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Private Equity Fund Managers: Annual Compliance Reminders and New Developments

Summary of private equity firms' compliance obligations, discussion of notable developments in 2017, and outlook for 2018.

US federal laws and regulations, as well as the rules of self-regulatory organizations (SROs), impose numerous yearly reporting and compliance obligations on private equity firms. In addition to many routine and ongoing requirements, new and emerging regulatory developments also impact private equity firms' compliance operations. This *Client Alert* provides a roundup of certain annual and periodic investment advisory compliance-related requirements that apply to many private equity firms. It also highlights material regulatory developments in 2017 and expectations for 2018.

A complete review of a private equity firm's compliance obligations is beyond the scope of this *Client Alert*. Operational aspects unique to a particular firm may entail additional regulatory obligations or different timelines for compliance.

Annual Compliance Reviews

Investment advisers registered under the Investment Advisers Act of 1940, as amended (the Advisers Act), are required to review compliance programs annually for adequacy and effectiveness. These annual compliance reviews continue to be a focal point of Securities and Exchange Commission (SEC) inspections. Chief Compliance Officers (CCOs) of private equity firms should consider whether their compliance documentation appropriately addresses applicable compliance areas, including:

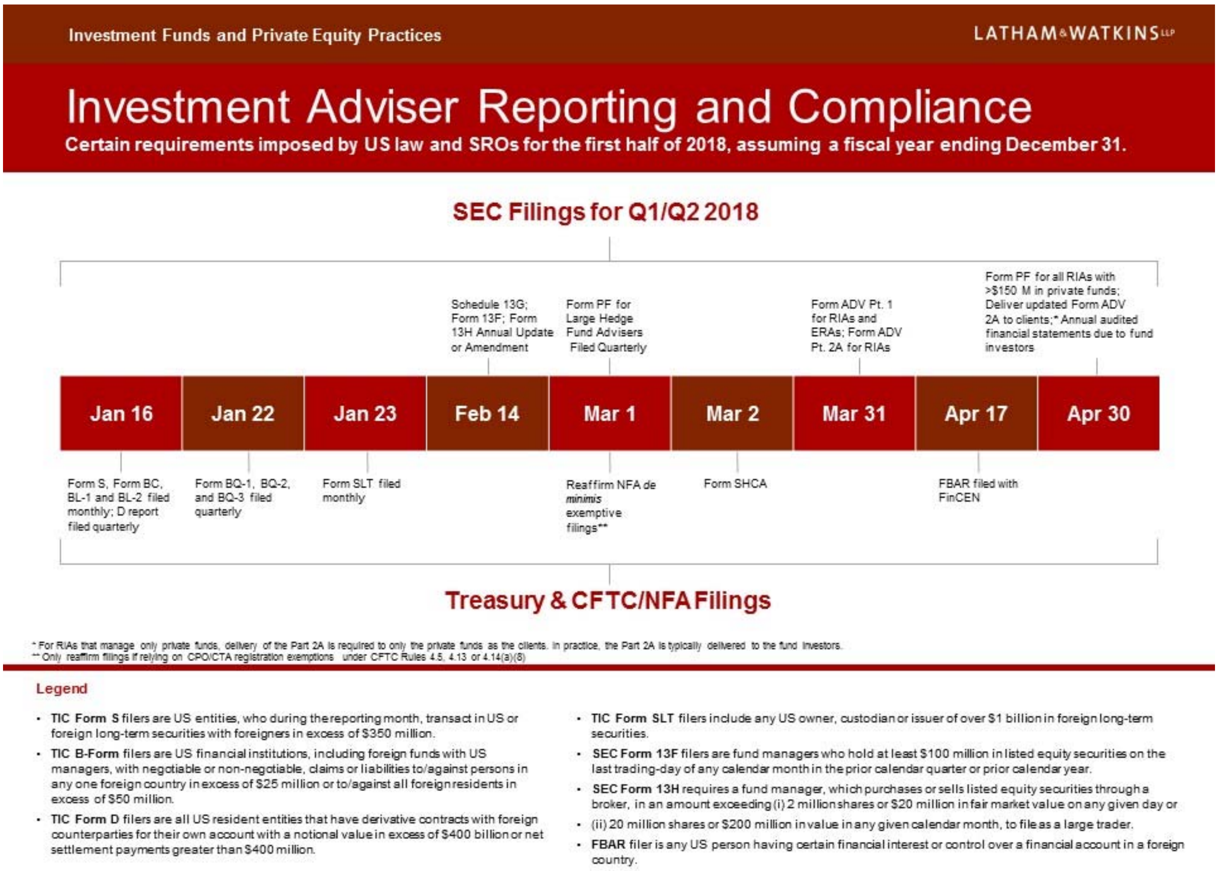
- Identifying and addressing conflicts of interest, *e.g.,* affiliate transactions, allocation of expenses, and allocations of investment opportunities; as well as documenting the basis for resolution of such conflicts
- Reviewing private fund offering materials, with a particular focus on "track record" presentations, and determining if updates are required (*e.g.,* for material changes in the adviser's investment objective, strategies, performance, risks, and conflicts of interest)
- Assessing the private equity firm's use of technology and associated cybersecurity risks
- Collecting annual certifications from all "supervised persons," certifying that each has read and understood the compliance policies and procedures, and collecting an annual personal securities holding report from each "access person"
- Monitoring compliance with the SEC's "pay-to-play" rule

- Updating, maintaining, and delivering to clients, as applicable, Form ADV Part 2B (the brochure supplement)
- Distributing an annual privacy notice to natural-person clients or investors
- Obtaining annual re-certifications regarding the absence of “bad actor” status pursuant to Securities Act Rule 506(d)
- Filing SEC Form D on or before the anniversary of any previous Form D filing for ongoing offerings and amending state blue sky filings, as applicable
- Completing US Department of Labor (DOL) filings and delivering venture capital operating company or real estate operating company certifications for Employee Retirement Income Security Act (ERISA) benefit-plan clients or investors, as applicable
- Confirming and complying with any contractual obligations in counterparty agreements, side letters, credit facilities, and other documents that require periodic notice, reporting, or similar requirements

In addition, CCOs should consider any compliance matters that arose during the previous year, any changes in the investment manager’s or its affiliates’ business activities, and any changes in applicable law that may require a revision to the compliance program. Documentation of these activities must be kept for a period of five years. CCOs should also coordinate, in conjunction with an investment adviser’s senior management, an overall review of the investment adviser’s compliance program and adopt any appropriate revisions.

Regulatory Filing Checklist

The following checklist provides a summary chronological listing of certain reporting obligations for the first half of 2018 as required by the SEC, the US Commodity Futures Trading Commission (CFTC), the National Futures Association (NFA), and the US Department of the Treasury. Many of the deadlines assume a fiscal year end of December 31.



Notable Developments in 2017

The SEC's Division of Enforcement (the Enforcement Division) brought a diverse mix of enforcement actions under the following five core principles:

- Focus on "Main Street investors"
- Focus on individual accountability
- Keep pace with technological change
- Impose sanctions that most effectively further enforcement goals
- Ongoing assessment of the allocation of its enforcement resources

The SEC brought 754 enforcement actions in FY 2017, resulting in US$3.789 billion in disgorgement and penalties. While the Enforcement Division's Annual Report suggests a heightened focus on activities affecting retail investors, the SEC Chairman's remarks also indicate continued attention towards fee disclosures. Additionally, regulators are paying increased attention to cybersecurity and advisors' uses of technology. Finally, the DOL's Fiduciary Rule had significant developments, while the State of California made extensive changes to its fee disclosure regime that other large state investment systems may model. The following are brief summaries of notable developments relevant to private equity firms.

- **New SEC Chairman** — Jay Clayton was sworn in as Chairman Mary Jo White's successor on May 4, 2017, following confirmation by the US Senate on May 2, 2017. Chairman Clayton's remarks in front of the Economic Club of New York outlined several areas on which he envisions the SEC will focus.

Those areas include bringing clarity and consistency to the DOL Fiduciary Rule, specifically as it pertains to investment advisers and broker-dealers. He further discussed his desire that the SEC continue its initiatives to improve disclosures to investors. In a later presentation entitled Governance and Transparency at the Commission and in Our Markets on November 8, 2017 at the PLI 49th Annual Institute on Securities Regulation, Chairman Clayton reiterated the SEC's focus on disclosures, especially with respect to fees. He stated that the Enforcement Division would continue actively pursuing cases in which hidden or inappropriate fees are at issue, although Chairman Clayton noted that the SEC is exploring whether there are ways to better clarify fee-disclosure obligations other than through enforcement.

- **Top Five Exam Deficiencies** — On February 7, 2017, the SEC Office of Compliance Inspections and Examinations (OCIE) released a risk alert regarding The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers. This risk alert provided a list of the five compliance topics most often identified in deficiency letters sent to registered investment advisers. Private equity firms should take note of the below issues and review their own practices, as the SEC often prioritizes the items it announces in subsequent routine examinations.

    1. *Compliance Rule:* Issues with compliance manuals and procedures were a common compliance deficiency for investment advisers in 2016. Primarily, OCIE noted that they found compliance manuals that were not reasonably tailored to actual business practices, failures to perform annual reviews or address the adequacy of investment advisers' policies and procedures, investment advisers outright not following their own compliance policies and procedures, and compliance manuals not being maintained and current.

    2. *Regulatory Filings:* Common issues with regulatory filings included: inaccurate disclosures, untimely amendments to Form ADVs, incorrect and untimely Form PF filings, and incorrect and untimely Form D filings. Please use the "Regulatory Filings Checklist" above to monitor certain key dates for common regulatory filings related to investment advisers.

    3. *Custody Rule*: Common deficiencies or weaknesses included advisers failing to recognize that they may have custody due to online access to client accounts. Further, OCIE noted that certain advisers failed to recognize that certain authority (*e.g.,* powers of attorney) created custody over client accounts. Finally, with respect to advisers who undergo surprise examinations of assets, OCIE found that advisers failed to provide surprise examiners with complete lists of accounts for which they had custody, and surprise examinations were not truly done on a surprise basis but may have been routine.

    4. *Code of Ethics Rule*: The Code of Ethics Rule (Ethics Rule) requires advisers to adopt and maintain a code of ethics. Problems found in connection with the Ethics Rule included: failures to identify access persons for reviewing personal securities transactions, codes of ethics missing certain information required by the Ethics Rule, untimely submission of transactions and holdings, and missing description of advisers' code of ethics in their Form ADVs.

    5. *Books and Records Rule*: OCIE noted that many deficiencies or weaknesses with respect to the Books and Records Rule. Often, advisers have failed to maintain all required books and records, had errors and omissions in their books and records, or maintained contradictory information in separate sets of records.

- **Cybersecurity Test Results** — In 2017, the OCIE released observations from its examination of 75 SEC registered broker-dealers, investment advisers, and investment companies to assess industry practices and legal, regulatory, and compliance issues associated with cybersecurity preparedness. OCIE released its findings on May 17, 2017 in a risk alert entitled Cybersecurity: Ransomware Alert, and on August 7, 2017 in a risk alert entitled Observations from Cybersecurity Examinations. Among the entities examined, OCIE found that:

  - 26% of advisers and funds failed to conduct periodic risk assessments of critical systems to identify cybersecurity threats and vulnerabilities

  - 57% of investment management firms failed to conduct penetration tests and vulnerability scans on what the firms considered to be critical systems

  - 4% of investment management firms had significant numbers of critical and high-risk security patches missing important updates

  Both the Division of Investment Management and OCIE have released guidance and information related to addressing cybersecurity risk online. OCIE further noted the following deficiencies:

  - Policies and procedures are not reasonably tailored to provide employees with specific guidance, failing to offer a sufficient variety of safeguards that employees might employ, or presenting an overly narrow scope.

  - Firms appear not to either adhere or enforce their policies and procedures, or such policies and procedures fail to reflect such firms' actual practices. Often, firms failed to adhere to the proscribed frequency of reviews, had policies that created contradictory instructions, and/or required employees to complete cybersecurity training without verifying completion of such training.

- **Inadvertent Custody Guidance** — In February 2017, the Division of Investment Management (IM) provided guidance regarding "inadvertent custody" in connection with Rule 206(4)-2 of the Investment Advisers Act of 1940 (the Custody Rule). Under the Custody Rule, investment advisers may inadvertently have custody of client funds or securities if the client has authorized the adviser to withdraw funds in the client's separate custodial agreement between its advisor client and a qualified custodian — even if the adviser has no knowledge of or intent to use this authority. The SEC advised that an adviser would have custody in a case in which, from the qualified custodian's perspective, the shared client has authorized the adviser to withdraw such client's funds or securities. Even if restraints on such ability to withdraw client funds exist in the advisory agreement between the adviser and the client, the qualified custodian may not be aware of them. However, if the custodial agreement is narrowly tailored to only permit the adviser to withdraw the shared client's funds in connection with advisory fees, the SEC advised that the adviser may have custody, but does not need a surprise examination — assuming the advisor otherwise complies with the exception under the Custody Rule. Advisers of separately managed accounts who do not intend to have withdrawal authority should obtain and review copies of any custodial agreements to confirm no such authority is being granted to cause the adviser to have custody over the account.

- **California Public Pension and Retirement Systems Disclosures** — On September 14, 2016, Assembly Bill No. 2833 was signed into law in California. The bill requires California public investment funds to make specified disclosures related to certain fees, expenses, and carried interest in connection with alternative investment vehicle investment contracts entered into on and after January

1, 2017 (and existing contracts where additional capital commitments are made on or after January 1, 2017). For contracts not covered by the January 1, 2017 period, the bill requires California public investment funds to use reasonable efforts to obtain such fee disclosures. Private equity firms should expect to be asked to agree in writing to make such disclosures to any California public pension plan making a new subscription. In the current political environment, state governments are increasingly scrutinizing the performance of their state pension plans, and additional states possibly will adopt similar fee disclosure laws as California.

- **Department of Labor Fiduciary Rule** — In connection with a Presidential Memorandum on Fiduciary Duty Rule issued February 3, 2017 ordering the DOL to review the effects on investors of its Fiduciary Rule (81 FR 20945), on April 7, 2017, the DOL announced that the applicability dates in its Fiduciary Rule would be delayed from April 10, 2017 to June 9, 2017. On November 27, 2017, the DOL announced that the special transition period for the Best Interest Contract Exemption and the Principal Transaction Exemption would be extended from January 1, 2018 to July 1, 2019. The extension also applied to certain amendments to the Prohibited Transaction Exemption. On March 15, 2018, a split panel of the Fifth Circuit ruled that the DOL broadly overreached its authority in promulgating the rule, specifically in respect of the Best Interest Contract Exemption and definition of "investment advice" fiduciary. The DOL could continue to defend the rule.
  Advisers are advised that, pending clarification from the DOL on how it intends to proceed following the Fifth Circuit opinion, they should comply with the "impartial conduct standards," which require that advice is given in the "best interest" of the retirement investor. Therefore, such advice:

  - Is under prudence and loyalty standards
  - Accrues no more than reasonable compensation
  - Offers no misleading statements about investment transactions, compensation, or conflicts of interest

  An adviser that does not give advice over whether an investment in a fund should be made or maintained will not create a fiduciary relationship. Further, if an adviser is transacting with independent fiduciaries (each a Plan Fiduciary) with financial expertise, they may be exempt from creating a fiduciary relationship if any of the following actions apply to the adviser:

  - Knows or reasonably believes that the Plan Fiduciary is capable of evaluating investment risks independently
  - Informs the Plan Fiduciary that it is not undertaking to provide impartial investment advice or give advice in a fiduciary capacity
  - Informs the Plan Fiduciary of the nature of the adviser's financial interest in the applicable transaction
  - Does not receive a fee or other compensation directly from the plan, Plan Fiduciary, plan participant or beneficiary, IRA, or IRA owner for the provision of investment advice in connection with the applicable transaction

- **Updates to the Form ADV** — On October 1, 2017, the SEC provided a Summary of Changes to Form ADV Part 1A. In brief:

- Form ADV Part 1A has been revised to allow for umbrella registrations for multiple related advisors.
- Item 1.F(1) or–"Principle Office and Place of Business" now requires a listing of the adviser's 25 largest offices (which previously was 5).
- Item 1.I requests social media platform accounts in addition to an adviser's managed websites.
- Item 1.J(2) requires the Internal Revenue Service (IRS) Employer Identification Number of any other person who employs the adviser's acting Chief Compliance Officer.
- Item 1.O requests more granular estimates for the adviser's balance sheet assets amounting to US$1 billion or more.
- Item 4 now defines "Successions" to include changes to the adviser's structure or legal status at the time of filing.
- Item 5.D now includes a table with a breakdown of client types and categories.
- Item 5.G-K now includes questions on wrap fee programs, differences in client asset calculations from regulatory assets under management, and details for separately managed account clients.

- **Tax Cuts and Jobs Act** — On December 22, 2017, H.R. 1, informally known as the Tax Cuts and Jobs Act (the Act), was signed into law. The Act, the most comprehensive tax legislation in a generation, changes key features of US law (please see the Latham white paper US Tax Reform: Key Business Impacts, Illustrated With Charts and Transactional Diagrams for a discussion of the potential effects on a range of business issues and business entities). Certain of these changes directly affect private equity firms and their investors, including the following:
  - *Carried Interest Holdings*: Generally, the Act imposes a three-year holding period requirement for long-term capital gains treatment on carried interest. If such holding period requirement is not met, gains with respect to carried interest will be treated as short-term capital gains and taxed at ordinary income rates. The provision under the Act does not apply to corporation-held interests (other than an S-corporation) or that provide for a return commensurate with capital contributions of the interest holder, or to amounts included in such holder's income as compensation under Section 83 of the Internal Revenue Code of 1986, as amended (the Code). Like most prior proposals addressing carried interest, the Act also leaves unchanged the position under prior law that the receipt of a profits interest in a partnership in exchange for services is not a taxable event to the recipient if certain conditions are satisfied.
  - *Certain Portfolio Company Structuring Considerations*: In light of the changes made by the Act, the US federal income taxes payable by a corporation or the owners of a partnership may be materially different from what such amounts would have been under prior law. These changes include:

    a) The corporate tax rate

    b) The limitations imposed on the ability to deduct interest expense in certain situations

    c) The deduction now available with respect to certain types of pass-through business income

d) The expansion of the attribution rules for determining whether an entity is treated as a "controlled foreign corporation" under the Code

e) The types of income that certain US shareholders of such an entity will be required to recognize on a current basis, regardless of whether cash is distributed or received by or from such entity

Accordingly, private equity firms should consult their tax advisors regarding the structuring of investments in portfolio companies even when considering an investment or structure that is substantially similar to a prior one made.

- *Treatment of and Potential Withholding on Gain Realized by Non-US Persons on Sale of Partnership Interests*: Under the Act, gain recognized by a non-US investor on the sale of a partnership interest (including an LLC taxed as a partnership) is subject to US tax as "effectively connected income" (ECI) in proportion to the US business assets held by the partnership. The Act also requires a buyer of an interest in a partnership with ECI assets to withhold 10% of the seller's amount realized unless the seller certifies its status as a US person under the Code. If the buyer fails to satisfy these withholding requirements, the partnership must withhold from distributions to the buyer the amount (plus interest) that the buyer failed to withhold on the purchase. Private equity firms should ensure they receive appropriate representations and undertakings from any buyer and any seller of any interest in the private equity fund regarding their compliance with this new provision, given that the private equity fund may have a withholding obligation if either the seller or the buyer, or both, do not comply with such provisions.

- **Changes to Partnership Tax Audit Procedures** — The US federal income tax rules for auditing partnerships changed significantly for partnership taxable years beginning on or after January 1, 2018. In general, subject to certain exceptions and unless the partnership properly executes a push-out election, any increase in a partnership's taxes, interest, or penalties as a result of a tax audit will be paid by such partnership in the year such tax audit is finally resolved. Under these rules, a partnership can reduce the amount of tax imposed that would otherwise be imposed on it or on its investors by providing certain information with respect to its investors to the IRS. As a result, private equity funds must have provisions that apportion any taxes imposed on the private equity fund under these new audit procedures among its investors, and require its investors to promptly provide information needed to reduce the tax so imposed. In addition, since these rules apply to any flow-through vehicles in which a private equity fund has an investment, the relevant portfolio company investment documentation should be carefully reviewed to ensure that the fund receives appropriate rights and undertakings with respect to any audits to which these rules and procedures apply.

SEC Enforcement Actions

- On January 17, 2017, the SEC announced a settlement with BlackRock Inc. (BlackRock), in which BlackRock agreed to pay a US$340,000 penalty in connection with improperly removing whistle-blower incentives from separation agreements with exiting employees. The relevant language stated that separating employees must "waive any right to recovery of incentives for reporting of misconduct" as a pre-condition for receipt of any separation payment from BlackRock. The SEC sought to demonstrate that firms may not deny whistleblowers the ability to accept financial awards for providing it information. Private equity firms should review their separation agreements and revise them as necessary to permit employees to report to governmental agencies.

- On January 17, 2017, the SEC announced that 10 investment advisory firms agreed to pay penalties in connection with charges of violations of the SEC's pay-to-play rule due to receiving compensation from public pension funds within two years following campaign contributions by each firms' associates. The penalties ranged from US$35,000 to US$75,000. Notably, the SEC found violations even when covered associates contributed as little as US$500 and later sought to return their contributions. If the contributions were smaller and the covered associate sought to return the contribution, the SEC levied smaller penalties than if repeated contributions were made and the contributions were never returned.

- On February 7, 2017, the SEC announced the permanent barring of SLRA Inc. and its sole owner from the securities industry. SLRA Inc. and its owner, Scott M. Landress, were ordered to pay a US$1.25 million penalty to settle charges that the owner withdrew improper fees from two funds under his management. The SEC alleged that Landress withdrew £16.25 million from the two funds, under the guise of payments for several years of services from an affiliate — he then directed those funds to his personal account. These actions followed a simultaneous decrease in the value of the funds' investments, and increase in the expense of managing the funds during the global financial crisis. These factors led to Landress requesting additional compensation from the limited partners of the two funds and being denied each time. Neither Landress nor his firm disclosed the related-party transaction or conflicts of interest until after withdrawal of the money. The SEC further alleged that Landress claimed the affiliated transfers were based on oral agreements with the affiliate, in which Landress was the principal on each side of the agreement, none of which were recorded on any of the funds' audited financial statements.

- On September 21, 2017, the SEC released an order instituting a settlement with Platinum Equity Advisers, LLC (Platinum) of claims that Platinum charged US$1.8 million in broken deal expenses in violation of Sections 206(2), 206(4) and Rule 206(4)-7 of the Investment Advisers Act of 1940. Platinum allegedly allocated all of such fees to three of its fund clients and none to co-investors who were to participate in the unconsummated deals. None of the funds' underlying governing agreements disclosed any ability of Platinum to allocate any fees beyond the respective funds' fees. Rather, each of the funds' private placement memorandums stated that the fund would be responsible for "expenses related to its own operation." Additionally, the SEC alleged that Platinum did not adopt or implement any written policy or procedures for dealing with the allocation of such fees. Platinum agreed to payment of more than US$1.9 million in disgorgement and US$1.5 million as civil penalty without admitting or denying the SEC's allegations.

- On October 25, 2017, the SEC charged a former senior partner at Apollo Management L.P. (Apollo) with defrauding Apollo's fund investors by secretly billing the funds for personal expenditures that included family vacations, hair salon visits, designer clothing, and electronics. The SEC further alleged that the senior partner doctored expense reports in order to claim as business expenses personal dinners and a gift to his father of a US$3,500 suit. Over a four-year period, Apollo discovered multiple improper charges by the senior partner. The SEC alleged that though Apollo sought repayment for the fraudulent charges, the firm did not take steps to ensure the senior partner would not misappropriate funds again. The SEC provided further detail on these allegations in the 2016 order against Apollo for disclosure and supervisory failures related to the senior partner's actions, which involved a US$52.7 million settlement by Apollo.

US Derivatives Regulatory Developments

The following are brief summaries of notable US derivatives regulatory developments of particular relevance to private equity firms. For further discussion, please refer to Latham's annual derivatives year-in-review webcast.

- **Uncleared Swap Margin Rules** — US Prudential Regulators[1] and the CFTC finalized their respective uncleared swap margin requirements (the PR Margin Rules, the CFTC Margin Rules, and the CFTC Cross-Border Rules, respectively, and, collectively, the US Margin Rules) at the end of 2015. This imposed a four-year phased-in compliance period that began on September 1, 2016 for the largest dealers, with all affected market participants becoming subject to the variation margin (VM) requirements on March 1, 2017. The US Margin Rules impose initial margin (IM) and VM posting and collection obligations on swap dealers, major swap participants (MSPs, and together with swap dealers, Swap Entities) and prudentially-regulated SEC-registered security-based swap dealers (SBSDs) and major security-based swap participants (MSBSPs and, together with SBSDs, SBS Entities) that enter into uncleared swap transactions with other Swap Entities, SBS Entities or Financial End-Users.[2] The US Margin Rules apply to uncleared swaps (and security-based swaps) entered into by US Swap Entities (and prudentially-regulated SBS Entities) and non-US Swap Entities (and prudentially regulated SBS Entities) if the risk flows back to the US. However, the US Margin Rules provide exemptions for entities hedging commercial risk and exclusions for certain transactions involving non-US persons and non-US Swap Entities (and prudentially-regulated SBS Entities).

  For a detailed summary of the uncleared swap margin requirements, please refer to Latham's resource guide comparing the US Margin Rules and the margin requirements for non-centrally cleared over-the-counter (OTC) derivative transactions under the European Market Infrastructure Regulation (EMIR) (the EU Margin Rules).

- **Cross-Border Compliance** — Importantly, this past year has been a significant year for harmonization globally. The CFTC and the European Commission (the EC) have issued comparability determinations and equivalence decisions, respectively, addressing their respective uncleared over-the-counter (OTC) uncleared swaps margin regulations. For further discussion, please refer to Latham's *Client Alert* on the CFTC EU Comparability Determination and the EC's related equivalence decision.

- **Minimum Transfer Amounts for Separately Managed Accounts** — CFTC Rule 23.153(c) provides that a CFTC Swap Entity is not required to collect/post VM under the CFTC Margin Rules with respect to a particular counterparty unless and until the combined amount of initial margin (IM) and VM required to be collected/posted under the CFTC Margin Rules, and that has not been collected/posted with respect to such counterparty, is greater than US$500,000 (the Minimum Transfer Amount). This rule, however, created many issues with Separately Managed Accounts (SMAs) (*i.e.,* accounts managed by an asset manager and governed by an investment management agreement (IMA) that grants the asset manager authority with respect to a specified amount of assets under management), as asset managers with respect to an SMA are not privy to activities of other asset managers in respect of such SMA. On February 13, 2017, the CFTC's Division of Swap Dealer and Intermediary Oversight (DSIO) granted no-action relief which permits CFTC Swap Entities entering into uncleared swaps with to treat each such account as a separate counterparty for purposes of applying the Minimum Transfer Amount under the CFTC Margin Rules, despite the fact that such accounts are owned by the same legal entity (CFTC Letter No. 17-12). In order to qualify for relief under CFTC Letter No. 17-12, the uncleared swaps of a market participant that is the owner of more than one SMA must satisfy certain enumerated requirements.

- **Virtual Currencies** — Further, the CFTC has continued to address and act in new areas of trading risk resulting from technology and innovation, in particular with respect to automated trading and virtual currencies.

  - **LabCFTC**: In 2017, the CFTC launched a platform to facilitate active engagement between the CFTC and financial technology (FinTech) companies. This platform — LabCFTC — allows members of the FinTech ecosystem to meet with regulators, submit inquiries, and attend "office hours" hosted by LabCFTC in different cities throughout the year. LabCFTC operates through the following three discrete yet reinforcing work streams:

    - Increasing the competitiveness of US markets by better understanding and utilizing emerging FinTech products

    - Identifying elements of the FinTech ecosystem that can be used by regulators to construct regulatory technologies (RegTech) that will assist the CFTC and other agencies in accomplishing their mission

    - Educating CFTC staff on emerging technologies and build out internal resources to facilitate the sharing of best practices among FinTech stakeholders

  - **Virtual Currency Primer**: LabCFTC released a CFTC primer for virtual currencies on October 17, 2017, explaining the nature of virtual currency, the CFTC's regulatory role, and the risks posed by virtual currencies. As a sign of LabCFTC's growing importance, the primer has already been cited in court documents from the Eastern District of New York. The primer explains that the CFTC (i) views virtual currency as a commodity and, (ii) as such, has regulatory jurisdiction over derivatives contracts linked to virtual currencies, as well as broad antifraud and anti-manipulation enforcement authority in the virtual currency "spot" or "cash" markets. The CFTC's goal is to facilitate responsible innovation while deterring manipulation and policing fraud.

  - **Actual Delivery of Virtual Currencies**: Section 2(c)(2)(D) of the Commodity Exchange Act, as amended (CEA), extends CFTC jurisdiction to margined, financed, or leveraged commodity transactions between non-eligible contract participants, unless the underlying commodity is actually delivered within 28 days. On December 15, 2017, the CFTC issued a proposed interpretation for the term "actual delivery" as applied to virtual currency transactions. The CFTC explained that, for actual delivery of virtual currency to occur: (i) the buyer must be able to take possession and control of the entire quantity of purchased virtual currency, no matter how the purchase was financed; (ii) the buyer must be able to use the purchased virtual currency freely in commerce, including outside of the platform used to purchase the virtual currency; and (iii) the seller and any affiliates thereof must not retain any interest in or control over the purchased virtual currency. The CFTC's proposal left many questions unanswered, and the CFTC has actively encouraged questions and participation by the virtual currency community. The proposal's 90-day public comment period closed on March 20, 2018.

    For further discussion, please refer to Latham's *Client Alert* on the CFTC's proposed interpretation of "actual delivery" for virtual currencies.

  - **NFA Reporting Requirements**: Beginning in December, 2017, the NFA has updated its reporting requirements for registered commodity pool operators (CPOs) and commodity trading advisors (CTAs) engaging in the virtual currency markets.

- On December 14, 2017, the NFA announced that CPOs and CTAs must report, on their annual questionnaires, whether their firm executes virtual currency or virtual currency derivative transactions for a commodity pool or managed account. The reporting obligation is ongoing, such that any CPO or CTA currently not transacting in virtual currencies or their derivatives must inform the NFA should the CPO or CTA choose to begin trading these assets. CPOs and CTAs can satisfy this new reporting obligation by amending the firm-level section of their annual NFA questionnaires, which now include the following questions:

Registration Category	Question
CPO	Does your firm operate a pool that has executed a transaction involving a virtual currency (*e.g.,* bitcoin)?
	Does your firm operate a pool that has executed a transaction involving a virtual currency derivative (*e.g.,* a bitcoin future, option, or swap)?
CTA	Does your firm offer a trading program for managed account clients (other than a pool you reported under the CPO questions) that has engaged in any transaction involving a virtual currency (*e.g.,* bitcoin)?
	Does your firm manage an account (other than a pool you reported under the CPO questions) that has executed a transaction involving a virtual currency derivative (*e.g.,* a bitcoin future, option, or swap)?

- The NFA's December 2017 announcement also mandated new quarterly reporting requirements for CPOs and CTAs that execute virtual currency or virtual currency derivative transactions. Beginning with Q1 of 2018, CPOs and CTAs trading virtual currencies or their derivatives must report (i) the number of pools or managed accounts that executed one or more virtual currency transactions and (ii) the number of pools or managed accounts that executed one or more virtual currency derivative transactions. This information must be submitted through the firm's NFA questionnaire within 15 days of the end of the firm's fiscal quarter.

- On January 18, 2018, the NFA announced that, effective for statements as of October 31, 2017 or later, CPOs and CTAs will have to answer two new yes/no questions concerning virtual currencies on the annual pool financial statement cover page. These questions can be accessed through the NFA's EasyFile (Annual Reports) portal.

- **Finalized CFTC Recordkeeping Amendments** — On May 23, 2017, the CFTC finalized amendments to its recordkeeping requirements under CFTC Rule 1.31. Those amendments went into effect on August 28, 2017 (the CFTC Recordkeeping Amendments). The CFTC Recordkeeping Amendments:

  - Eliminated the representation and technical consultant requirements which had previously existed under CFTC Rule 1.31

  - Removed the previous requirements under CFTC Rule 1.31 to keep electronic records in their native file format and retain all records in a non-rewritable, non-erasable format

- Introduced a new streamlined, flexible, and "technology-neutral" regulatory scheme for recordkeeping by "Records Entities" (*i.e.,* any person required to keep Regulatory Records[3] under the Commodity Exchange Act or CFTC regulations promulgated thereunder)

- Delineated other requirements with which Records Entities' electronic storage systems must comply in order to satisfy the CFTC's new "principles-based approach" to retaining electronic records

- **Position Limits and Aggregation Rules** — The CFTC has federal position limits (Federal Position Limits) in effect for certain agricultural futures and option contracts (Legacy Agricultural Contracts). While various amendments to the CFTC position limits regime have been proposed, which would expand the Federal Position Limits to include position limits on certain metals and energy contracts, as well as on additional agricultural contracts beyond the Legacy Agricultural Contracts, such amending regulation is in (re-)proposed form and has not yet been finalized (the Proposed CFTC Position Limits). While the Proposed CFTC Position Limits have not yet been finalized, the related aggregation rules were adopted by the CFTC on December 5, 2016 (the CFTC Aggregation Rules) and apply to existing CFTC position limits (*i.e.,* to Legacy Agricultural Contracts) as of February 14, 2017, though DMO has issued time-limited no-action relief until August 12, 2019 from compliance with certain requirements in respect of an exemption under the CFTC Aggregation Rules. Notably, the two-year no-action relief provided by the CFTC is limited to certain notice filing requirements and certain other aspects of the CFTC Aggregation Rules with respect to the exemptions thereunder. In particular, a fund would still be required to file a disaggregation notice within five business days of a request by the CFTC or an exchange — as such, funds must work to implement policies as soon as possible to ensure their ability to comply with the CFTC Aggregation Rules, notwithstanding the limited relief provided under the CFTC's no-action letter.

  Under the CFTC Aggregation Rules, market participants are generally required to aggregate their positions with the positions of another person in each of the following instances, absent an applicable exemption:

  - The market participant directly or indirectly controls the trading of such other person.

  - The market participant holds ≥10% ownership or equity interest in such other person.

  - Even if an exemption from aggregation would otherwise be available, any market participant that — by power of attorney or otherwise — holds or controls the trading of positions in more than one account or pool with substantially identical trading strategies, such market participant must aggregate all such positions with all of its other positions or trading.

  Exchanges also impose position limits or accountability levels for certain futures and options for which no regulatory position limits apply (Exchange Position Limits), and have amended their respective rulebooks to incorporate aggregation rules in respect of Exchange Position Limits which are analogous to the CFTC Aggregation Rules.

- **Third-Party Recordkeeping Relief for CTAs** — On April 20, 2017, DSIO issued relief exempting registered CTAs from the requirement under CFTC Rules 4.33 and 4.7(c)(2) that books and records be kept at the CTA's main business office (CFTC Letter No. 17-24). CPOs already enjoy analogous relief through its post-Dodd-Frank Act rule harmonization efforts and CFTC Letter No. 14-114, which removed the analogous main business office requirement from CFTC Rule 4.23. CFTC Letter No. 17-24 conforms the CFTC's interpretation of CFTC Rule 4.33 (for CTAs) with that of CFTC Rule 4.23 (for

CPOs). However, the relief under the CFTC Letter is not self-executing — a CTA that uses a third-party recordkeeper must both (i) file a notice of claim with the CFTC following the procedures set forth in CFTC Letter No. 17-24 and (ii) notify the NFA of such exemptive filing.

What to Expect in 2018

As outlined in the Enforcement Division's Annual Report, the SEC is expected to continue to focus on "Main Street investors"; individual accountability; keeping pace with technological change; imposing sanctions that most effectively further enforcement goals; and constantly assessing the allocation of its resources. Though this portends a higher focus on retail investors, private investment funds should still expect the SEC to maintain heightened levels of scrutiny on pay-to-play schemes, fees, and cybersecurity. In terms of examination efforts, OCIE examined 15% of all investment advisers during the 2017 fiscal year, up from 8% five years ago. Importantly, the SEC announced its 2018 OCIE examination priorities as discussed above and particularly noted that it intends to focus on private fund advisers managing funds with a high concentration of capital from retail investors, pension plans, and non-profit entities. Further, private fund investment advisers should continue to be prepared for rigorous examinations on these issues:

- **Fees and Expenses** — The SEC is maintaining its focus on private fund advisers' fees and expenses (including disclosure practices, wrap fee programs, and conflicts of interest).

- **Cybersecurity** — As demonstrated by its publishing of 2017 cybersecurity test results, cybersecurity protections remain critical in the eyes of OCIE, specifically; data loss prevention, vendor management, governance and risk assessment, access rights and controls, training, and incident response. Managers should continue to focus their efforts on ensuring that personnel are appropriately trained, and policies and practices are in place in response to the increasing risks related to cyber-attacks that are becoming more frequent and sophisticated.

- **Anti-Money Laundering Programs** — OCIE intends to prioritize examinations of how firms adopt their AML programs and procedures and the timely filing and accuracy of Suspicious Activity Reports (SARs). In addition to the SARs, OCIE will pay particular attention to the due diligence requirements firms have for their customers. Finally, firms can expect that OCIE will remain interested in if firms independently test their AML programs and adjust to appropriately respond to risks.

Conclusion

During the past year significant developments from multiple regulators mean an increasing pool of market participants will need to ensure their compliance with evolving requirements. Given the complexities of determining which requirements apply – even as new forms of payments, currencies, and trades evolve – broker-dealers, fund managers, and swaps traders should work closely with counsel to ensure their activities remain in compliance, as the risks of potential fines are significant.

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Endnotes

1 The term "Prudential Regulators" refers to the Office of the Comptroller of the Currency (Department of Treasury), the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency.

2 The US Margin Rules define "Financial End-User" to include (among other enumerated types of counterparties): (i) private funds (as defined in Section 202(a) of the Investment Advisers Act of 1940), entities that would be an investment company under Section 3 of the Investment Company Act of 1940 (the Investment Company Act), but for Section 3(c)(5)(C), and entities that are deemed not to be an investment company under Section 3 of the Investment Company Act pursuant to SEC Rule 270.3a-7; (ii) commodity pools, commodity pool operators and commodity trading advisors; (iii) employee benefit plans (as defined in Section 3 of the Employee Retirement Income and Security Act of 1974); (iv) entities, persons or arrangements that are, or hold themselves out as being, an entity, person or arrangement that raises money from investors, accepts money from clients, or uses its own money primarily for investing or trading (or facilitating the investing or trading in) loans, securities, swaps, funds, or other assets; and (v) entities that would fall within one of the Financial End-User categories if it were organized under the laws of the United States or any State thereof.

3 The CFTC Recordkeeping Amendments define "Regulatory Records" under CFTC Rule 1.31 to include all records required to be maintained under CFTC regulations, including any record of any correction or other amendment to records, provided that, with respect to records stored electronically, Regulatory Records also include: (i) any data necessary to access, search or display any such records; and (ii) all data produced and stored electronically describing how and when such records were created, formatted or modified.