (AIFM Directive) has now been implemented into the national laws of all key European Economic Area (EEA) member states. Managers bringing funds to the market in the EEA have to comply with the AIFM Directive and its varied implementation across the EEA. The AIFM Directive subjects EEA private fund sponsors and private fund sponsors using EEA fund vehicles to certain operational and organizational requirements.

The AIFM Directive also impacts U.S. (and other non-EEA) private fund managers that market fund interests to investors in the EEA by imposing a subset of the full AIFM Directive rules upon them. In particular, such managers become subject to certain ongoing compliance requirements including disclosure and reporting obligations, restrictions on extracting capital from EEA portfolio companies and other measures designed to improve transparency when acquiring EEA portfolio companies. In each jurisdiction which has implemented the AIFM Directive there is a separate private placement regime governing the registration requirements for that particular jurisdiction - some require a straightforward notification, while others require an application to be submitted, with approvals from regulators being necessary prior to marketing to investors in the relevant jurisdiction. Some EEA jurisdictions have supplemented the AIFM Directive's minimum requirements for non-EEA private fund sponsors with additional obligations such as, in the case of Denmark and Germany, the appointment of a depositary to oversee the fund's investments and cash flows. In the case of other jurisdictions, such as Austria and France, workable private placement regimes have not been implemented and therefore the only way for U.S. (and other non-EEA) private fund managers to admit investors from such jurisdictions is following a genuine reverse solicitation fact pattern. Private fund sponsors will have to carefully plan their marketing campaigns and register for marketing (by way of notification or application, as applicable) in any relevant EEA jurisdictions in good time. For those jurisdictions where an approval is required, the applications should be submitted well in advance of anticipated marketing efforts commencing since regulators in some EEA jurisdictions have been taking several months to approve marketing, while in others the process can be completed in a matter of days or weeks. In addition, fund managers will be required to carry out a short form compliance process to ensure they are ready to meet the European reporting requirements. We are currently assisting a significant number of U.S.-based and global private fund managers in making applications to EEA regulators for approval under the AIFM Directive's private placement regimes in a variety of EEA jurisdictions.

We are seeing an increasing interest from U.S. (and other non-EEA) private fund managers and their investors in establishing parallel fund structures based in the EEA that can access the AIFM Directive's single market passporting regime. We would be happy to discuss options with you on a case-by-case basis in due course.

Furthermore, in a referendum held on June 23, 2016, the United Kingdom resolved to leave the European Union (Brexit). Such exit will have widespread trade, economic and legal ramifications. A Brexit deal has been agreed in principle with the European Union. Both the United Kingdom and the European Union are expected to approve and sign a withdrawal agreement (the effect of which will be to agree the terms of an implementation period within which aspects of European Union law would continue to apply in the United Kingdom). As of January 22, 2020 this has not been signed.

## ENDNOTES

[1] This Private Equity Alert is not intended to provide a complete list of an investment adviser's compliance obligations or to serve as legal advice and, accordingly, has not been tailored to the specific needs of a particular investment adviser's business.
[2] The full publication is available here.
[3] The release regarding the proposed amendments can be found here.
[4] Note, however, that a private fund offering generally would still have to comply with the investor eligibility requirements of Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (Investment Company Act).
[5] Rule 3c-5 under the Investment Company Act generally defines a "knowledgeable employee" with respect to a private fund as: (i) an executive officer, director, trustee, general partner, advisory board member, or person serving in a similar capacity, of the private fund or an affiliated management person (as defined in Rule 3c-5(a)(1)) of the private fund; and (ii) an employee of the private fund or an affiliated management person of the private fund (other than an employee performing solely clerical, secretarial or administrative functions with regard to such company or its investments) who, in connection with his or her regular functions or duties, participates in the investment activities of such private fund, other private funds, or investment companies the investment activities of which are managed by such affiliated management person of the private fund, provided that such employee has been performing such functions and duties for or on behalf of the private fund or the affiliated management person of the private fund, or substantially similar functions or duties for or on behalf of another company for at least 12 months.
[6] The current thresholds are (i) individuals who have a net worth exceeding $1 million (excluding the value of the individual's primary residence), either alone or with their spouses and (ii) individuals who had an income in excess of $200,000 in each of the two most recent years, or joint income with the individual's spouse in excess of $300,000 in each of those years, and have a reasonable expectation of reaching the same income level in the current year (the Individual Financial Tests).
[7] The proposing release can be found here.
[8] The proposal defines clients and investors that are "qualified purchasers" or "knowledgeable employees" under the Investment Company Act as "Non-Retail Persons" and defines all other clients and investors as "Retail Persons." Advertisements directed at Non-Retail Persons are defined as "Non-Retail Advertisements" and all other advertisements are defined as "Retail Advertisements."
[9] The SEC stated that an example of an untrue or misleading inference would be an advertisement that includes a single investor testimonial stating that investor's account was profitable, which is factually true for that particular investor but nonetheless atypical among all the adviser's investors. If the communication did not disclose the extent to which most other investor accounts were not profitable, this testimonial would create an untrue or misleading impression about the adviser's performance history.
[10] Gross performance is defined in the proposal as "the performance results of a portfolio before the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the investment adviser's investment advisory services to the relevant portfolio." The proposed rule would define "net performance" to mean "the performance results of a portfolio after the deduction of all fees and expenses, that a client or investor has paid or would have paid in connection with the investment adviser's investment advisory services to the relevant portfolio" and includes a non-exhaustive list of the types of fees and expenses to be considered in preparing net performance.
[11] The proposed rule would prohibit in any advertisement (Retail or Non-Retail) any presentation of gross performance, unless the advertisement provides or offers to provide promptly a schedule of the specific fees and expenses deducted to calculate net performance. Such a schedule must itemize the specific fees and expenses that were incurred in generating the performance of the specific portfolio being advertised. Where an adviser presents net performance, whether because net performance is required under the proposed rule or because the adviser otherwise chooses to present it, the schedule should show the fees and expenses actually applied in calculating the net performance that is presented. Where an adviser does not otherwise present or calculate net performance, the schedule should show the fees and expenses that the adviser would apply in calculating net performance as though such adviser were presenting net performance.
[12] The interpretation can be found here.
[13] *See, e.g., SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963). An exempt reporting adviser owes the same fiduciary duty to its clients as a registered adviser.
[14] The SEC noted that in connection with the disclosure of conflicts of interest, saying a conflict "may" exist would be inappropriate if the adviser knows that the conflict actually exists.
[15] Exempt reporting advisers are not subject to the Form CRS requirement.
[16] The SEC release regarding the Form CRS Relationship Summary and related matters can be found here.
[17] The SEC release regarding Regulation Best Interest can be found here.
[18] The SEC order can be found here.
[19] The Custody Rule requires advisers registered with the SEC that have custody of client assets to take steps to safeguard those assets. A private fund adviser may comply with the Custody Rule by having the financial statements of its funds audited annually by an independent public accountant that is registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board. If the auditor is not independent, the adviser will not be in compliance with the rule. Exempt reporting advisers are not subject to the Custody Rule.
[20] For example, at one point consulting teams were not required to search for audit services provided to affiliates of their clients, and even after a requirement to conduct such a search was implemented, two consulting teams failed to complete the required forms, and a team that did complete the form inaccurately responded that its client was not majority-owned by the fund complex in question. Furthermore, on several occasions consulting personnel improperly entered their clients' names into a client database and did not tag their clients as related to the adviser.
[21] The SEC recently proposed amendments to the Independence Rules which, if adopted, will provide greater flexibility for auditor relationships and services that technically would have triggered breaches of the current rules. Our memo regarding this proposal can be found here.
[22] Certain deadlines are calculated based on the assumption that the adviser has a fiscal year-end of December 31.
[23] In addition, an investment adviser must update its Form ADV promptly if certain information becomes inaccurate as indicated in the instructions to Form ADV.
[24] Please note that certain large "hedge fund" advisers and "liquidity fund" advisers are subject to more frequent and extensive reporting requirements and shorter deadlines.
[25] For more information on the *de minimis* exemption and the changes made to the Commodity Exchange Act and the CFTC Rules by the Dodd-Frank Act, please see our September 2012 Private Equity Alert *Changes to CFTC Regulations Affecting Private Funds* available here.
[26] If the 10% threshold, but not the $3 million threshold, is crossed, a BE-13 Claim for Exemption must be filed.

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The Private Equity group's practice includes the formation of private equity funds and the execution of domestic and cross-border acquisition and investment transactions. Our fund formation practice includes the representation of private equity fund sponsors in organizing a wide variety of private equity funds, including buyout, venture capital, distressed debt, and real estate opportunity funds, and the representation of large institutional investors making investments in those funds. Our transaction execution practice includes the representation of private equity fund sponsors and their portfolio companies in a broad range of transactions, including leveraged buyouts, merger and acquisition transactions, strategic investments, recapitalizations, minority equity investments, distressed investments, venture capital investments, and restructurings.

If you have questions concerning the contents of this issue, or would like more information about Weil's Private Equity practice group, please speak to your regular contact at Weil or to the author:

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