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

By David Wohl

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 2019.<sup>1</sup>

### CURRENT AREAS OF SEC FOCUS AND OTHER REGULATORY DEVELOPMENTS

#### *OCIE Announces 2019 National Exam Program Priorities*

On December 20, 2018, the Securities and Exchange Commission's (SEC) Office of Compliance Inspections and Examinations (OCIE) issued its examination priorities for 2019 principally focused around six themes: (i) compliance and risk at entities responsible for critical market infrastructure; (ii) matters of importance to retail investors, including seniors and those saving for retirement (such as potential conflicts of interest and other issues relating to advisers that manage both private and registered funds); (iii) 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; (iv) matters concerning the offer and sale, trading and management of digital assets (such as cryptocurrencies, coins and tokens); (v) cybersecurity; and (vi) anti-money laundering programs of registered broker-dealers.<sup>2</sup>

On the cybersecurity front, OCIE noted that examinations will focus on, among other things, proper configuration of network storage devices, information security governance generally, and policies and procedures related to trading information security. Specific to investment advisers, OCIE stated it will emphasize cybersecurity practices at advisers with multiple offices and will continue to focus on governance and risk assessment, access rights and controls, data loss prevention, vendor management, training, and incident response.

While private fund sponsors were not a named target of the 2019 priorities, such advisers undergoing OCIE examinations continue to experience intense scrutiny regarding the disclosure, calculation and allocation of fees and expenses and, as described below under "*Recent Notable SEC Enforcement Actions*," the SEC's Division of Enforcement is still aggressively pursuing fee and expense cases. Of note, several recent exams have focused on the calculation and application of management fee offsets.

### ***OCIE Risk Alert Regarding Electronic Messaging***

In December 2018, OCIE issued a Risk Alert reminding advisers of their compliance obligations regarding the use of electronic messaging by their personnel. OCIE conducted limited-scope examinations of advisers designed to obtain an understanding of the various forms of electronic messaging used by advisers and their personnel, the risks of such use and the challenges in complying with certain provisions of the Investment Advisers Act of 1940 (Advisers Act). Advisers Act Rule 204-2 (Recordkeeping Rule) requires advisers to make and keep certain books and records relating to their advisory business, including typical accounting and other business records and certain client communications. OCIE noted that electronic business communications conducted on a platform other than an adviser's email system (e.g., via text or personal email) raise significant issues under the Recordkeeping Rule. Additionally, such communications raise other compliance concerns, such as issues surrounding the misuse of material non-public information. OCIE encouraged advisers to review their risks, practices, policies, and procedures regarding electronic messaging and to consider any improvements to their compliance programs that would help them meet their regulatory obligations.<sup>3</sup>

### ***Recent Notable SEC Enforcement Actions***

#### Improper Allocation of Expenses and Management Fee Offsets Related to Co-Investment Vehicles

The SEC settled an enforcement action with a private fund adviser for alleged violations of the Advisers Act arising from the adviser's (i) improper allocation of expenses related to employee and similar co-investment vehicles and (ii) failure to properly offset management fees in connection with undisclosed fee-sharing agreements with certain co-investors.<sup>4</sup> The adviser sponsored multiple private equity funds (Main Funds) as well as employee funds that generally invest side-by-side on a proportional basis with the Main Funds. In addition, the adviser permitted co-investors to invest in certain transactions. The SEC alleged that the adviser failed to disclose to Main Fund investors that the employee funds and other co-investment vehicles would not bear their share of broken deal, legal, consulting, insurance and similar expenses, all of which were allocated to the Main Funds. The adviser also represented to investors that it would seek to have prospective portfolio companies bear the cost of broken deal expenses, but it failed to adopt policies and procedures to do so.

In addition, the adviser often received fees from portfolio companies for providing certain advisory services. The limited partnership agreements of the Main Funds required such fees to be offset against the management fees paid by the funds to the adviser. The adviser also entered into fee-sharing agreements with certain co-investors pursuant to which the adviser shared a portion of the advisory fees it received with the co-investors. From 2010 through 2015, approximately \$1 million was paid to co-investors under this arrangement. The co-investors provided no services to the portfolio companies for these fees. The adviser did not disclose the fee-sharing agreements to investors in the Main Funds. The SEC noted that sharing fees with co-investors reduced the management fee offset (thus increasing the management fees paid by the Main Funds to the adviser) and, because the payments were generally paid by the portfolio companies directly to the co-investors, the investors in the Main Funds had no way of knowing that the Main Funds did not receive the management fee offset that they would have received absent the fee-sharing agreements.

The SEC found that the adviser failed to adopt written policies and procedures reasonably designed to prevent violations of the Advisers Act regarding (i) how it allocated fees and expenses among the Main Funds and employee and co-investment vehicles, (ii) the application of the management fee offsets in connection with the fee-sharing agreements with co-investors and (iii) recouping broken deal expenses from prospective portfolio companies. By virtue of this conduct, the SEC alleged that the adviser violated Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder. As part of

the settlement, the adviser paid a civil monetary penalty of \$400,000 and voluntarily reimbursed the Main Funds for expenses found to be attributable to the employee funds and co-investment vehicles.

#### Improper Allocation of Compensation-Related Expenses

The SEC settled an enforcement action with a private fund adviser for alleged violations of the Advisers Act arising from the adviser's improper allocation of compensation-related expenses to funds that it managed.<sup>5</sup> The adviser sponsored three private equity funds whose investment objective was to acquire minority stakes in other alternative investment managers (Partner Managers). The adviser created a group of employees, referred to as the "Business Services Platform" or "BSP," to provide client development, talent management, operational advisory and other services, support and advice to Partner Managers. Under their organizational documents, the funds were responsible for paying the expenses relating to the utilization of the BSP up to a specified percentage of committed capital, and the adviser was responsible for all compensation costs of its investment professionals other than those related to the BSP.

The SEC found that although some BSP employees spent a portion of their time on tasks not directly related to the BSP, such as assisting the funds' investment team and raising capital, the adviser allocated all compensation expense for BSP employees to the funds. Of the \$28.7 million paid by the funds to BSP employees from 2012 through 2016, approximately \$2 million was paid for time spent on tasks not related to the BSP in violation of the funds' organizational documents and disclosures to fund investors. In addition, the SEC found that the adviser failed to adopt and implement written compliance policies and procedures reasonably designed to prevent this misallocation of expenses. By virtue of this conduct, the SEC alleged that the adviser violated Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder. As part of the settlement, the adviser paid disgorgement of \$2,073,988, prejudgment interest of \$284,620 and a civil monetary penalty of \$375,000.

#### Improper Allocation of Fees and Expenses and Failure to Disclose Conflicts of Interest

The SEC settled an enforcement action with a private fund adviser for alleged violations of the Advisers Act arising from the adviser's misallocation of fees and expenses as well as its failure to disclose financial conflicts of interest to its funds.<sup>6</sup>

From 2010 through 2015, the adviser had the funds pay \$570,198 for a portion of the cost of the adviser's in-house tax partner and in-house tax manager. Both employees assisted in the preparation of the funds' tax returns, as well as the tax returns for the adviser, its affiliates and some of the personal investments of the adviser's principal (the Principal). Although the organizational documents of the funds provided that the funds would bear the costs for the "preparation of the Partnership's financial statements, tax returns and schedules K-1," the documents also provided that the adviser would bear "the costs and expenses incurred by the Manager in providing for its or the General Partner's normal operating overhead, including salaries, other compensation and benefits of the Manager's employees." The SEC alleged that the adviser failed to disclose to the funds' investors or advisory boards (i) that it was charging the funds for a portion of the cost of its employees who were assisting in the preparation of the funds' tax returns and (ii) how it allocated the costs of its in-house tax personnel.

The adviser also engaged a consulting firm (Consulting Firm A) to provide bankruptcy consulting services to certain of the funds and deal sourcing services to the adviser. On two occasions, the adviser caused the entire fee due to Consulting Firm A to be paid by the funds even though a portion of the fee was properly allocable to the adviser. Additionally, the Principal made a \$215,000 personal loan to Consulting Firm A's principal that was secured by money owed by the adviser or the funds, and repaid through consulting fees paid by one of the funds to Consulting Firm A.

The adviser engaged another consulting firm (Consulting Firm B) to provide consulting services to a fund and one of its portfolio companies. At the same time, Consulting Firm B was also providing services to

certain personal investments of the Principal. However, all payments made to Consulting Firm B were from the fund and its portfolio company even though some portion should have been allocated to the Principal's personal investments. Furthermore, the Principal made a personal investment in Consulting Firm B, receiving the right to 25% of its profits. In recognition for services the Principal rendered to Consulting Firm B, Consulting Firm B sold the Principal the interest at a discount. Pursuant to the fund's organizational documents, after the Principal made this investment, 70% of the fees Consulting Firm B received from the portfolio company should have been offset against the fund's management fee, but it was not.

The SEC alleged that the adviser failed to disclose the above misallocated fees and expenses and conflicts of interest to the funds' investors or advisory boards, and failed to adopt written policies and procedures reasonably designed to prevent conflicts of interest arising from the allocations of those payments. As a result, the adviser violated Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder. As part of the settlement, the adviser paid disgorgement of \$1,863,242, prejudgment interest of \$71,070 and a civil monetary penalty of \$1,000,000. The adviser also voluntarily reimbursed the funds \$940,244 for improperly charged expenses, expanded the size of its compliance department, enhanced its written policies and procedures and retained an independent compliance consultant to conduct a review of its compliance program.

#### Improper Allocation of Fees and Expenses and Failure to Properly Value Assets

The SEC settled an enforcement action with an adviser of two business development companies (BDCs) for alleged violations of the Advisers Act and other provisions of the federal securities laws arising from the adviser's misallocation of fees and expenses, as well as its failures relating to the valuation of portfolio company investments.<sup>7</sup>

The adviser and the BDCs used the same office space and several employees performed work for both the adviser and the BDCs. From June 2013 through September 2014, the adviser had between 52 and 75 employees. While the adviser allocated compensation expenses for only eight or nine of these employees to the BDCs during this period, the SEC found it allocated essentially all the rent and other overhead expenses associated with its employees (\$1,208,510) to the BDCs. In addition, from April through November 2014, the adviser improperly allocated \$118,895 to the BDCs for the compensation of two adviser employees who assisted in preparing the Form S-1 for the initial public offering of the adviser's affiliate.

One of the BDCs loaned funds to, and invested in, small and mid-sized companies, some of which were difficult to value. In its public filings, the BDC described a board-approved methodology and nine-step process that it used to value its portfolio on a quarterly basis. The adviser's portfolio company analysts (Analysts) were heavily involved in the BDC's valuation process. Certain of the Analysts failed to flag incorrect or unreasonably high valuation model inputs for at least two of the BDC's investments. Those inputs resulted in materially inaccurate financial statements of the BDC that were included in its Forms 10-Q and 10-K. The SEC alleged that the adviser failed to adopt and implement written policies and procedures concerning the BDC valuation process, and failed to train adequately its Analysts who participated in the process. In addition, because the amount of advisory fees the BDC paid to the adviser was based on the value of the BDC's assets and its performance, because of the overvaluation of these two portfolio companies the BDC paid excess advisory fees to the adviser.

The adviser also advised a hedge fund, and some of its investment professionals simultaneously performed work for the BDCs and such hedge fund. Thus, the adviser acquired information about the BDCs' portfolio companies that, according to the hedge fund's marketing materials, the adviser sought to use in connection with its management of the hedge fund. The SEC alleged that although the adviser had a written insider trading policy, it did not address the situation of using one client's material, non-public

information for the benefit of another. Therefore, the adviser failed to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material, non-public information gained from working for one client and using it for the benefit of another.

The SEC found that the adviser violated several provisions of the federal securities laws, including Sections 204A, 206(2), 206(4) and 207 of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder. As part of the settlement, the adviser paid disgorgement of \$1,999,115.86, prejudgment interest of \$334,545.65 and a civil money penalty of \$1,650,000.

### Failure to Adopt Compliance Policies and Procedures

#### *Disclosure Issues*

The SEC settled an enforcement action with a private fund adviser for alleged violations of the Advisers Act arising from the adviser's failure to adopt and implement sufficient compliance policies and procedures.<sup>8</sup> The lack of such policies and procedures led to, among other things, (i) disclosure deficiencies regarding redemption procedures for a managed fund, (ii) failure to complete audits or surprise examinations for managed funds as required by the custody rule and (iii) inaccurate statements concerning assets under management and private fund clients in the adviser's Form ADV that resulted in the adviser maintaining its Advisers Act registration with the SEC when it was no longer entitled to do so. As a result, the SEC alleged that the adviser violated Sections 203A, 206(4) and 207 of the Advisers Act and Rules 206(4)-2, 206(4)-7 and 206(4)-8 thereunder. As part of the settlement, the adviser paid a civil penalty of \$150,000.

#### *Customer Records and Information*

The SEC settled an enforcement action with an investment adviser for alleged violations of Rule 30(a) of Regulation S-P and Rule 201 of Regulation S-ID arising from the adviser's failure to (i) adopt and implement written policies and procedures reasonably designed to protect customer records and information and (ii) develop and implement a written Identity Theft Prevention Program.<sup>9</sup>

The adviser, a dually registered broker-dealer and investment adviser, gave its independent contractor financial representatives access to its clients' information through a proprietary web portal. The representatives accessed the personally identifiable information (PII) of clients and managed their brokerage accounts through the portal, which was maintained by the adviser's parent company (Parent). In April 2016, one or more persons impersonating contractor representatives called the portal's technical support line and requested a reset of three representatives' passwords for the web portal used to access client information, in two instances using phone numbers previously identified by the Parent as associated with fraudulent activity. The prior activity also involved attempts to impersonate contractor representatives in calls to the Parent's technical and customer support lines. Nonetheless, technical support staff reset the passwords and provided temporary passwords over the phone, and on two of the three occasions, they also provided the representative's username.

Three hours after the first fraudulent reset request, the targeted contractor representative notified a technical support employee of the Parent that he had received an email confirming the password change, but he had not requested such a change. Although the Parent took some action to respond to the intrusion, the intruders obtained passwords and gained access to the portal by impersonating two additional representatives over the next several days. The SEC found that the Parent did not terminate the intruders' access to the three representatives' accounts due to deficient cybersecurity controls and an erroneous understanding of the operation of the portal.

The intruders used the contractor representatives' usernames and passwords to log in to the portal and gain access to PII for at least 5,600 of the adviser's clients. However, the SEC stated that there were no known unauthorized transfers of funds or securities from client accounts as a result of the attack. After

the intrusion, the Parent undertook remedial actions, including, among other things, revising its user authentication policy to prohibit provision of a temporary password by phone, issuing breach notices to the affected customers describing the intrusion and offering one year of free credit monitoring. The Parent also named a new Chief Information Security Officer.

As part of the settlement, the adviser paid a civil penalty of \$1 million. It also agreed to retain a compliance consultant to conduct a comprehensive review of its policies and procedures for compliance with Regulation S-P and Regulation S-ID.

### Secondary Transactions - Failure to Provide Material Disclosures Regarding Valuations

The SEC settled an enforcement action with a private fund adviser for alleged failures to provide material disclosures related to valuations in connection with an offer by the owner and managing partner of the adviser (the Principal) to purchase fund limited partnership interests from investors.<sup>10</sup> The fund in question was in its 17th year and had two investments left in its portfolio. In response to requests from fund limited partners for liquidity, in April 2015 the adviser decided to dissolve the fund through a distribution in-kind. The adviser simultaneously presented the limited partners with an option to sell their distributed in-kind interests to the Principal for cash at a price based on 100% of the fund's December 2014 audited net asset value (NAV). In mid-May 2015, the adviser (i) decided not to close the fund in order to give limited partners that wanted to remain in the fund the ability to do so and (ii) revised the offer to limited partners to provide that the Principal would purchase their limited partnership interests, rather than their in-kind interests, at the same price offered in April. However, on May 1, 2015, the adviser and the Principal received preliminary information that the fund NAV had materially increased during the first quarter of 2015. This increase was not disclosed to limited partners. Between May 15 and May 31, 2015, more than 80% of the fund limited partners accepted the May 2015 offer to sell their limited partnership interests to the Principal for cash at 100% of the December 2014 NAV. In addition, the adviser never sent financial statements for the first quarter of 2015 to the limited partners, as required by the fund's limited partnership agreement.

The SEC alleged that the failure to disclose the increase in fund NAV to limited partners prior to their acceptance of the Principal's offer was a violation of Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. As part of the settlement, the adviser and the Principal jointly and severally paid a civil money penalty of \$200,000.

### ***Umbrella Registration***

Private fund sponsors that use the "Umbrella Registration" option to include relying advisers on their Form ADV should remember that amendments to the form that went into effect last year now require expanded disclosure, including filling out Schedule R to Form ADV, for each such relying adviser.

### ***Cayman Anti-Money Laundering Rules***

In light of changes made by the Cayman Islands Monetary Authority in 2018 to its anti-money laundering regulations, private funds domiciled in the Cayman Islands now have to comply with additional rules, including the appointment of designated anti-money laundering officers. Sponsors who manage Cayman funds and who are not already in compliance with these new rules should discuss with counsel as soon as possible.

## COMPLIANCE OBLIGATIONS FOR PRIVATE EQUITY FUND ADVISERS<sup>11</sup>

### FORM ADV

#### ***(Annual Amendment due by April 1, 2019)***

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 April 1, 2019 for advisers with a fiscal year-end of December 31 (because the 90th day falls on a weekend)).<sup>12</sup>

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 30, 2019)***

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 30, 2019 for advisers with a fiscal year-end of December 31).<sup>13</sup> 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 Exemption due by March 1, 2019)***

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.<sup>14</sup> 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.

### 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 or not 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 Bureau of Economic Analysis (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.<sup>15</sup> 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 and the transitional rules terminated in July 2014. Managers bringing funds to the market in the EEA since such date 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. Such exit will have widespread trade, economic and legal ramifications. The formal notification to the European Council required under Article 50 of the Treaty on European Union was made on March 29, 2017, triggering a two-year period during which the terms of exit are to be negotiated. At the time of writing, these have not been agreed and there is great uncertainty around the subject.

\* \* \*

Annual Compliance Obligations	
Due Date	Regulatory Filing
February 14, 2019	Annual amendment to <u>Form 13H</u> <u>Form 13F</u>
March 1, 2019	Annual <u>CFTC exemption</u> affirmation due for commodity pool operators and commodity trading advisors
April 1, 2019	<u>Form ADV</u> annual amendment
April 30, 2019	As required by the <u>Custody Rule</u> , distribute audited financial statements to investors
April 30, 2019	Distribute updated <u>Form ADV</u> Part 2A to clients
April 30, 2019	Annual update to <u>Form PE</u> due for registered investment advisers to private equity funds with more than \$150 million of assets under management attributable to private funds

Other Compliance Obligations	
TIC Form SLT	Due on 23rd day following last business day of preceding month
TIC Form B	Due on 15th day following month-end and 20th day following quarter-end
TIC Form S	Due on 15th day following last business day of preceding month
Form 13H initial filing	Due promptly (within 10 days) after first effecting transactions equal to or greater than the threshold activity level
Other than annual amendment to Form 13H	Due promptly (within 10 days) following quarter-end in which information became inaccurate
Form 13F	Due within 45 days of the last day of the calendar year and within 45 days after the last day of each of the first three calendar quarters of the subsequent calendar year
Form BE-13	Due on 45th day after the transaction is completed
Other than annual amendment to <u>Form ADV</u>	Due promptly after information becomes materially inaccurate (or, for certain items, after information becomes inaccurate in any way)
Review of compliance policies and procedures	Annually
Employee training	Annually
Notice of changes to privacy policies, if any	Annually
Update of "bad actor" representations	Annually during the fundraising process and as appropriate with respect to placement agents
Lobbying registration and compliance obligations	Prior to marketing to pension funds and in accordance with rules of the particular jurisdiction

## ENDNOTES

- <sup>1</sup> 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.
- <sup>2</sup> The full publication is available [here](#).
- <sup>3</sup> The full publication is available [here](#).
- <sup>4</sup> The SEC order can be found [here](#).
- <sup>5</sup> The SEC order can be found [here](#).
- <sup>6</sup> The SEC order can be found [here](#).
- <sup>7</sup> The SEC order can be found [here](#).
- <sup>8</sup> The SEC order can be found [here](#).
- <sup>9</sup> The SEC order can be found [here](#).
- <sup>10</sup> The SEC order can be found [here](#).
- <sup>11</sup> Certain deadlines are calculated based on the assumption that the adviser has a fiscal year-end of December 31.
- <sup>12</sup> In addition, an investment adviser must update its Form ADV promptly if certain information becomes inaccurate as indicated in the instructions to Form ADV.
- <sup>13</sup> Please note that certain large "hedge fund" advisers and "liquidity fund" advisers are subject to more frequent and extensive reporting requirements and shorter deadlines.
- <sup>14</sup> 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](#).
- <sup>15</sup> If the 10% threshold, but not the \$3 million threshold, is crossed, a BE-13 Claim for Exemption must be filed.

**Private Equity Alert** is published by the Private Equity practice group of Weil, Gotshal & Manges LLP, 767 Fifth Avenue, New York, NY 10153, +1 212 310 8000, [www.weil.com](http://www.weil.com).

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 authors:

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