

Proskauer»

**2016 Proskauer
Annual Review and Outlook**
for Hedge Funds, Private Equity Funds and
Other Private Funds



2016 Proskauer Annual Review and Outlook for Hedge Funds, Private Equity Funds and Other Private Funds

The following annual review (**Annual Review**) is a summary of some of the significant changes and developments that occurred in the past year and certain recommended practices that investment advisers to hedge funds, private equity funds and other private funds (collectively, **private funds**) should consider when preparing for 2017.

Acknowledgements

This Annual Review is a service to our clients and friends. It is designed only to give general information on the developments actually covered. It is not intended to be a comprehensive summary of recent developments in the law, treat exhaustively the subjects covered, provide legal advice or render a legal opinion.

This Annual Review was prepared by Robert G. Leonard, Michael F. Mavrides, Christopher M. Wells, Howard J. Beber, Niamh A. Curry, Sean J. Hill, Anthony M. Drenzek, Tiffany Kwa, Tiffany Quach, Christopher W. Ryder and Mona Xia with contributions from Philip M. Abelson, Connie N. Bertram, Martin J. Bienenstock, Allan S. Bloom, Ira G. Bogner, Benjamin J. Catalano, Lloyd B. Chinn, John E. Failla, Robert E. Gaut, Edward A. Kwalwasser, Henry J. Leibowitz, Jeremy Leifer, Ying Li, Sigal P. Mandelker, Kristen J. Mathews, Peter McGowan, Timothy W. Mungovan, Joshua M. Newville, Amanda H. Nussbaum, Jonathan E. Richman, Kathy H. Rocklen, Scott K. Rutsky, Catherine Sear, Jay D. Waxenberg, Fabio A. Yamada, Frank Zarb, Chantel L. Febus, Nathan R. Lander, Adam W. Scoll, Susan L. Wiener, Daniella Abel, Martine Agatston, Gabriella A. Ahdoot, Edward J. Canter, Amy G. Drais, Pinchos (Pinny) Goldberg, Michael R. Hackett, Daniel W. Hatten, Lijuan Hou, Mani Kakkar, Lindsay Kroyer, Charles Lee, Alexandre Leal Ribeiro Leite, Charles E. Perez, Rachel J. Peyser, Ebony Ray, Samantha Springer, Jared Zajac and Max D. Brashear.

Table of Contents

2016 Developments and Outlook for 2017	1
SEC Examination Priorities and Initiatives	1
SEC Enforcement Developments	5
Record Number of Investment Adviser Cases Filed During FY 2016	5
Focus on Private Equity	5
Continued Focus on Fees and Conflict Disclosures	6
Cybersecurity	7
Insider Trading	8
Valuation	8
Pay-to-Play	9
Focus on “Gatekeepers” in the Fund Industry	9
Other Enforcement Highlights	10
SEC Administrative Proceeding Updates	10
Courts Rule in Favor of Constitutionality of Administrative Proceedings	10
Amendments to Rules Governing Administrative Proceedings	11
SEC’s Win Rate Increases in Federal Court	11
SEC Reverses Liability Finding by ALJ	11
SEC Whistleblower Updates	12
Whistleblower Bounty Program Awards More in 2016 than in All Previous Years Combined	12
OCIE Staff to Examine Policies and Agreements for Whistleblower Rule Compliance	12
Continued Scrutiny of Separation Agreements	13
SEC Rulemaking Developments & Other Guidance	14
Adoption of Amendments to Form ADV Affecting Advisers of Private Investment Funds	14
Proposed Rule Requiring Registered Advisers to Adopt Business Continuity and Transition Plans	19
Proposed Amendment to Accredited Investor Definition	20
Higher Net Worth Threshold Adopted for Qualified Clients	20

Proposed Rule on Incentive-based Compensation Arrangements	20
Speech by SEC Chair on Private Start-Ups and Private Funds	21
Private Funds Litigation	22
CFTC Updates.....	23
Regulation AT Proposal.....	23
Proposed Amendments to Annual Report Regulations.....	25
Proposed Amendment to Exemption from Registration for Non-U.S. CPOs and CTAs	25
NFA Introduces Late Fee	25
NFA Proposes Collecting Additional Financial Information on Forms PQR and PR	26
FINRA/Broker-Dealer Updates.....	26
Capital Acquisition Brokers – A New Alternative for Private Funds Raising Capital	26
SEC Takes Action on FINRA and MSRB Pay-to-Play Rules	27
State Regulatory Updates.....	27
New California Law on Increased Disclosure of Private Fund Fees and Expenses	27
Insider Trading Updates	28
Waiting for <i>Salman</i>	29
SEC Enforcement Highlights.....	31
CFTC Tackles Insider Trading.....	32
FCPA Updates	33
SEC and DOJ FCPA Enforcement Activity.....	33
An Expanding and Aggressive Enforcement Environment.....	36
Key Risks for Private Funds	37
Anti-Money Laundering Updates.....	38
FinCEN Issues Final Rule on Beneficial Ownership	38
FinCEN Proposed Rule for Registered Investment Advisers	39
BEA Filing Updates	39
Tax Updates.....	40
New Due Dates for Tax Returns	40
Tax Treatment of Partnership Audits.....	40
871(m) Regulations.....	41
Section 385 Regulations.....	41

Proposed Regulations under Section 305(c)	42
PATH Act	42
Continued FATCA Implementation and International Tax Information Exchange	43
BEPS and Country by Country Reporting	44
Deferred Compensation under Section 457A	46
ERISA Updates	46
Private Investment Fund Managers and Other Investment Advisers May Be Affected by the U.S. Department of Labor’s New Fiduciary Rules	46
<i>Sun Capital</i> Court Finds Co-Investing Funds Part of Controlled Group and Liable for Portfolio Company’s Pension Liabilities	48
Employment Law Updates	49
New Federal Overtime Rule to Become Effective on December 1, 2016.....	49
EEOC Releases New Guidance on Unpaid Leave as a Reasonable Accommodation...	50
President Signs Defend Trade Secrets Act into Law.....	51
Trend of Laws Restricting Background Checks Continues	52
Caregiver Discrimination and Family Leave Laws	53
EEOC Announces Revised EEO-1 Rule.....	54
OSHA Issues Final Rule Regarding Injury and Illness Reporting	55
Liability Insurance Updates	55
Enhancing Coverage for Government Investigations.....	56
Protecting Against Cyber Risks	56
Focus on Protecting Key Individuals.....	56
Increased Attention to Portfolio Company Risk and Insurance.....	57
Looking Ahead to 2017	57
Activist Investing Updates	57
Proposed Amendments to Regulation 13D-G	57
Estate Planning Updates	58
Proposed Regulations Seek to Curtail Valuation Discounts.....	58
Lifetime Estate, Gift and GST Tax Exemptions.....	59
Gift Tax Annual Exclusion.....	59
2016 Gift Tax Returns	60
Reorganization and Chapter 11 Developments	60

Use of “Blocking Members” to Insulate a Borrower from Bankruptcy.....	60
SDNY Bankruptcy Court Denies Debtors’ Motion to Equitably Subordinate or Recharacterize Secured Lenders’ Claim, and Refuses to Eliminate or Limit Credit Bid Rights	63
District Court Awards Unsecured Creditors Post-petition Interest at the Contract Rate	66
European Union Regulatory Updates	66
ESMA Issues Advice on Extension of AIFMD Third Country Passport to Non-EU Countries	66
Brexit: No Short-Term Regulatory Change but Significant Longer-Term Implications.....	69
MiFID II and MiFIR Updates	71
Market Abuse Regulation	72
Securities Financing Transactions Regulations	73
FCA Guidance and Updates	75
The Impact of the U.K. Modern Slavery Act 2015 and Supply Chain Transparency on Private Investment Funds	78
New U.K. Income-Based Carried Interest Rules Introduced	80
China Regulatory Updates.....	81
New AMAC Regulations on the Registration and Conduct of Private Fund Managers	81
Restriction on Foreign Ownership of Private Securities Investment Fund Management Companies Lifted.....	82
Hong Kong Regulatory Updates	82
Shenzhen-Hong Kong Stock Connect Approved	82
Expansion of the Short Position Reporting Regime	83
SFC Publishes Consultation Paper on Proposed Enhancements to the Open Position Limit Regime.....	83
SFC Imposes New Client Agreement Requirements	84
SFO Ordinance Provides for Use of Open-ended Fund Companies as Investment Fund Vehicles.....	85
Brazil Regulatory Updates	86
Introduction to the Legal Framework of Brazilian Funds.....	86
New Regulatory Framework for Brazilian Funds.....	87

Investment Opportunities	90
Annual Compliance Review and Filing Requirements.....	91
Offering Document Updates.....	91
Compliance Policies and Procedures Review and Employee Training	91
Rule 506(d) Bad Actor Due Diligence.....	91
Broker-Dealer Registration Issues.....	92
Identity Theft Red Flags Policies	92
Business Continuity and Disaster Recovery Plans.....	93
Anti-Money Laundering Policies.....	93
Annual and Other Periodic Filing Requirements.....	93
Form ADV	94
Form PF	94
Form D and Blue Sky Filings	95
Form 13F	96
Schedules 13D and 13G	96
Forms 3, 4 and 5.....	97
Form 13H.....	98
CFTC Annual Reaffirmations and Periodic Reports	98
TIC Form B.....	100
TIC Form S.....	101
TIC Form SLT.....	101
BE-13.....	102
Annual U.S. Tax Elections and Filings	103
Other Annual Requirements and Considerations.....	105
Audited Financial Statements Delivery.....	105
Privacy Policy Delivery.....	105
Schedule K-1 Delivery.....	106
New Issues Investor Reaffirmations.....	106
ERISA/VCOG Annual Certifications and Compliance.....	106
California Finance Lenders Law Requirements.....	107
Lobbyist Registration.....	107
Liability Insurance.....	107

2017 Federal Filings and Other Document Delivery Calendar.....	108
Contacts	123

2016 Developments and Outlook for 2017

SEC Examination Priorities and Initiatives

On March 10, 2016, the Office of Compliance Inspections and Examinations (**OCIE**) of the U.S. Securities and Exchange Commission (**SEC**) released a [report](#) stating that OCIE had completed examinations of 1,221 of 11,956 registered investment advisers in the SEC's fiscal year 2015, which ended on September 30, 2015, or about 10.2% of the total number of registered advisers. This seemed consistent with our experience during the year, as we saw a steady flow of examinations of private fund advisers, both large and small, with a continued focus on advisers not previously examined, but an apparent shift away from private equity and real estate advisers and back to hedge fund advisers.

As in prior years, examinations of smaller advisers followed a fairly predictable pattern focused around a one week on-site visit to the adviser's office. Larger advisers also were usually subject to the same pattern, although on occasion larger and more complex advisory firms were subject to much longer on-site visits. The off-site portion of the exam, involving follow-up responses to additional written inquiries, often went on for a much longer period of time, with nine months or longer not being uncommon.

The principal focuses of many of the recent exams of our clients reflected many of the key themes and areas identified repeatedly by SEC staffers, including: fees and expenses; conflicts of interest; the treatment of parallel accounts, proprietary accounts and personal accounts; and issues related to access to and the use of nonpublic information.

On January 11, 2016, OCIE released its [annual announcement](#) on examination priorities for the coming calendar year. While the announcement contained broad and general descriptions of areas in which OCIE staff intends to direct its focus, there are several key points to which advisers to private funds should pay close attention.

Fees and Expenses. The announcement specifically affirmed OCIE staff's continuing attention to fees and expenses allocated and charged by private fund advisers. In 2015 and 2016, the SEC obtained significant settlements with several private fund advisers in areas involving (i) allocation of management company operating expenses to fund vehicles, (ii) the disclosure of the allocation of broken-deal expenses incurred in connection with unconsummated portfolio company investments, and (iii) the disclosure of the receipt of accelerated monitoring fees received by advisers from portfolio companies upon their sale or initial public offering. The announcement specifically stated that OCIE staff would be evaluating, among other things, the controls and disclosure associated with side-by-side management of performance-based and purely asset-based fee accounts. In re-committing to its focus in this area, OCIE staff appeared to indicate that there remain fee and expense allocation and disclosure practices that it will seek to review and influence through its examination (and potentially enforcement) programs.

Illiquid Securities. OCIE staff also referenced its interest in reviewing advisers to private funds that have exposure to potentially illiquid fixed-income securities. It could be presumed that the staff's review had included disclosures and representations made to investors and potential investors with respect to such securities, as well as the adviser's controls over risk management, valuation and trading activity, and whether the liquidity of such investments could adversely impact the liquidity offered to investors.

Cybersecurity. Although OCIE staff indicated that it would expand its focus in the area of cybersecurity to include the testing and assessment of advisers' implementation of procedures and controls (and we

very much expect that will happen), to date we still have not seen a materially increased focus on cybersecurity issues in exams.

Parallel Investments. The announcement also referenced OCIE staff's interest in reviewing controls and disclosures associated with side-by-side management of performance-based and purely asset-based fee accounts. This area was previously identified as presenting the potential for conflicts of interest in OCIE staff's [2013](#) and [2014](#) examination priorities announcements. Specifically, in 2013, OCIE staff stated that it intended to "confirm that the registrant has controls in place to monitor the side-by-side management of its performance-based fee accounts, such as certain private investment vehicles, and registered investment companies, or other non-incentive fee-based accounts, with similar investment objectives, especially if the same portfolio manager is responsible for making investment decisions for both kinds of client accounts or funds."

The staff will also continue to conduct focused, risk-based examinations of selected registered investment advisers and advisers that they have not yet examined. The staff's 2016 announcement also noted a focus on pay-to-play and certain other key risk areas related to advisers to public pensions, including the identification of undisclosed gifts and entertainment.

High Risk Individuals. Finally, the 2016 announcement disclosed that OCIE staff would continue to review the supervision of investment adviser representatives in branch offices of SEC-registered advisers, including using data analytics to identify representatives in branches that appear to be engaged in potentially inappropriate trading. Analytic capabilities also would be used to identify recidivist individuals with a track record of misconduct, such as having been disciplined by a past employer or barred by a regulatory authority. The staff will seek to schedule examinations of investment advisers that employ these individuals, with the goal of assessing the level of compliance oversight and controls of these firms.

On September 12, 2016, in a follow-up to OCIE's annual announcement on examination priorities, OCIE issued a [risk alert](#) regarding examinations of supervision practices at registered investment advisers. The risk alert stated that OCIE intends to conduct examinations of registered investment advisers that employ or contract with supervised persons that have a history of disciplinary events. These examinations will focus on evaluating the effectiveness of advisers' compliance programs, supervisory oversight practices, and disclosures to clients and prospective clients, particularly relating to the potential risk associated with financial arrangements (e.g., unique products, services or discounts) initiated by supervised persons with a disciplinary history.

Of note, the risk alert stated that SEC staff is employing resources external to the SEC to identify registered advisers for examinations under this initiative. In particular, the alert indicated that OCIE is using its analytical capabilities to evaluate information from a variety of sources to identify registered advisers for examinations under this initiative. These sources include SEC databases and filings as well as external sources. Examples of factors that the staff is using to identify exam candidates include: disciplinary information that is reported on an adviser's Form ADV; information about other legal actions (e.g., private civil actions) not required to be reported on Form ADV, but which are nonetheless relevant to the advisory services offered to clients; and information from SEC enforcement actions, which barred or suspended individuals from certain financial industries. Additionally, the risk alert stated that examiners will review a registered adviser's advertisements including pitch-books, website postings, and public statements to identify any conflicts of interests or risks associated with supervised persons with a history of disciplinary events.

Private Equity Industry Experience. As noted above, a primary focus of most examinations remains fees and expenses, with a number of firms being cited for deficiencies associated with fees and expense disclosure and allocation practices. Private equity fund sponsors, in particular, should pay close attention to any representations in the governing documents of a fund to the effect that any operating partners (e.g., consultants retained to enhance portfolio company value) will be paid market rates for their services. Where these representations exist, SEC examiners are expecting that private equity fund sponsors have conducted due diligence as to what the market rates for the services really are. SEC staff has challenged due diligence conducted by private equity fund sponsors where, in the staff's view, the diligence into market rates did not use appropriate peer groups for comparison purposes. It may help to alleviate SEC staff's concerns if the fund sponsor discloses to fund investors the methodology used to determine market rates for operating partners retained by a fund sponsor.

SEC examiners are reviewing private fund marketing materials, including information on fund sponsor websites, to determine how fund sponsors differentiate between core "team" employees of the general partner (or managing member) or the adviser, on one hand, and consultants who may be employed as operating partners, on the other hand.

In general, SEC examiners are now asking for large amounts of data from advisers in the course of examinations. Recent data requests have specifically requested documentation on travel and entertainment expenses. Accordingly, it is prudent that advisers review the quality of their recordkeeping and data retrieval systems.

In the area of co-investments, SEC examiners have also been attuned to any indications of undisclosed promises by fund sponsors to preferred current or prospective investors. This was reflected in a May 13, 2015 [speech](#) by the then-OCIE Acting Director Marc Wyatt in which he stated "[t]o be clear, I am not saying that an adviser must allocate its co-investments pro-rata or in any other particular manner, but I am suggesting that all investors deserve to know where they stand in the co-investment priority stack."

SEC examiners continue to request minutes of valuation committee meetings in the course of examinations to determine, among other things, whether a private equity or venture capital fund is still following the same valuation metrics as it did earlier in its life. Moreover, where a fund has exited a portfolio company investment below its prior interim valuation marks, the SEC staff likely will review the marks with greater scrutiny.

As reflected in recent private fund enforcement actions, SEC examiners have been vigilant in reviewing any loan arrangements between sponsor entities and private funds. Where SEC examiners find such arrangements, it can be expected that they will carefully review the specificity of the disclosure regarding such arrangements including the calculation of any interest as well as the specific parties who are to receive the interest payments.

Hedge Fund Industry Experience. As noted above, a key focus of recent examinations of hedge fund managers has been the management of accounts invested on a parallel basis or using similar strategies, particularly where different fees are charged, or where the adviser and/or its principals and other personnel own different interests in different accounts, or where the same positions also are traded in proprietary or personal accounts.

The SEC staff continues to focus on statements made in an adviser's marketing materials. Increasingly, the staff is requesting supporting documentation relating to not just factual statements made in the

marketing materials, but also actions taken by the adviser that were described in disclosures made with respect to the adviser's investment and risk management processes.

Finally, the SEC staff remains keenly focused on issues related to insider trading, including access to nonpublic information generally, the maintenance and use of restricted lists and watch lists, the use of independent consultants and policies and procedures for recording and monitoring communications with public company insiders.

General Observations. The SEC's examination program is a risk-based program. An adviser may be selected for examination for any number of reasons, including, but not limited to, the entity's risk profile; a tip, complaint or referral; or a review of a particular compliance risk area. The reason an entity has been selected for examination is nonpublic information, and typically will not be shared with the entity under examination. Advisers engaging in what might be viewed by SEC staff as a "novel" advisory practice could be selected in order to inform the SEC and/or its policymaking divisions about an emerging industry practice. Registrants should remember that SEC staff might only be seeking to assess compliance approaches and practices with respect to certain matters and, therefore, should not assume that SEC staff's interest in a particular approach or practice predisposes it to being considered inappropriate or troublesome.

We noted a significant increase in the number of SEC staffers participating in each exam, either in person or, more frequently, by telephone. The industry has also reported increased presence of enforcement personnel accompanying OCIE staff on examinations, which might result in a perception of enforcement being more tied to the examinations process. We note, however, that senior SEC officials have stated publicly that where enforcement staff are attending examinations for enforcement purposes, that fact will be disclosed to the registrant at the commencement of the examination. Absent this disclosure, registrants may assume that enforcement staff are attending an examination for general training and/or other purposes unconnected to a particular enforcement investigatory effort involving the registrant.

Section 4E of the Securities Exchange Act of 1934, as amended, (**Exchange Act**) requires examination staff to complete compliance examinations within 180 days from the later of (i) the date on which SEC staff completes the on-site portion of its compliance examination or inspection, and (ii) the date SEC staff receives all records requested from the entity being examined or inspected. For certain complex examinations, the examination deadline may be extended for an additional 180-day period.

The examined entity will be asked to respond in writing to any issues identified in a deficiency letter, including any steps that it has taken or will take to address the issues and to prevent their reoccurrence. The entity's response generally will be due within 30 days of the date of the deficiency letter. If the examination staff has any comments on the entity's response, it generally will either provide the comments to the entity within 60 days of receipt of the entity's response, or contact the entity within the 60-day period to discuss when examination staff will be able to provide comments. Finally, there does not seem to be a clear line between when matters from examinations are resolved in the context of a deficiency letter versus a referral to the SEC's Enforcement Division. Whether a matter ultimately is referred to the Enforcement Division may depend largely on the subjective determinations of the specific examination team members and their supervisors. Based on what the SEC has commonly reported the number of examinations referred to enforcement typically has hovered around 10% annually.

Registrants should also be reminded that on September 27, 2016, SEC Chair Mary Jo White was reported as saying that SEC staff has completed the "independent compliance reviews" plan, which would mandate

third-party compliance examinations for advisers, and that the proposal was passed on to the commissioners. The same report stated that Chair White told reporters at a Securities Industry and Financial Markets Association meeting on September 27, 2016 that SEC Commissioners Kara Stein and Michael Piwowar were “studying” the SEC staff’s recommendation regarding the third-party exam rule for advisers, but said that she couldn’t predict the timing on when the rule would come up for a vote.

SEC Enforcement Developments

Record Number of Investment Adviser Cases Filed During FY 2016

On October 11, 2016, the SEC [announced](#) its enforcement results for fiscal year 2016, reaching new highs in the number of actions brought and relief obtained through disgorgement, interest and penalties. The SEC brought a total of 868 actions in 2016 (including 548 independent or standalone actions), obtaining over \$4 billion in relief and distributing over \$57 million to whistleblowers. It also brought the most cases ever involving investment advisers or investment companies (160 total, 98 of which were standalone actions). Eight of these enforcement actions related to private equity fund advisers, a group that has clearly been a priority for the SEC over the past year as evidenced by comments from Enforcement Division Director Andrew Ceresney, which are discussed [below](#). The SEC also brought 21 actions under the Foreign Corrupt Practices Act (**FCPA**).

Focus on Private Equity

Recent enforcement actions involving private equity fund advisers have targeted fee and expense allocations that potentially give rise to undisclosed conflicts of interest. On May 12, 2016, Enforcement Division Director Andrew Ceresney gave a [keynote address](#) on private equity enforcement, reiterating the SEC’s view that private equity is a key area, highlighting three primary categories of actions against private equity fund advisers:

- Failing to disclose the receipt of fees and expenses (*e.g.*, undisclosed conflicts of interest related to accelerated monitoring fee payments);
- Impermissibly shifting and misallocating expenses (*e.g.*, misallocating “broken deal” expenses to certain funds, misallocating expenses among portfolio companies, and misallocating adviser expenses to funds managed by it, all allegedly without sufficient disclosure); and
- Failing to adequately disclose conflicts of interests, and potential conflicts of interest, including conflicts arising from fee and expense practices (*e.g.*, failing to disclose certain material consulting agreements, and fee and expense payments from portfolio companies to affiliates of the adviser).

The SEC’s regulatory strategy can be described as an attempt to create “community standards” for the private funds industry. These cases share a common denominator: a business practice that, in the SEC’s view, creates a conflict of interest between the fund manager’s own interests and the interests of the fund, resulting in a breach of the manager’s fiduciary duties. To the extent a practice that appears to benefit the manager is expressly and specifically disclosed in writing at the time that the investor decides to invest, or maintain its investment in the fund, the less of a basis the SEC generally will have to challenge it.

Please see our [April 27, 2016](#) and [May 14, 2016](#) posts on Proskauer’s [Capital Commitment Blog](#) for more information.

Continued Focus on Fees and Conflict Disclosures

Disclosures Regarding Accelerated Monitoring Fees and Conflicts. On August 23, 2016, the SEC announced a \$52.7 million settlement with a private equity firm for allegedly misleading fund investors about certain fees and a loan agreement and failing to supervise a senior partner who was discovered to have charged personal expenses to the funds. First, the SEC alleged that the advisers at issue failed to adequately disclose accelerated monitoring fees owed by the funds' portfolio companies upon the sale or initial public offering (**IPO**) of those companies. The failure to adequately disclose these payments from the portfolio companies to the advisers constituted an undisclosed conflict of interest, because the fees reduced the value of the funds' assets (*i.e.*, the portfolio companies making the accelerated monitoring payments), consequently reducing the amounts available for distribution to fund investors. Second, the SEC found that an adviser entity made misleading disclosures concerning interest payments on a loan from five funds to the adviser's general partner. Instead of taking carried interest, the general partner arranged for a loan from the funds in an equivalent amount, which allowed the general partner to defer taxes on the amount, but the adviser failed to disclose that the interest on the loans was then allocated solely to the general partner. Finally, the SEC alleged that the adviser entity failed to properly supervise a senior partner who was found to have repeatedly charged personal expenses to the funds. To settle the action, the adviser entities, without admitting or denying the SEC's findings, paid disgorgement and prejudgment interest of approximately \$40 million in addition to a \$12.5 million penalty.

Allocations for Transaction Fee Offsets. On August 24, 2016, the SEC settled an investigation involving a private equity fund adviser for failure to fully disclose certain fee allocation practices to investors in several funds it advised, which resulted in approximately \$10.4 million in additional management fees received during a ten-year period. The relevant limited partnership agreements (**LPAs**) required a management fee offset based on "all" transaction fees that the adviser received from portfolio investments. However, the LPAs were ambiguous concerning how to allocate those fees when the funds invested along with co-investors, the latter of whose investment arrangements did not typically have a fee offset provision. According to the SEC, when the adviser received transaction fees in these situations, it adopted an allocation methodology that resulted in the adviser retaining a higher amount of transaction fees for itself than was expressly permitted by the LPAs. Specifically, the adviser offset fees based only on each non-co-investing fund's ownership percentage in the portfolio company, rather than allocating the entire transaction fee it had received on a pro-rata basis among the applicable non-co-investing funds. According to the SEC order, in connection with an examination by OCIE, the adviser reported its past practices to the SEC, voluntarily adopted and retroactively applied a new allocation methodology allocating the fees pro-rata across the funds, and reimbursed approximately \$11.8 million in management fees and interest to the funds. To resolve the matter, the adviser, without admitting or denying the SEC's findings, also agreed to pay a civil penalty of \$2.3 million.

Consent to Additional Management Fees and Expenses. On September 14, 2016, the SEC announced a settlement against a private equity fund adviser for failure to disclose conflicts of interest relating to certain fee and expense allocation practices. The adviser allegedly caused its existing funds to invest in a new pooled investment vehicle (along with co-investors) and set up a separate adviser entity to manage the new vehicle. According to the SEC, this arrangement caused the funds to incur an additional layer of management fees and expenses effectively encompassing the overhead of the adviser entity to the pooled investment vehicle, which was not disclosed or consented to by the existing funds' limited partners. In addition, the SEC alleged that the adviser improperly allocated the entirety of the adviser's insurance premiums to funds it advised, notwithstanding that the insurance policy covered the adviser

itself for various risks, some but not all of which arose out of the adviser's management of the funds. Further, the adviser did not disclose that it had negotiated a discounted fee on legal services for the adviser, but not for the funds. After an SEC exam identified the issues, the firm voluntarily reimbursed \$8 million to the funds. To settle the matter, the SEC imposed an additional \$3.5 million civil penalty.

Unregistered Broker-Dealer Conduct and Conflicts of Interest. After foreshadowing its concerns in various speeches over the last three years, the SEC returned its attention to the "unregistered broker" issue. On June 1, 2016, the SEC announced a settlement with a private equity adviser and its owner relating to a variety of alleged violations, including that the adviser improperly failed to register as a broker-dealer. According to the *Wall Street Journal*, the SEC Assistant Regional Director responsible for the matter called it "the first case of a private-equity adviser violating section 15(a) of the [Securities Exchange Act of 1934] for acting as a broker and failing to register as a broker." The SEC order alleged that the adviser performed brokerage services with respect to the acquisition and disposition of portfolio companies held by its funds, including soliciting deals, identifying buyers or sellers, negotiating and structuring transactions, arranging deal financing, and executing the transactions themselves, some of which involved the purchase or sale of securities. The respective LPAs allowed the adviser to charge transaction or brokerage fees and the entity received \$1.87 million in transaction-based compensation in connection with these services.

Please see our [June 9, 2016](#) post on Proskauer's [Capital Commitment Blog](#) for more information.

The SEC also alleged additional categories of violations relating to undisclosed conflicted transactions and improper expense allocations. For example, the advisory firm purchased for itself a departing employee's shares in certain portfolio companies, although according to the share purchase agreement, a repurchase option belonged to the portfolio companies themselves. In addition, the firm's owner allegedly engaged in additional conflicted transactions by individually purchasing interests from other limited partners and then waiving his obligation to satisfy future capital calls related to those interests. The SEC also alleged that the adviser improperly allocated expenses contrary to the funds' LPAs, using fund assets to make political and charitable contributions and to purchase event tickets and maintain a luxury suite at a professional sports arena. The fund adviser and its owner agreed to pay approximately \$2.6 million in disgorgement and pre-judgment interest and a \$500,000 civil penalty to settle the matter.

Please see our [June 8, 2016](#) client alert for more information.

Cybersecurity

The SEC likely will bring more cybersecurity enforcement cases in the near future. At the SEC Speaks conference in February 2016, Stephanie Avakian, Deputy Director of the Enforcement Division, indicated the SEC's cybersecurity enforcement priorities. Avakian discussed the SEC's focus on the following three categories of cybersecurity-related enforcement cases:

- Where companies have failed to adequately safeguard customer information, such as failing to comply with Regulation S-P or Regulation S-I or failing to adopt policies and procedures to safeguard customer information;
- Where material nonpublic information has been stolen to gain an advantage or manipulate the market; and
- Where companies have failed to make adequate cybersecurity disclosures.

Avakian noted that the SEC has brought enforcement proceedings that fall under the first two categories, but has not yet brought an action alleging that a company has failed to disclose a cyber incident. Avakian expressed that the SEC's position is to encourage companies to report cyber incidents rather than stay silent, emphasizing that the SEC views companies that have experienced cyberattacks as victims and "will give significant credit to companies that self-report." Her advice to such companies is to respond quickly and, if appropriate, involve law enforcement such as the FBI or the Department of Homeland Security.

Avakian's comments on cybersecurity enforcement are of particular interest to investment advisers, as there have been reports that the SEC intends to scale back examinations of brokers to focus more on investment advisers.

Insider Trading

The SEC noted in its [year-end review](#) that it had charged 78 parties in cases involving trading on the basis of inside information. A number of these cases involved complex insider trading rings which were investigated by the Enforcement Division after using data and analytics to spot suspicious trading patterns. Yet enforcement actions appeared to have tapered a bit during the past year, in the wake of the 2nd Circuit's *Newman* decision. The biggest development is the *Salman v. United States* case currently pending before the Supreme Court.

Please see our discussion on "Insider Trading Updates" [below](#) for more information regarding SEC insider trading enforcement actions.

Valuation

The SEC typically notes that valuation is one of its priorities for private fund exams and enforcement. In our experience, however, the SEC rarely challenges valuations per se, given the significant levels of judgment required to determine the fair value of illiquid Level 3 assets under Financial Accounting Standards Board Statement 157. Instead, the SEC has tended to focus on issues "around" valuation practices, including: (i) breakdowns in controls/policies/procedures; (ii) violations of generally accepted accounting principles (**GAAP**); and (iii) disclosures to investors and auditors. As Enforcement Division Director Andrew Ceresney noted in a [speech](#) earlier this year, the SEC looks very closely at valuation and asset impairment, "[p]articularly in times of economic turmoil, when valuation adjustments and management discretion may be the last avenues for improperly enhancing performance."

Allegations of Misleading Disclosures Regarding Valuation Practices. In January 2016, the SEC [announced](#) a settlement with an alternative fund manager for allegedly misleading investors about how it valued certain assets and overcharged management fees based on those valuations. The SEC alleged that the firm, which was the adviser to a managed futures fund, failed to disclose that the valuation methodology it used was different from that disclosed in the fund's public filings. The adviser stated that its methodology of valuing certain derivatives was "corroborated by weekly counterparty values," when it allegedly received indicative counterparty valuations that were materially lower than the valuations it used. The SEC also alleged that the adviser failed to disclose a material valuation change – the early termination of an option (one fund's largest investment) at a valuation that was materially different than the valuation that had been recorded. In settlement of the matter, the adviser agreed to refund to investors approximately \$6 million in excessive management fees and prejudgment interest for a seven-year period, and agreed to pay a \$400,000 penalty.

Pay-to-Play

On October 13, 2016, Enforcement Division Director Andrew Ceresney gave a [keynote address](#) on public finance, noting that the Enforcement Division was focused on pay-to-play schemes involving public pension fund assets (as well as accurate disclosure of pension fund liabilities). Ceresney noted that the Enforcement Division had been increasing parallel coordination with public corruption and public integrity units within U.S. Attorneys' Offices and the FBI in connection with pay-to-play investigations. The reason: Where public corruption arises in other contexts (*e.g.*, in hiring practices or awarding construction contracts), SEC staff suspects that there may be corruption when investment advisory contracts are awarded.

Over the past year, the SEC has been investigating a number of entities in connection with pay-to-play issues. Under the Investment Advisers Act of 1940, as amended, (**Advisers Act**), Rule 206(4)-5 (**Pay-to-Play Rule**) prohibits an investment adviser from receiving compensation in connection with providing investment advisory services to a state or local government entity if the adviser or any of its "covered associates" has made a political contribution to non-federal elected officials (or candidates for such office) within the preceding two years, and the elective office holder (or candidate therefor) is in (or would be in) a position to direct or otherwise influence the award of the government entity's investment advisory business. The Pay-to-Play Rule also restricts advisers from circumventing the rule's prohibition on direct contributions to certain elected officials by "bundling" a large number of small employee contributions. The Enforcement Division and OCIE staff have been interested in situations involving even small political contributions of a few hundred dollars made years after the investment decision. We understand that SEC staff might pursue cases based on purely technical violations of the Pay-to-Play Rule, even where there is no obvious connection between the contribution and any state or municipal investment decision.

In an election season, fund advisers with current or prospective state or local government entity investors should pay close attention to political contributions by their personnel – both current personnel and prospective hires – which could raise concerns under existing pay-to-play regulations. Investment advisers need to be versed in the SEC's interpretation of the rule and various political activities, implement and follow robust compliance procedures, and be vigilant in monitoring covered associates' contributions.

Advisers would be prudent to review their pay-to-play policies (including the designation of who would be a "covered associate" for purposes of the rule), confirm that recordkeeping requirements are complied with, and ensure that all staff members are adequately educated on the requirements and ramifications of political donations by, or on behalf of, an adviser's covered associates.

Please see our [August 18, 2016](#) client alert for further guidance on pay-to-play issues during election season.

Focus on "Gatekeepers" in the Fund Industry

In an October 2016 press release announcing the SEC's year-end enforcement results, the SEC reiterated that it was "holding gatekeepers accountable" by filing cases alleging failures to comply with professional standards. Gatekeepers identified by the SEC in both public comments and enforcement actions include a firm's audit committee members, external auditors, private fund administrators, consultants and attorneys.

Private Fund Administrator Charged with Gatekeeper Failures. On June 16, 2016, the SEC [charged](#) a private fund administrator with allegedly ignoring "red flags" of fraud for two private funds to which it provided services. The administrator was contracted to keep records and prepare financial statements and investor account statements for two private funds, whose advisers were subsequently charged with

fraud in separate SEC enforcement actions. The SEC found that the administrator had ignored or missed “red flags” during the course of its engagement as the funds’ administrator, including undisclosed brokerage and bank accounts, related-party transactions, inter-series and inter-fund transfers made in violation of fund offering documents, undisclosed margin and loan agreements, improper accounting for undisclosed withdrawals of funds by the adviser as receivables owed to the funds, and account statements delivered to investors that overstated the investors’ true holdings. In settlement of the allegations, the administrator agreed to pay over \$350,000, including disgorgement, interest and penalties.

Case Alleging Deficient Surprise Exams by Accounting Firm. On April 29, 2016, the SEC [charged](#) an accounting firm and one of its partners with conducting deficient surprise custody examinations of client assets at an investment adviser, whose president secretly stole money from accounts belonging to professional athletes. The SEC alleged that the accountants did not adequately consider fraud risk factors, and filed paperwork with the SEC incorrectly stating that they had complied with certain procedures to verify client assets and that client assets were held with a qualified custodian. The accounting firm and its partner were suspended from appearing and practicing before the SEC. The accounting firm also agreed to disgorgement of \$25,800 in profits that the firm obtained for performing the exams plus interest of \$3,276.76 and a penalty of \$15,000. The partner agreed to pay a \$15,000 penalty.

Other Enforcement Highlights

SEC Sanctions Advisory Firms for Repeating Misleading Third Party Performance Claims. In August 2016, the SEC sanctioned a number of investment advisory firms for repeating misleading claims made by an investment management firm about its primary fund product. The firm that initially used the performance information had been previously charged by the SEC and admitted wrongdoing. This year, the SEC brought a follow-on case against advisers that sub-licensed and advertised the fund strategy, alleging that these firms distributed the misleading performance information without fully investigating or obtaining sufficient documentation supporting the claims. Without admitting or denying the SEC’s findings, the penalties assessed against the firms ranged from \$100,000 to a half-million dollars based upon the fees each firm earned.

Custody Rule Violators Settle Charges. In November 2015, the SEC [announced](#) that it had settled charges against an investment advisory firm, two of its owners, and its former chief compliance officer for repeated violations of Rule 206(4)-2 under the Advisers Act (**Custody Rule**). Among other things, the Custody Rule requires firms to obtain independent verification of assets when they can access or control client money or securities. Previously in 2010, the adviser and its principals had agreed to settle separate Custody Rule violations with the SEC by paying a \$60,000 penalty in connection with an enforcement action concerning the delivery of financial statements for nine funds which contained the auditor’s disclaimer of opinion. The adviser faced new charges in 2015 when the firm was repeatedly late in providing investors with audited financial statements of its private funds. Collectively, the firm and individuals agreed to pay a \$1 million penalty and were suspended for a year from raising money from new or existing investors.

SEC Administrative Proceeding Updates

Courts Rule in Favor of Constitutionality of Administrative Proceedings

Although respondents have continued to assert Constitutional objections to SEC administrative proceedings, these claims have not gained traction over the past year. Courts of Appeals in the Second,

Seventh and Eleventh Circuits have held that the constitutional arguments can be raised only on appeal, after the administrative process has concluded. In August, the D.C. Circuit was the first appellate court to consider the merits of the constitutional argument in [Raymond J. Lucia Cos. Inc. v. SEC \(Aug. 9, 2016\)](#). The petitioner argued that administrative law judges (**ALJs**), as inferior officers, are required to be appointed in accordance with the Appointments Clause. Yet the D.C. Circuit rejected that argument, holding that ALJs are employees, not officers, and thus their appointment is not covered by the Appointments Clause. The court held that ALJs are not officers with authority for “final” decisions because the SEC has discretion to review ALJ decisions and must issue a finality order before any ALJ decision is final.

[Amendments to Rules Governing Administrative Proceedings](#)

On July 13, 2016, the SEC [announced](#) that it will adopt certain [amendments](#) to its rules of practice governing administrative proceedings. Faced with criticism from practitioners and the media regarding a perceived “home field advantage” in administrative proceedings, the SEC approved amendments “intended to update the rules and introduce additional flexibility into administrative proceedings.” The final amendments expand the deadlines for administrative proceedings, in part by expanding the “prehearing period” – the time between service of the initial order instituting proceedings and the hearing on the merits before the ALJ. The new rules could expand the initial decision timeline in complex cases from the current 10-month deadline up to approximately 17 months from service of the order. The SEC also agreed to incrementally expand the availability of a handful of depositions in administrative proceedings, and further outlined when motions for summary disposition may be filed. Although these are incremental steps in the right direction, the amendments stop well short of allowing a full discovery process akin to that found in civil proceedings in federal district court.

Please see our [July 13, 2016](#) post on Proskauer’s [Corporate Defense and Disputes Blog](#) and [expert analysis](#) for more information.

[SEC’s Win Rate Increases in Federal Court](#)

The conventional narrative has been that the SEC has a distinct “home field advantage” before its own ALJs. According to the *Wall Street Journal*, from October 2005 through March 2015, the SEC had a 90% win rate in cases it brought before ALJs, and a 69% win rate in federal court trials. However, it appears that more recently, those win rates have been reversed. We have analyzed the SEC’s results from October 2014 to the present. It appears that the SEC has won over 90% of its federal district court trials during the most recent two-year period, while winning only about 80% of its contested administrative proceedings. Excluding pro se respondents, the SEC’s win rate in administrative proceedings drops to 75%. Although this is a relatively small sample size, the likely explanations are (i) an increase in the number of contested matters filed before ALJs, and (ii) a reduction in the number of insider trading cases (typically brought in federal court) since the *Newman* decision (discussed [below](#)) and related setbacks for the SEC.

Please see our [August 8, 2016](#) post on Proskauer’s [Corporate Defense and Disputes Blog](#) for more information.

[SEC Reverses Liability Finding by ALJ](#)

The analysis above does not include a rare [SEC opinion](#) issued on August 18, 2016, overturning a fraud finding by one of the SEC’s own ALJs. In 2013 an ALJ had [ruled](#) that an individual trader had violated SEC rules and committed fraud by engaging in an “abusive naked” short-selling strategy through an online brokerage account. After reviewing the ALJ’s initial decision, the SEC determined that the Enforcement

Division had failed to prove that the respondent intended to defraud or mislead anyone with his investment strategy, and that he did not violate rules regarding naked short selling. This ruling put the SEC in the uncommon situation of dismissing an enforcement case that it had previously authorized the Enforcement Division to bring, and it demonstrates that the administrative review process is not necessarily a rubber stamp.

SEC Whistleblower Updates

Given the SEC's sustained increase of its enforcement efforts as discussed [above](#), we expect the SEC to continue expanding the whistleblower program in 2017 by promoting whistleblower awards and protecting whistleblowers from retaliation. During fiscal year 2016, the SEC paid out record awards totaling over \$57 million under the whistleblower bounty program. The SEC also [named](#) Jane Norburg as the new Chief of the SEC's Office of the Whistleblower, which intakes and reviews whistleblower tips, evaluates whistleblower award claims, and makes recommendations on whether claimants have satisfied eligibility requirements to receive an award. In addition, the SEC continued to aggressively enforce Exchange Act Rule 21F-17, which prohibits the use of confidentiality agreements to impede a whistleblower from communicating with the SEC.

Below is a summary of some of the notable developments in 2016:

Whistleblower Bounty Program Awards More in 2016 than in All Previous Years Combined

On October 11, 2016, the SEC [announced](#) that the whistleblower bounty program established under the Dodd-Frank Wall Street Reform and Consumer Protection Act, as amended (**Dodd Frank Act**) awarded over \$57 million to 13 whistleblowers in fiscal year 2016, which is more than in all previous years combined. This announcement followed the SEC's [announcement](#) on August 30, 2016, that awards to whistleblowers under the bounty program had surpassed \$100 million since the SEC paid its first award in 2012, just over a year after it had established the Office of the Whistleblower.

OCIE Staff to Examine Policies and Agreements for Whistleblower Rule Compliance

On October 24, 2016, OCIE published a [risk alert](#) stating that OCIE staff intends to examine registrants' compliance with the Dodd-Frank Act's whistleblower provisions. The alert noted recent enforcement actions charging violations of Rule 21F-17 as a result of confidentiality or severance agreements that allegedly impeded individuals from communicating with the SEC. In light of those actions, OCIE staff intends to review registered investment advisers' policies and agreements for whistleblower compliance. Advisers should expect OCIE staff to include in their exams a review relating to Dodd-Frank whistleblowers.

What documents will examiners request? Documents OCIE staff might request include:

- Compliance manuals;
- Codes of ethics;
- Employment agreements; and
- Severance agreements

What will examiners look for? OCIE staff might look for agreements that:

- Limit the types of information that an employee may convey to the SEC or other authorities;

- Require departing employees to waive their right to any monetary recovery in connection with reporting information to the government;
- Require representations that an employee has not assisted in any investigation involving the registrant; or
- Require an employee to notify or obtain consent prior to disclosure, allow disclosure “only as required by law,” or prohibit any and all disclosure of confidential information, without an exception for voluntary communications with the SEC concerning possible securities law violations.

What remedial actions might be taken? The SEC has imposed the following remedial actions in recent SEC enforcement cases:

- Requiring documents to be revised on a going-forward basis to clarify that nothing therein will prohibit employees from voluntarily communicating with the SEC concerning potential violations or from recovering a related whistleblower award;
- Requiring general notices to employees of their right to contact the SEC or other authorities; and
- Contacting former employees who signed severance agreements to inform them that they are not prohibited from communicating with the SEC or seeking a whistleblower award.

Please see our [October 31, 2016](#) and [June 28, 2016](#) client alerts and our [August 12, 2016](#) post on Proskauer’s [Capital Commitment Blog](#) for more information.

Continued Scrutiny of Separation Agreements

After [announcing](#) in 2015 its first settlement of an enforcement action under the SEC’s Rule 21F-17, which prohibits any person from taking “any action to impede an individual from communicating directly with SEC staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement with respect to such communications,” the SEC brought additional enforcement actions in fiscal year 2016 for violations of this rule.

On August 10, 2016, the SEC [announced](#) that a Georgia-based distributor of building products settled charges that it violated Rule 21F-17 by requiring outgoing employees to waive whistleblower bounty award eligibility in connection with severance agreements and by using an overly restrictive confidentiality clause. The company agreed to pay a penalty of \$265,000 and revise its agreements. According to the [SEC order](#), in mid-2013, the company had added to its severance agreements a provision waiving potential whistleblower award eligibility. The SEC took issue with that waiver based on Rule 21F-17. In addition to agreeing to pay the above-referenced penalty, the company agreed to include the following provision in its severance agreements:

“Protected Rights. Employee understands that nothing contained in this Agreement limits Employee’s ability to file a charge or complaint with the Equal Employment Opportunity Commission, the National Labor Relations Board, the Occupational Safety and Health Administration, the Securities and Exchange Commission or any other federal, state or local governmental agency or commission (“Government Agencies”). Employee further understands that this Agreement does not limit Employee’s ability to communicate with any Government Agencies or otherwise participate in any investigation or proceeding that may be conducted by any Government Agency, including providing documents or other information, without notice to the Company. This Agreement does not limit Employee’s right to receive an award for information provided to any Government Agencies.”

Please see our [August 12, 2016](#) post on Proskauer's [Whistleblower Defense Blog](#) for more information.

On August 16, 2016, the SEC [announced](#) that a California-based health insurance provider had agreed to pay a \$340,000 penalty to settle charges that it violated Rule 21F-17 by using severance agreements that allegedly prohibited its employees from receiving whistleblower awards from the SEC. According to the [SEC order](#), the company violated federal securities laws by requiring its employees to sign severance agreements in which employees waived their rights to file applications for, or accept, whistleblower awards from the SEC. In June 2013, the company amended the Waiver and Release of Claims in its severance agreements, removing the language that required employees to waive "the right to file an application for award for original information submitted pursuant to Section 21F of the Securities Exchange Act of 1934." However, it retained language that prohibited employees from receiving monetary recovery for reporting information to "any federal, state or local government agency or department" until October 2015, when it struck all such language from its severance agreements. The company also agreed to make "reasonable efforts" to contact all former employees who signed severance agreements from August 12, 2011 to October 22, 2015 and inform them that they are not prohibited from seeking and receiving whistleblower awards from the SEC.

Please see our [August 17, 2016](#) post on Proskauer's [Whistleblower Defense Blog](#) for more information.

On September 28, 2016, the SEC [announced](#) that a company had agreed to pay \$6 million to settle charges that it had violated the FCPA and chilled a whistleblower who had reported the misconduct. According to the [SEC order](#), a whistleblower employee who was previously voluntarily communicating directly with the SEC stopped doing so after signing a separation agreement that contained strict confidentiality provisions and a \$250,000 liquidated damages provision for any violations of the agreement. The SEC alleged that these provisions violated Rule 21F-17 by impeding the employee from communicating directly with the SEC.

SEC Rulemaking Developments & Other Guidance

Adoption of Amendments to Form ADV Affecting Advisers of Private Investment Funds

On August 25, 2016, the SEC [announced](#) the [adoption](#) of numerous substantive and technical amendments to Form ADV, Part 1A, which had been previously [proposed](#) on May 20, 2015. Several of the amendments will affect how investment advisers to private investment funds file initial and annual updating amendment reports with the SEC on Form ADV. Advisers will need to begin complying with the amendments on October 1, 2017.

Umbrella Registration for Multiple Related Advisers. The changes adopted amended Form ADV to accommodate the registration of private fund advisers operating a single advisory business through multiple legal entities via the filing of a single Form ADV.

The new amendments set forth the following conditions under which a private fund adviser (**filing adviser**) can file a single Form ADV on behalf of itself and other advisers that are controlled by, or under common control with, the filing adviser (each, a **relying adviser**), provided that they together conduct a single advisory business (collectively, an **umbrella registration**):

- The filing adviser and each relying adviser advise only (i) private funds, and (ii) separately managed accounts that (a) are beneficially owned by qualified clients (as defined in Rule 205-3 under the Advisers Act), (b) are otherwise eligible to invest in the private funds advised by the filing adviser or a

relying adviser, and (c) pursue investment objectives and strategies that are substantially similar or otherwise related to those private funds;

- The filing adviser has its principal office and place of business in the U.S. and, therefore, all of the substantive provisions of the Advisers Act and the rules thereunder apply to the filing adviser's and each relying adviser's dealings with each of its clients, regardless of whether any client or the filing adviser or relying adviser providing the advice is a United States person;
- Each relying adviser, its employees and the persons acting on its behalf, are subject to the filing adviser's supervision and control and, therefore, they are all "persons associated with" the filing adviser (as defined in Section 202(a)(17) of the Advisers Act);
- The advisory activities of each relying adviser are subject to the Advisers Act and the rules thereunder, and each relying adviser is subject to examination by the SEC; and
- The filing adviser and each relying adviser operate under a single code of ethics and a single set of written policies and procedures that are administered by a single chief compliance officer.

For purposes of umbrella registration, the SEC stated that it would consider the following factors as indicia of multiple legal entities conducting a single advisory business:

- A commonality of advisory services and clients;
- A consistent application of the Advisers Act and the rules thereunder to all advisers in the business; and
- A unified compliance program.

To accommodate umbrella registration, several additional modifications were made to Form ADV:

- The Glossary in the Instructions to Form ADV was amended to include definitions of the terms: (i) "filing adviser"; (ii) "relying adviser"; and (iii) "umbrella registration." As defined, a "relying adviser" itself must be eligible to register with the SEC.
- Form ADV was amended to include a new Schedule R, which requires each relying adviser to disclose: (i) its basic identifying information; (ii) its basis for SEC registration; (iii) its form of organization; and (iv) its control persons.
- A new question was added to Schedule D that requires advisers to identify the filing advisers and relying advisers that manage or sponsor private funds reported on Form ADV.

The SEC also clarified that it was not expanding the concept of umbrella registration to include multiple exempt reporting advisers. However, the SEC noted that the previous views of SEC staff, which permitted certain exempt reporting advisers to file a single Form ADV on behalf of multiple special purpose entities, would not be withdrawn as a result of the new amendments to Form ADV.

Additional Reporting Requirements for Separately Managed Accounts. The new amendments will also require investment advisers to report certain aggregated information about their separately managed accounts (**SMAs**) (*i.e.*, advisory accounts that are not pooled investment vehicles). These additional reporting requirements include:

- New Section 5.K.(1) of Schedule D will require advisers to report the approximate percentage of SMA regulatory assets under management that are invested in twelve broad asset categories. Advisers to

\$10 billion or more in SMA regulatory assets under management will have to annually report both mid-year and end-of-year percentages. Advisers should not look through investments in pooled investment vehicles for purposes of reporting the underlying asset type.

- New Section 5.K.(2) of Schedule D will require advisers with at least \$500 million, but less than \$10 billion, in SMA regulatory assets under management to report under Section 5.K.(2)(b) the amount of SMA regulatory assets under management and the dollar amount of borrowings attributable to those assets that correspond to three levels of gross notional exposures. Advisers with at least \$10 billion in SMA regulatory assets under management will also be required to report under Section 5.K.(2)(a) the derivative exposure across six derivatives categories. Advisers may limit their reporting for both (a) and (b) to individual accounts of at least \$10 million.
- New Section 5.K.(3) of Schedule D will require advisers to identify any custodians that maintain at least 10% of SMA regulatory assets under management, and report the amount of the adviser's regulatory assets under management attributable to SMAs held by each of the custodians.

In addition, the SEC clarified that a sub-adviser to an SMA should provide information only about the portion of the account that it sub-advises. Moreover, the SEC clarified that advisers with a principal office and place of business outside the U.S. are required to report information regarding SMAs for all of their clients, including clients who are not United States persons.

Additional Information Regarding Investment Advisers. Investment advisers will also be required to provide additional disclosure about themselves, including the following:

- **Social Media Platforms.** Form ADV Item 1.I. will require an adviser to disclose whether it has one or more accounts on social media platforms (e.g., Twitter, Facebook or LinkedIn), and the address of such social media pages (in addition to the address of the adviser's website(s)). An adviser is only required to disclose accounts on publicly available social media platforms over which the adviser controls the content. Social media accounts of an adviser's employees and social media accounts used solely to promote the business of an adviser's affiliate or affiliates that are not themselves advisers registered with the SEC are excluded from the disclosure requirement.
- **Offices.** Advisers will be required to (i) report the total number of offices at which they conduct investment advisory business, (ii) identify the adviser's 25 largest offices in terms of number of employees, (iii) report the number of employees who perform advisory functions from each office, (iv) identify from a list of securities-related activities the business activities conducted from each office, and (v) provide a description of any other investment-related business conducted from each office.
- **Compensation of CCO.** Form ADV, Item 1.J. will require an adviser to report whether its chief compliance officer is compensated or employed by any person or entity other than the adviser (excluding certain related persons of the adviser and investment companies registered under the Investment Company Act of 1940, as amended (**ICA**), advised by the adviser) for providing chief compliance officer services to the adviser and, if so, to report the name and IRS Employer Identification Number (if any) of that other person or entity.
- **Assets.** In connection with the SEC's proposed rules concerning incentive compensation discussed [below](#), Form ADV Item 1.O will require advisers with assets of \$1 billion or more (that is, their own assets and not assets they manage for others) to report their assets within three ranges: (i) \$1 billion to less than \$10 billion; (ii) \$10 billion to less than \$50 billion; and (iii) \$50 billion or more.

- **Clients.** Form ADV, Item 5 will require an adviser to report: (i) the number of clients for whom the adviser provides advisory services; (ii) the amount of regulatory assets under management attributable to each category of clients; (iii) the number of clients for whom the adviser provides advisory services, but does not have regulatory assets under management; (iv) whether the adviser reports client assets in Part 2A of Form ADV differently from the regulatory assets under management reported in Part 1A of Form ADV; and (v) the approximate amount of an adviser's total regulatory assets under management that is attributable to clients that are non-United States persons.
- **Audit Firm.** Form ADV, Item 7 will require an adviser relying on the annual audit or annual surprise examination for compliance with the Custody Rule to report the auditing firm's Public Company Accounting Oversight Board (**PCAOB**) assigned number (if applicable). However, an auditing firm performing a surprise examination will not be required to be registered with the PCAOB, unless the adviser or its related person is serving as qualified custodian.
- **Qualified Client Status.** Section 7.B.(1) of Form ADV, Schedule D will require an adviser to a private fund that qualifies for the exclusion from the definition of investment company under section 3(c)(1) of the ICA to report whether it limits sales of the fund to "qualified clients" (as defined in Rule 205-3 under the Advisers Act). Advisers will not be required to recertify the qualified client status of their investors annually. In addition, advisers that are not registered with the SEC (*e.g.*, exempt reporting advisers) will not be required to determine whether the fund's investors are qualified clients and may therefore simply respond "No" to the question.

Clarifying and Technical Amendments to Form ADV. Several technical amendments of note to private fund advisers were made to Form ADV, including the following:

- Section 7.B.(1) of Schedule D requires advisers to provide information about the private funds they manage. Item 7.B was amended to clarify that Section 7.B.(1) of Schedule D should not be completed if another SEC-registered adviser or SEC-exempt reporting adviser reports the same information.
- Text from Question 10 of Section 7.B.(1) of Schedule D that directs advisers to refer to the underlying funds of a fund-of-funds when selecting the type of fund (*e.g.*, hedge fund, private equity fund, venture capital fund, etc.) will be removed.
- Question 19 of Section 7.B.(1) of Schedule D was amended to make it clear that an adviser should not consider feeder funds as clients of the adviser to a private fund when answering whether the adviser's clients are solicited to invest in the private fund.
- Question 21 of Section 7.B.(1) of Schedule D was amended to ask if the private fund has *ever* relied on an exemption from registration of its securities under Regulation D, in order to better reflect the intention of the question.
- Question 23.(g) of Section 7.B.(1) of Schedule D currently asks whether the private fund's audited financial statements are distributed to the private fund's investors. The question as revised will now add "for the most recently completed fiscal year" to clarify the question.
- Question 23.(h) of Section 7.B.(1) of Schedule D currently asks whether the report prepared by an auditing firm auditing a private fund contains an unqualified opinion. The question as revised will now ask whether all of the reports prepared by the auditing firm since the date of the adviser's last annual updating amendment contain unqualified opinions.

- Item 8.H. of Part 1A of Form ADV currently asks whether the adviser or any related person of the adviser, directly or indirectly, compensates any person for client referrals. This item is addressing advisory clients and not investors in private funds. Item 8.H. was revised to divide the question into two parts. Revised Item 8.H.(1) covers compensation to persons other than an adviser's employees for client referrals. Revised Item 8.H.(2) covers compensation to employees, in addition to employees' regular salaries, for obtaining clients for the adviser.
- Item 8.I. currently asks whether the adviser or any related person of the adviser, directly or indirectly, receives compensation from any person other than the adviser or related person of the adviser for client referrals. Item 8.I. was amended to clarify that advisers should not include the regular salary that the adviser pays to an employee in responding to this item.
- In coordination with revisions to Item 7 and Section 7.B.(1) of Schedule D discussed above, Section 9.C. of Schedule D, which asks an adviser to identify any independent public accountant engaged to perform a surprise examination or perform an audit of a pooled investment vehicle managed by the adviser, was amended in two respects. First, an adviser will now be required to provide the PCAOB-assigned number of the adviser's independent public accountant. Second, Section 9.C.(6) will now ask whether all reports prepared by the independent public accountant since the date of the last annual updating amendment have contained unqualified opinions.

Amendments to Performance Reporting Recordkeeping Rules. Rule 204-2(a)(16) under the Advisers Act currently requires registered advisers to maintain records supporting performance claims in communications that are distributed or circulated to ten or more persons. Rule 204-2(a)(16) was amended by removing the ten or more persons condition and replacing it with "any person." Accordingly, under the amended rule, registered advisers will be required to maintain all materials listed under Rule 204-2(a)(16) that demonstrate the calculation of the performance or rate of return in any communication circulated or distributed by the adviser, directly or indirectly, to any person.

The SEC also adopted amendments to Rule 204-2(a)(7) under the Advisers Act, which currently requires registered advisers to maintain certain categories of written communications received and copies of written communications sent by such advisers. Rule 204-2(a)(7) was amended to require advisers to maintain originals of all such communications relating to the performance or rate of return of any or all managed accounts or securities recommendations.

Compliance Dates. Any adviser filing an initial Form ADV or an amendment to an existing Form ADV on or after October 1, 2017 will be required to provide responses to the form revisions. Accordingly, most advisers will be utilizing the revised Form ADV in connection with their 2018 annual updating amendments due on March 31, 2018 (for an adviser employing a calendar fiscal year). SEC staff is working closely with the Financial Industry Regulatory Authority (**FINRA**) to re-program IARD and the system is expected to be able to accept filings of revised Form ADV by October 1, 2017. The SEC's amendments to Rule 204-2 under the Advisers Act will apply to communications circulated or distributed after October 1, 2017. Accordingly, investment advisers that distribute communications after October 1, 2017 that contain performance information in respect of the period prior to October 1, 2017 will be required to maintain the records required by amended Rule 204-2 supporting the prior performance claims.

Please see our [May 22, 2015](#) and [August 31, 2016](#) client alerts for more information.

Proposed Rule Requiring Registered Advisers to Adopt Business Continuity and Transition Plans

On [June 28, 2016](#), the SEC proposed new [Rule 206\(4\)-4](#) under the Advisers Act that would require registered investment advisers to adopt and implement written business continuity and transition plans reasonably designed to address operational and other risks related to a significant disruption in their operations. The SEC also proposed to amend Rule 204-2 under the Advisers Act to require registered investment advisers to make and keep all business continuity and transition plans that are currently in effect or that were in effect at any time within the past five years.

Under proposed Rule 206(4)-4, the content of an SEC-registered adviser's business continuity and transition plan should include policies and procedures that address the following areas:

- Maintenance of critical operations and systems, and the protection, backup, and recovery of data;
- Pre-arranged alternate physical location(s) of the adviser's office(s) and/or employees;
- Communications with clients, employees, service providers, and regulators;
- Identification and assessment of third-party services critical to the operation of the adviser; and
- A plan of transition that accounts for the possible winding down of the adviser's business or the transition of the adviser's business to others in the event that the adviser is unable to continue providing advisory services.

Under proposed Rule 206(4)-4, the business transition components of a business continuity and transition plan would be required to include:

- Policies and procedures intended to safeguard, transfer and/or distribute client assets during transition;
- Policies and procedures facilitating the prompt generation of any client-specific information necessary to transition each client account;
- Information regarding the corporate governance structure of the adviser, including an organizational chart and other information about the adviser's ownership and management structure, such as the identity and contact information for key personnel, and the identity of affiliates (both foreign and domestic) whose dissolution or distress could lead to a change in, or material impact on, the adviser's business operations;
- The identification of any material financial resources available to the adviser; and
- An assessment of the applicable law and contractual obligations governing the adviser and its clients, including pooled investment vehicles, implicated by the adviser's transition.

The proposed rule would require that the plan be reasonably designed to minimize material service disruptions and to address the operational and other risks of each particular adviser, and thus an adviser would need only take into account the risks associated with its particular operations (*e.g.*, the nature and complexity of the adviser's business, its clients, and its key personnel).

Under proposed Rule 206(4)-4, each registered adviser would be required to review the adequacy of its business continuity and transition plan, and the effectiveness of its implementation, at least annually.

Please see our [July 8, 2016](#) client alert for more information.

Proposed Amendment to Accredited Investor Definition

The Dodd-Frank Act directed the SEC to review the definition of an “accredited investor” as it relates to natural persons every four years to determine whether the definition should be modified or adjusted. To satisfy this requirement, on December 18, 2015, the SEC issued a [staff report](#) on the accredited investor definition. The report includes several recommendations on the approaches that the SEC should consider in revising the accredited investor definition. These approaches include, among others: (i) implementing a test based on a person’s investments rather than such person’s assets; (ii) indexing all financial thresholds for inflation on a going-forward basis; and (iii) permitting individuals to qualify as accredited investors based on other methods of sophistication, such as experience investing in exempt offerings, certain professional credentials, or being a knowledgeable employee of the issuer.

Please see our [January 25, 2016](#) client alert for more information.

Higher Net Worth Threshold Adopted for Qualified Clients

On June 14, 2016, the SEC [adopted](#) its [proposal](#) to increase the net worth threshold for “qualified clients” under Rule 205-3 of the Advisers Act from \$2 million to \$2.1 million. The increase came into effect on August 15, 2016. This adjustment is being made pursuant to a five-year indexing adjustment required by section 205(e) of the Advisers Act.

Sponsors of section 3(c)(1) funds should keep in mind that:

- Prospective investor net worth representations in subscription agreements for section 3(c)(1) funds should reflect the updated threshold; and
- Documents used in effectuating secondary transfers of ownership interests in section 3(c)(1) funds should also contain representations to reflect the revised net worth requirements.

The new net worth threshold will not be retroactively applied to advisory contracts entered into prior to August 15, 2016.

Please see our [May 24, 2016](#) and [June 22, 2016](#) client alerts for more information.

Proposed Rule on Incentive-based Compensation Arrangements

On May 16, 2016, six federal agencies, including the SEC, issued a [joint release](#) inviting public comment on a [proposed rule](#) to prohibit or condition certain incentive-based compensation arrangements with employees. This proposed rule was mandated by section 956 of the Dodd-Frank Act and is a revision of the agencies’ [previously published proposed rule](#).

The proposed rule would only apply to “covered institutions” with average total consolidated assets greater than or equal to \$1 billion that offer incentive-based compensation to “covered persons.” A “covered institution” includes any institution that meets the definition of “investment adviser” under the Advisers Act, regardless of whether the institution is registered, or exempted or prohibited from registration, as an investment adviser under the Advisers Act. A “covered person” includes any executive officer, employee, director, or principal shareholder who receives incentive-based compensation at a covered institution.

For a covered institution that is an investment adviser, average total consolidated assets would be determined by the investment adviser’s total assets (exclusive of non-proprietary assets) shown on the balance sheet for the adviser’s most recent fiscal year-end. Significantly, the SEC stated that investment advisers should only include proprietary assets in the calculation and that, non-proprietary assets, such as

client assets under management, should be excluded, regardless of whether they appear on an investment adviser's balance sheet.

The SEC estimated that out of 11,702 investment advisers identified as either being registered with the SEC (**RIAs**), or reporting to the SEC as exempt reporting advisers (**ERAs**), 669 investment advisers (5.7% of registered RIAs and reporting ERAs) had total assets of at least \$1 billion as of December 31, 2014.

The requirements under the proposed rule are tiered based on assets. Specifically, covered institutions would be divided into three tiers:

- Level 1: Institutions with assets of \$250 billion and above;
- Level 2: Institutions with assets of \$50 billion to \$250 billion; and
- Level 3: Institutions with assets of \$1 billion to \$50 billion.

Covered institutions would be subject to general prohibitions on incentive-based compensation arrangements that could encourage inappropriate risk-taking by providing excessive compensation or that could lead to a material financial loss.

In particular, the proposed rule would require, among other things:

- Covered institutions to annually document the structure of incentive-based compensation arrangements and retain those records for seven years, including all incentive-based compensation plans, records of who is subject to each plan, and a description of how the incentive-based compensation program is compatible with effective risk management and controls. However, Level 3 covered institutions would not be required to report the actual amount of compensation, fees, or benefits of individual covered persons.
- Boards of directors of covered institutions to conduct oversight of incentive-based compensation arrangements.

Covered institutions would be required to be in compliance with an enacted final rule on the date of the beginning of the first calendar quarter that begins at least 540 days after the final rule is published in the Federal Register. Incentive-based compensation plans with performance periods that were in effect prior to the compliance date will not be subject to the regulations.

Speech by SEC Chair on Private Start-Ups and Private Funds

On March 31, 2016, SEC Chair Mary Jo White delivered the [keynote address](#) at the Silicon Valley Initiative. A substantial portion of Chair White's remarks focused on "unicorns," or private start-up companies with valuations exceeding \$1 billion. Chair White provided a number of regulatory signals not only to unicorns (and other investment-backed private companies), but also to the private funds that invest in them. There are a number of key takeaways from Chair White's speech for private investment funds:

- First, the SEC is monitoring unicorn valuations and the broader market implications (especially in the event of a unicorn bust). Where there has been so much discussion about the possibility of a unicorn bubble (and bust) it is not at all surprising that the SEC is focused on the area – regulators have been criticized in the past for being initially too passive and subsequently overly reactive.
- Second, in the event of substantial devaluations, the SEC is likely to scrutinize the roles of venture capital and private equity funds. Indeed, Chair White repeatedly referenced the roles (and the implicit obligations) of private funds with respect to private companies, emphasizing that securities

transactions in all companies, both public and private, are subject to SEC scrutiny under the anti-fraud provisions of the federal securities laws. In this vein, Chair White reminded the audience that “unregistered” does not necessarily mean “unregulated.”

- Third, the SEC is likely to scrutinize the facts and circumstances surrounding the financing and valuation of private companies, particularly those that involve substantial losses or changes in value. Chair White highlighted the duties of candor and fair dealing owed by companies seeking pre-IPO financing, especially with regard to information supplied to potential investors in connection with private offerings.
- Fourth, Chair White’s expansive view of “investors” includes “employees” who “are typically paid, in part, in stock and options” and other investors in later rounds of financing. These comments suggest that the SEC may focus on the effects of stock restrictions, including liquidation preferences or anti-dilution provisions, which could impact valuations and decision-making by portfolio company boards.

Please see our [May 4, 2016](#) post on Proskauer’s [Capital Commitment Blog](#) for more information.

Private Funds Litigation

Private investment funds are likely to face increased litigation risk in 2017 due to transparency and compliance initiatives of limited partners and other market developments. Here are several areas that should be on the top of every private fund sponsor’s list and how to assess and manage the associated risks.

Fees and Expenses. A critical issue is whether a particular fee/expense was adequately disclosed to investors at, or prior to, the time of the investment decision, which is often viewed in hindsight through the lens of current market practices. Sponsors should perform a comprehensive review to confirm adequate disclosure of the allocation of fund expenses. At a minimum, sponsors should update the disclosure in their Form ADV where necessary, and if there is a question as to the adequacy of the disclosure, also consider appropriate action, including obtaining consents or waivers from fund investors and/or, amending the fund’s governing documents.

Devaluation of Tech Unicorns. If there is a continued wave of unicorn devaluations and failures, sponsors should be prepared for ensuing private litigation. Stories in the press about down rounds and the impact on employees and early stage investors will fuel greater scrutiny. Potential areas of dispute could include preferential stockholder rights, such as liquidation preferences, valuation practices, trading in private companies, transfer restrictions, and various insolvency, creditor rights, and bankruptcy issues. Late stage investors, in particular, should be mindful of these risks.

On October 10, 2016, a San Francisco-based hedge fund filed a lawsuit in the Delaware Court of Chancery seeking to rescind a \$96.1 million investment the fund had made in 2014 in medical-testing company Theranos Inc. It was reported that while private investments implied a \$9 billion valuation for the company in 2014, as of June 21, 2016, a collection of industry experts concluded that a realistic current value for Theranos is approximately \$800 million.

Valuation Practices and Performance Marketing. Any significant devaluation of unicorns is likely to amplify the scrutiny of valuation practices, particularly of funds with significant exposure to unicorns. Fund investors will almost certainly focus on sponsors’ adherence to their own valuation policies, as well as discrepancies in valuations between private funds and mutual funds. Other areas of focus may include

the quality of a sponsor's valuation policy and whether it tracks the FASB Accounting Standards Codification for Fair Value Measurement (Topic 820).

Fund Extensions. By some accounts, there are more than 1,100 so-called zombie funds that are near or beyond the end of their contractual life with more than \$120 billion in unrealized assets in their portfolios. If market conditions deteriorate, opportunities to exit will diminish and the problem will worsen. Sponsors of private funds near or beyond the end of their contractual life should be aware of the appearances of potential conflicts of interest between the management company and fund investors as they seek an orderly and economical disposition of a fund's assets. Sponsors who seek to extend the terms of their funds should document the justifications for any extension, including the commercial benefits of the extension for their fund investors, and their strict compliance with the terms of the fund agreements for such extensions.

Litigation Risk to Sponsors Relating to Portfolio Companies. In litigation involving portfolio companies, there is a growing trend for plaintiffs to name as defendants not only the board of directors, including a sponsor's designees, but also the investment fund and affiliated sponsor entities. The claims often relate to the management and decision-making of the company involving change of control transactions, conflicts of interest, unfunded pension plans or catastrophic tort-related events. While there are a variety of suitable risk management precautions, the most important consideration for sponsors is to recognize that the economic benefits of control are not cost-free but come with legal obligations and increased risk of liability.

Cybersecurity. The SEC has stated that firms are expected to anticipate potential cybersecurity events and have clear written policies and procedures in place for the protection of private client information instead of waiting to react once a breach occurs. Accordingly, sponsors should proactively evaluate their exposure to cybersecurity threats from an operational perspective at both the firm and portfolio companies, and, if necessary, retain experts to assist.

Professional Liability Insurance. In the face of increased litigation risk, sponsors should re-examine their professional liability insurance programs in light of the scope of available indemnification rights, not just at the fund level but also from portfolio companies as shareholders and directors. A typical "off the shelf" general partner liability policy may be deficient in a number of important areas. Coverage review should include an assessment of whether the customary "insured versus insured" exclusion excludes claims by fund investors against the general partner or sponsor entities, and the relative priority between policies and with respect to indemnification rights. Please see [below](#) for more information on liability insurance developments.

It is clear that the litigation climate for private fund sponsors is rapidly changing. However, sponsors who take early and proactive steps to manage their risk will be well positioned to weather the storm.

CFTC Updates

Regulation AT Proposal

On December 17, 2015, the U.S. Commodity Futures Trading Commission (**CFTC**) published a [notice of proposed rulemaking \(Notice\)](#) for rules related to automated (also known as algorithmic) trading, collectively referred to as Regulation AT. On November 4, 2016, the CFTC [approved](#) a [supplemental proposal](#) to the Notice that revises and streamlines certain requirements of the Notice.

Of key potential interest to some hedge fund managers, the new rules, if adopted, may require a hedge fund manager to register with the CFTC as a floor trader if (i) it uses an algorithm to trade futures, (ii) the manager has direct access to a designated contract market (**DCM**), even if the trading is otherwise within the limits of the CFTC Rule 4.13(a)(3) exemption from CFTC registration, and (iii) it meets a minimum trading volume test of an aggregate volume of 20,000 contracts traded on average per day, for its own account, the accounts of customers, or both, over a six-month period (**Volume Test**). If adopted, Regulation AT would require AT Persons (as defined below) to maintain an algorithm source code repository that may be accessed by the CFTC via subpoena or a special call approved by the CFTC.

Regulation AT includes a very broad definition of “Algorithmic Trading” and a new term “AT Person” that would include any person registered or required to be registered with the CFTC that engages in algorithmic trading on a DCM and meets the Volume Test. The proposed definition of “AT Person” also includes a new category of previously unregistered persons that, as mentioned above, will be required to register as floor traders. Under the proposed regulation, any person or entity must register as a floor trader if such person or entity is not otherwise registered with the CFTC, but nonetheless engages in algorithmic trading via Direct Electronic Access and meets the Volume Test. “Direct Electronic Access” is defined under the proposed regulation as “the electronic transmission of an order for processing on or subject to the rules of a contract market, including the electronic transmission of any modification or cancellation of such order; provided, however, that this term does not include orders, or modifications or cancellations thereof, electronically transmitted to a designated contract market by a futures commission merchant that such futures commission merchant first received from an unaffiliated natural person by means of oral or written communications.” This potentially could mean that any person or entity that is otherwise not registered with the CFTC (including pursuant to the exemption under Rule 4.13(a)(3)), but which engages in some form of algorithmic trading through Direct Electronic Access to a contract market, must become registered.

The proposed regulation will impose a number of requirements on any AT Person registered with the CFTC in any capacity, including: (i) implementation of pre-trade risk controls and order cancellation systems; (ii) development, testing and ongoing monitoring of algorithmic trading systems (**ATS**), including the maintenance of a source code repository; and (iii) maintenance of certain books and records and the submission of an annual certification attesting to compliance with Regulation AT to each DCM on which the AT Person engages in algorithmic trading.

In particular, an AT Person will be required to:

- Adopt controls or “throttles” on the maximum order message and execution frequency for a certain designated period of time, parameters on the order price and maximum size limits on each order;
- Implement standards regarding the development and ongoing monitoring and compliance of any ATS; and
- Conduct ongoing training for employees that have been given responsibility for algorithmic trading.

The written policies and procedures related to the development and testing of ATS that would be required under Regulation AT include:

- Maintaining a “production trading environment” that is independent of the actual trading environment for use while developing, modifying and testing source code;
- Testing all source code and systems used for algorithmic trading before actual use;

- Regular and ongoing testing of the ATS to ensure that the ATS functions properly in a variety of market situations;
- Procedures to document the strategy and design of the ATS as well as any changes to the source code that have been implemented in the production trading environment; and
- Maintenance of a source code repository to manage source code access and copies of all code, and any changes thereto, used in the production trading environment. AT Persons will be required to maintain the source code repository and related records for five years. Upon request by the CFTC via subpoena or a special call approved by the CFTC, source code and related records will be subject to inspection.

Please see our [December 8, 2015](#) post on Proskauer's [Corporate Defense and Disputes Blog](#) and [January 25, 2016](#) client alert for more information.

[Proposed Amendments to Annual Report Regulations](#)

On July 29, 2016, the CFTC [proposed](#) amending regulations applicable to the Annual Report that each person registered as a commodity pool operator (**CPO**) (and each person required to be registered as a CPO) must distribute for each commodity pool that it operates. If adopted, the proposed amendment would (i) allow financial statements to be presented and computed in accordance with GAAP followed in the U.K., Ireland, Luxembourg, or Canada, and (ii) provide for an exemption from the audit requirement applicable to the Annual Report for a pool's first fiscal year when the period from formation of the pool to the end of the pool's first fiscal year is three months or less.

[Proposed Amendment to Exemption from Registration for Non-U.S. CPOs and CTAs](#)

On July 27, 2016, the CFTC [proposed](#) an amendment to Rule 3.10(c)(3)(i), which would change the conditions under which CPOs and commodity trading advisors (**CTAs**) located outside the U.S. would qualify for an exemption from registration with the CFTC. The proposed change would conform with the Dodd Frank Act (which subjected swap transactions to regulation under the Commodity Exchange Act, as amended (**CEA**)) and clarify ambiguity related to swap transactions. Under the current rules, CTAs and CPOs are eligible for an exemption from registration where the entity (i) is located outside the U.S., (ii) acts only on behalf of persons located outside the U.S., and (iii) submits commodity interest transactions for clearing through a registered futures commission merchant. Because not all swap transactions are required to be cleared, this exemption was difficult to apply in the case of swap transactions. If adopted, the proposed amendment would remove ambiguity by removing the clearing requirement of Rule 3.10(c)(3)(i), which would eliminate the risk that the CFTC would take enforcement action against a CPO or CTA that simultaneously is relying on Rule 3.10(c)(3)(i) and transacting in non-cleared swaps.

[NFA Introduces Late Fee](#)

On May 19, 2016, the Board of Directors of the National Futures Association (**NFA**) [approved](#) an amendment to [NFA Compliance Rule 2-46](#) to impose a \$200 late fee on CPO and CTA members for each business day the member files its quarterly NFA Form PQR or PR after the due date.

Payment and acceptance of the fee does not preclude the NFA from filing a disciplinary action for failure to comply with the deadlines imposed by NFA Compliance Rules or CFTC rules. The late fee is effective for all NFA Forms PQR and PR required under NFA Compliance Rule 2-46, beginning with reports dated September 30, 2016 and later.

NFA Proposes Collecting Additional Financial Information on Forms PQR and PR

On September 6, 2016, the NFA [proposed](#) an amendment to NFA Compliance Rule 2-46, which would require CPO and CTA members to report additional information about their financial condition. The proposal would require CPOs and CTAs to provide information in the form of two ratios: (i) the ratio of current assets to current liabilities, which is designed to measure a firm's liquidity; and (ii) the ratio of total revenue to total expenses, which is designed to measure a firm's operating margin.

FINRA/Broker-Dealer Updates

Capital Acquisition Brokers – A New Alternative for Private Funds Raising Capital

On August 18, 2016, the SEC [approved](#) FINRA's [proposal](#) to adopt a new limited membership category for broker-dealers that meet the definition of a "capital acquisition broker" (**CAB**). Generally, an entity qualifies as a CAB if it engages solely in specific capital raising or corporate advisory activities, including acting as a private fund placement agent. Firms that engage in other types of activities, such as carrying customer accounts, producing research or chaperoning non-U.S. broker-dealers under Rule 15a-6 of the Exchange Act, cannot register as CABs.

CAB registration provides a new alternative for private funds seeking to raise capital. Historically, many funds have relied on exemptions from broker-dealer registration, including a safe harbor under Exchange Act Rule 3a4-1, for the sale of their securities through their own officers or employees. However, this "self-sale" exemption is subject to a number of limiting conditions, including a prohibition against payment of transaction-based compensation. Another alternative for funds looking to raise capital is to hire a third-party registered broker-dealer to act as a placement agent. A third alternative is for the fund manager or an affiliate to register as a broker-dealer. However, operating a brokerage firm, with all of its attendant infrastructure and regulatory obligations, solely to raise capital is often viewed by fund managers as unduly burdensome. Because of the more limited regulatory obligations imposed on CABs, this new registration category may be a more viable alternative.

The [CAB rules](#) provide that persons associated with a CAB would be prohibited from participating in any manner in any securities transactions outside the regular course or scope of the associated person's employment with the CAB. This condition may ultimately restrict, or negate, the utility of the CAB registration with respect to private equity fund portfolio company transactions.

Although the registration process for CABs is the same as for full service broker-dealers, the limited scope of their activities and regulatory responsibilities may mean that CAB applications are processed more expeditiously. Once registered, firms that qualify as CABs may elect to be governed under the more streamlined CAB rules. CAB principals and representatives will have to meet the same registration, examination and continuing education requirements as associated persons at other broker-dealers.

CABs will be subject to more limited conduct, supervision and financial and operational rules, among others. They will have greater flexibility to tailor their supervisory structures to their particular business models. So, for example, CABs will not be subject to the requirements for annual compliance meetings, review and investigation of transactions, documentation and supervisory procedures for supervising personnel, and internal inspections. Although CABs will have to designate a chief compliance officer, there is no requirement that the chief executive officer provide an annual certification regarding compliance policies and supervisory procedures.

While FINRA has lessened the regulatory burden on CABs, they will remain subject to the FINRA bylaws, core FINRA rules that FINRA believes should apply to all of its members and other applicable federal securities regulations. CABs and their associated persons will continue to be responsible for understanding and complying with these requirements. It is too soon to know how FINRA's expectations around CAB compliance and supervision will evolve. Thus, whether the more limited regulatory requirements applicable to CABs will make the registration category sufficiently attractive to private funds looking to raise capital ultimately remains to be determined.

[FINRA Regulatory Notice 16-37](#) provides that the effective dates for the CAB program are set at January 3, 2017 (for CAB Member Application and Associated Person Registration Rules) and April 14, 2017 (for all other CAB Rules).

SEC Takes Action on FINRA and MSRB Pay-to-Play Rules

On September 20, 2016, the SEC issued a pair of orders finding that FINRA [Rule 2030](#), and Municipal Securities Rulemaking Board (**MSRB**) [Rule G-37](#) are consistent with the SEC's own pay-to-play rule, Rule 206(4)-5 under the Advisers Act. The relevant amendments to MSRB Rule G-37 became effective August 17, 2016, and FINRA Rule 2030 will become effective on August 20, 2017. Following this latter date, Rule 206(4)-5 will make it unlawful for any investment adviser, or its covered associates, to provide or agree to provide, directly or indirectly, payment to any third party to solicit government clients for investment advisory services on its behalf, unless such third parties are registered (i) investment advisers, (ii) broker-dealers, or (iii) municipal advisors subject to the rules of the MSRB.

State Regulatory Updates

New California Law on Increased Disclosure of Private Fund Fees and Expenses

On September 14, 2016, the Governor of California approved a [bill](#) adding Section 7514.7 to the California Government Code, which imposes significant new disclosure requirements for private funds with investments by California state and local public pension and/or retirement systems, including the University of California's retirement plan (**Public Plan Investors**).

Section 7514.7 will apply to Public Plan Investors investing in private investment funds (defined to include private equity funds, venture capital funds, hedge funds and absolute return funds) on and after January 1, 2017. A Public Plan Investor will be required to obtain assurances that the fund will make specified disclosures regarding fees, expenses, carried interest and portfolio company fees, in addition to other specified information. Section 7514.7 will also require a Public Plan Investor to disclose such information, as well as the gross and net rates of return of the fund since inception, at least once annually at a meeting open to the public.

Specifically, each Public Plan Investor will need to require each private investment fund in which it invests to make each of the following disclosures to the Public Plan Investor at least annually:

- Fees and expenses that the Public Plan Investor pays directly to the private investment fund, the fund manager (including the general partner) or related parties;¹

¹ A "related party" includes (i) any current or former employee, manager, or partner of any entity owned 10% or more by related persons (as defined in Section 7514.1) that is involved in the investment activities or accounting and valuation functions of the general partner, investment adviser or separate carried interest vehicle (each a **relevant entity**), and (ii) any operational partner, senior advisor, or other consultant or employee whose

- The Public Plan Investor's pro rata share of fees and expenses not included in the item above that are paid from the private investment fund to the fund manager or related parties. The Public Plan Investor may independently calculate this information based on information contractually required to be provided by the private investment fund to the Public Plan Investor. If the Public Plan Investor independently calculates this information, then the private investment fund will not be required to provide the information identified in this item;
- The Public Plan Investor's pro rata share of carried interest distributed by the private investment fund to the fund manager or related parties;
- The Public Plan Investor's pro rata share of aggregate fees and expenses paid by all portfolio companies held by the private investment fund to the fund manager or related parties; and
- Certain other information required to be disclosed upon request pursuant to Section 6254.26 of the [California Public Records Act](#) (e.g., the name, address, and vintage year of the private investment fund; the private investment fund's net internal rate of return and investment multiple since inception; and the dollar amount of the commitment and cash contributions made by the Public Plan Investor to the private investment fund).

Section 7514.7 will apply to new contracts entered into on or after January 1, 2017, and for existing contracts for which a new capital commitment is made on or after January 1, 2017. Section 7514.7 will also require Public Plan Investors to undertake reasonable efforts to obtain the above-mentioned information with respect to contracts in place prior to January 1, 2017.

Please see our [September 27, 2016](#) client alert for more information.

Other State Legislation. Additionally, on February 11, 2016, Illinois House Bill 6292 was filed which would impose similar requirements on advisers to private funds with Illinois public pension plan investors. It has been reported that the Illinois House is likely to vote on a version of Bill 6292 in November 2016. However, if passed, it cannot be predicted with certainty whether the current republican gubernatorial administration will sign Bill 6292 into law. Additionally, the Illinois Senate may further amend Bill 6292.

Similar legislation may be introduced in other states. Accordingly, sponsors of private investment funds should be vigilant for potential disclosure requirements that could apply in connection with investments secured from state and local retirement and pension plans and consult with counsel versed in these areas to ensure that provisions in fund governance documents comply with statutory requirements.

Insider Trading Updates

All eyes are on the Supreme Court, which heard oral argument on October 5, 2016 in *Salman v. United States*, Docket No. 15-628. The Court's decision could resolve a possible circuit split between the Second Circuit and the Ninth Circuit (as well as the First Circuit) on the nature of the "personal benefit" needed to create liability for insider trading, although the Court could go even further and reshape the entire law of insider trading. Meanwhile, the SEC brought several insider trading cases, including a settlement with a hedge fund adviser on a failure-to-supervise claim, and the CFTC has begun to pursue insider-trading claims based on theories familiar from securities laws.

primary activity for a relevant entity is to provide operational or back office support to any portfolio company, private investment fund or account manager by a related person.

Waiting for *Salman*

As we noted in our [2014](#) and [2015](#) Annual Reviews of insider-trading issues, a debate has been raging about the nature of the “personal benefit” needed to establish insider-trading liability. The personal-benefit requirement stems from the Supreme Court’s 1983 decision in *Dirks v. SEC*, 463 U.S. 646 (1983), which established the framework for a tippee’s liability. The Supreme Court held that tippee liability depends in part on tipper liability – and that a tipper cannot be liable for disclosing material, nonpublic information unless he or she breached a fiduciary (or fiduciary-like) duty by doing so. That breach of duty requires not only the disclosure of the confidential information, but also the receipt of a personal benefit in exchange for the disclosure. The Supreme Court defined the “personal benefit” that constitutes the insider’s breach of duty as including “a pecuniary gain or a reputational benefit that will translate into future earnings [...] The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend.”

The personal-benefit requirement had generally been viewed as relatively easy to meet. Courts had often concluded that even generalized, nonpecuniary benefits such as friendship and psychic gratification could satisfy the *Dirks* standard.

Second Circuit. In *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), however, the Second Circuit construed – or narrowed (depending on one’s viewpoint) – *Dirks*’s language and held that “the mere fact of friendship, particularly of a casual or social nature,” does not prove receipt of a personal benefit. An inference of personal benefit based on a mere personal relationship between the tipper and the tippee “is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature. In other words [...] this requires evidence of a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the [latter].” Thus, “the personal benefit received in exchange for confidential information must be of some consequence.”

Turning to the facts of the *Newman* case, the Second Circuit found insufficient evidence to suggest that the tippers had received any personal benefit for disclosing their employers’ allegedly material, nonpublic information. The tippers and their direct tippees had not had a close personal relationship, and the tippers had not received anything resembling a classic quid pro quo. One of the tippers had known his direct tippee for years, having attended the same school and worked together at the same company. But the tipper had received only “career advice” from the tippee – the kind of “encouragement one would generally expect of a fellow alumnus or casual acquaintance.” The other tipper purportedly had had even less of a relationship with his direct tippee. The two had been “merely casual acquaintances” – “family friends” who had met through church and had “occasionally socialized together.” The Second Circuit therefore ruled that the tippers had not received cognizable personal benefits – although that holding was arguably dictum because the Second Circuit first concluded that the remote tippees’ convictions should be reversed because of a lack of evidence that the tippees had known (or should have known) that the tippers had breached any duty of confidentiality in exchange for any personal benefit.

Ninth Circuit. The *Newman* decision set off a firestorm and led to a possible circuit split with the Ninth Circuit, which held in *United States v. Salman*, 792 F.3d 1087 (9th Cir.), cert. granted in part, 136 S. Ct. 242 (2015), that insiders can engage in insider trading if they disclose material, nonpublic information with the intent to benefit a trading relative or friend, even if the tippers do not receive a pecuniary gain or other quid pro quo type of benefit in exchange for the tips.

The *Salman* case arose from an alleged insider-trading scheme involving members of an extended family. The tipper, who worked for an investment bank, had allegedly provided confidential information to his brother about upcoming transactions involving the bank's clients. In so doing, the tipper had known that his brother would trade on the information. The brother then tipped Salman, whose sister had become engaged to and later married the tipper. The brother eventually pled guilty to insider trading and testified for the Government against Salman.

The Ninth Circuit held that the case was governed by *Dirks's* statement that "[t]he elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend." The tipper's "disclosure of confidential information to [his brother], knowing that [the brother] intended to trade on it, was precisely the 'gift of confidential information to a trading relative' that *Dirks* envisioned." The court also found sufficient evidence that Salman had known the initial source of the tip and "could readily have inferred [the tipper's] intent to benefit [his brother]."

The Ninth Circuit rejected Salman's *Newman*-based argument that the tipper needed to have received "at least a potential gain of a pecuniary or similarly valuable nature," and the trial record did not contain evidence of any such concrete benefit. Instead, the Ninth Circuit ruled that, "[t]o the extent *Newman* can be read to go so far, we decline to follow it. Doing so would require us to depart from the clear holding of *Dirks* that the element of breach of fiduciary duty is met where an 'insider makes a gift of confidential information to a trading relative or friend.'" The court added that, if evidence of a desire to benefit a friend or relative could not suffice to establish a tipper's breach of duty, insider trading could proliferate: "a corporate insider or other person in possession of confidential and proprietary information would be free to disclose that information to her relatives, and they would be free to trade on it, provided only that she asked for no tangible compensation in return."

Salman petitioned for certiorari, and the Supreme Court granted the petition – although it had previously denied the Government's certiorari petition in *Newman*. One would hope that the Court will take this opportunity to clarify the nature of the "personal benefit" needed to support an insider-trading claim. With *Dirks's* personal-benefit requirement now before the Court, anything is possible, and the Court could choose to revisit the entire nature of insider-trading liability – as some amici curiae have urged it to do. The Government essentially did so as well, arguing for a bright line between use/disclosure of material, nonpublic information for corporate purposes and use/disclosure of such information for noncorporate, presumably personal purposes. But the oral argument seemed to suggest that the Court might stick with some version of *Dirks*, perhaps with some refinements. The Justices did not appear eager to require an actual financial benefit, at least in cases involving family members.

First Circuit. Meanwhile, the lower federal courts have tried to navigate between *Newman* and *Salman*. The First Circuit, in two related cases – *United States v. Parigian*, 824 F.3d 5 (1st Cir. 2016), and *United States v. McPhail*, ___ F.3d ___, 2016 WL 3997214 (1st Cir. July 26, 2016) – adhered to its pre-*Newman* precedent, which appears to be more in line with Ninth Circuit law under *Salman* than with Second Circuit law under *Newman*.

Parigian and *McPhail* involved an alleged insider-trading ring in which the original tipper had received inside information from a corporate executive and had then tipped his "golfing buddies." The tipper had allegedly "solicited 'getting paid back' by [the tippees] with wine, steak, and visits to a massage parlor," as well as a golf outing.

In *Parigian*, the First Circuit recognized that the Second Circuit (in *Newman*) had “recently adopted a more discriminating definition of the benefit to a tipper in a classical insider trading case, rejecting as insufficient the mere existence of a personal relationship ‘in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.’” The court also noted that the Ninth Circuit (in *Salman*) “seemed to align itself more closely with our holding in” *SEC v. Rocklage*, 470 F.3d 1 (1st Cir. 2006), which had held that “the mere giving of a gift to a relative or friend is a sufficient personal benefit’ to the giver.”

The First Circuit concluded: “How this will all play out, we do not venture to say because, as a three-judge panel, we are bound to follow this circuit’s currently controlling precedent. We therefore hold that the indictment’s allegations of a friendship between [the tipper] and [the tippee] plus an expectation that the tippees would treat [the tipper] to a golf outing and assorted luxury entertainment is enough to allege a benefit if a benefit is required.”

Sean Stewart Trial. In another high-profile case, the Government won a conviction in August 2016 in *United States v. Stewart*, No. 1:15-cr-00287 (S.D.N.Y.), a criminal prosecution against a former investment banker who had allegedly misappropriated his employer’s confidential information about healthcare company mergers and had tipped his father. The father had then provided the information to at least one friend, who traded on the information. Both the father and the friend pled guilty.

The son testified at trial that he had expected his father to keep the information confidential, but that his father had betrayed him. The jury apparently did not believe that testimony.

The son also contended that, under Second Circuit law as established in *Newman*, he had not received a legally cognizable personal benefit in exchange for his alleged tips. The prosecution argued, however, that the son had benefited from his father’s trades because the father had paid \$10,055 for the photographer at the son’s wedding. That alleged benefit appears to have been enough for the jury (and for the judge, on the defendant’s unsuccessful motion to dismiss). Stay tuned for the appeal, which will likely be affected by the Supreme Court’s ruling in *Salman*.

SEC Enforcement Highlights

SEC Charges Hedge Fund Manager as a Temporary Insider. On September 21, 2016, the SEC [charged](#) a well-known hedge fund manager and his firm with insider trading based on material nonpublic information he learned in confidence from a corporate executive. According to the [SEC complaint](#), the fund was one of the company’s largest shareholders and the fund manager used this status to gain access to the executive and obtain confidential details about an asset sale. The SEC alleges that during a series of conversations, the fund manager explicitly agreed to keep the nonpublic information confidential and not to use it for trading purposes, but instead caused his fund to purchase securities after learning the information. The complaint does not allege any personal benefit given to the source of the information, and the defendants are contesting the SEC’s allegations.

Notably, the SEC did not file this insider trading case in the Second Circuit, where *Newman*’s “personal benefit” analysis might apply. Instead, it filed in the Third Circuit, and is relying on the theory that the fund manager was a temporary “insider” and thus had a duty to refrain from trading. In 2014, the Third Circuit Court of Appeals previously approved the SEC’s Rule 10b5-2 under the Exchange Act, which sets out additional categories of relationships that give rise to a duty to disclose or refrain from trading. These categories include “[w]henver a person agrees to maintain information in confidence” or “[w]henver the

person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences.” *United States v. McGee*, 763 F.3d 464 (3d Cir, Aug 14, 2014). The Third Circuit held in that case that a tippee’s history of confidential communications as an Alcoholics Anonymous sponsor was enough to give rise to a duty under Rule 10b5-2. It is conceivable that if the case were filed in the Second Circuit, *Newman* would require a showing of a personal benefit to the tipper as well as a duty of confidence; some district courts in the Second Circuit have held that the personal benefit requirement applies in misappropriation cases as well. In our view, this complaint may not have survived under *Newman*’s personal benefit analysis.

SEC Settlement on Hedge Fund Adviser’s Failure to Supervise. On October 13, 2016, the SEC [announced](#) it had settled an administrative proceeding against a hedge fund adviser and its senior research analyst for failing to supervise another analyst “with a view to detecting and preventing his violations of the federal securities laws.” According to the [SEC order](#), the settlement involved the adviser allegedly trading on material, nonpublic information that one of its analysts had received from an insider at a public company that was being acquired by another company.

The SEC seems to have focused on the alleged circumstances that, “[u]nlike a typical research analyst at a hedge fund advisory firm, [the analyst] did not construct analytical models regarding financial performance of the companies he covered, did not provide written reports supporting his recommendations to buy or sell the securities of such companies, and did not maintain his research files available for review by his supervisor. . .or others at [the adviser]. Instead, [the analyst] based his recommendations primarily on information from his industry sources and communicated this information and his trading recommendations to [his supervisor] or others at [the adviser] by telephone.” In addition, “unlike most of the other analysts,” the analyst at issue worked out of his home, rather than his employer’s office, “and spent much of his time communicating with industry sources about technology companies that he covered.”

The SEC concluded that these alleged “red flags” should have alerted the adviser and the supervisor to risks of potential insider trading: “Despite knowledge of [the analyst’s] role as an analyst making recommendations primarily based on information gathered from industry sources, and [his] relationships with industry insiders, [the adviser] did not take steps to ensure that (i) its policies relating to insider trading were adequately enforced, and (ii) it had systems in place to ensure that [the adviser] was not trading on the basis of material nonpublic information. For example, [the adviser] did not require [the analyst] (who worked outside of [the adviser’s] offices) to report his interactions with employees of public companies, and it did not have policies to track or monitor these interactions.” The adviser and the supervisor settled with the SEC without admitting or denying the allegations.

This proceeding might have involved an unusual set of alleged facts, in that the SEC viewed the analyst’s modus operandi as “[u]nlike [that of] a typical research analyst at a hedge fund advisory firm.” However, this proceeding might also indicate a heightened interest in scrutinizing advisers’ policies and procedures when an employee has allegedly used or provided material, nonpublic information.

[CFTC Tackles Insider Trading](#)

The CFTC has now gotten into the act on insider trading. In 2010, Congress amended the CEA through the Dodd-Frank Act. Those amendments drew from the language of the Exchange Act and allow the CFTC to pursue claims based on fraud, not just on market manipulation. The CEA thus provides

essentially the same statutory framework available to the SEC and the DOJ to pursue insider-trading claims under the securities laws.

The CFTC exercised its newly given enforcement authority under the Dodd-Frank Act to take its first enforcement action against insider trading. On December 2, 2015, the CFTC [announced](#) the filing and simultaneous settlement of an [administrative proceeding](#) against a proprietary trader in the office of a large public company. The proceeding, *In the Matter of Arya Motazed*, adopted the securities laws' "misappropriation theory" of insider trading and charged the trader with misusing his employer's proprietary and confidential information about the times, amounts, and prices at which the company intended to trade energy commodity futures for its own account. The CFTC contended that the trader had "cheated and defrauded his employer by engaging in a series of trades between [his] personal accounts and the company account at prices favorable to the personal accounts as well as misappropriating his employer's confidential business information by placing personal orders ahead of the orders he placed for the company's trading account."

The *Motazed* proceeding suggests that the CFTC might now be interested in using the CEA as the SEC and the DOJ have been using the securities laws to prosecute alleged insider trading. In fact, the CFTC is pursuing other investigations based on securities law theories of liability. To the extent that it seeks to import those theories into the CEA, however, the CFTC will presumably find itself subject to the same limitations that apply under the securities laws, including the personal-benefit requirement at issue in *Newman* and *Salman* as well as the requirement that a remote tippee had known (or should have known) about the tipper's breach of duty and receipt of a personal benefit.

FCPA Updates

Enforcement of the FCPA remains a top priority of the DOJ and the SEC. This year, we saw the first significant action by both the DOJ and the SEC targeting the private fund industry, an action that the government had been forewarning for years. With more sure to come, this is an important time for advisers to private investment funds to conduct risk assessment of their corruption risks, review their compliance programs, engage in targeted training of their officers and employees, and, if necessary, make tailored adjustments.

The FCPA contains two components: (i) the anti-bribery provision and (ii) the accounting provisions. The anti-bribery component of the statute broadly prohibits corruptly offering or giving anything of value to a foreign official with the intent to obtain or retain business. The statute also includes certain accounting provisions, which require "issuers" to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer" and to "devise and maintain a system of internal accounting controls." There are many nuances to the statute and advisers should provide employees with regular training to make sure that employees understand the statute, the risks, and the adviser's compliance program.

SEC and DOJ FCPA Enforcement Activity

There have been 22 corporate FCPA-related enforcement actions by the SEC and DOJ in 2016 – the most in FCPA history. These enforcement actions have encompassed a number of different industries, including the pharmaceutical, finance, manufacturing, consumer products, energy, technology, healthcare, and telecommunications sectors.

On September 29, 2016, a private fund manager agreed to settle charges related to potential violations of the FCPA. This settlement provides important guidance for private funds. The settlement sets forth the government's FCPA compliance expectations in great detail for this manager, and all private fund managers should follow these expectations in light of their own particular circumstances. The private fund manager's agreement with the DOJ, for example, requires that the private fund manager's internal controls, compliance code, policies and procedures going forward should, at a minimum, contain the following elements:

- **High-Level Commitment.** Support and commitment from directors and senior management for the firm's anti-corruption policy and its compliance code.
- **Policies and Procedures.** A clearly articulated anti-corruption policy memorialized in the firm's written compliance code. The policy should apply to all directors, officers, and employees. Also, where necessary and appropriate, the policy should apply to outside parties acting on behalf of the firm in non-U.S. jurisdictions (*e.g.*, agents, intermediaries, consultants, and joint venture partners). Among other things, the policy should address gifts; hospitality, entertainment, and expenses; customer travel; political contributions; charitable donations; facilitation payments; and solicitation and extortion.
- **Periodic Risk-Based Review.** Periodic risk assessments tailored to the firm's individual risks/circumstances (*e.g.*, geographic footprint, government interaction, industrial sectors, and involvement in joint venture arrangements). The firm should review and update its anti-corruption policies and procedures at least once per year.
- **Proper Oversight and Independence.** One or more corporate executives who are assigned responsibility for implementation and oversight of the firm's anti-corruption compliance code, policies and procedures. The corporate executive(s) should have the authority to report directly to independent monitoring bodies, including internal audit, the board of directors, or any appropriate committee of the board of directors. The executive should also have an adequate level of autonomy from management as well as sufficient resources.
- **Training and Guidance.** Mechanisms designed to ensure that the firm's anti-corruption compliance code, policies and procedures are effectively communicated throughout the firm. These mechanisms include (i) periodic training for all directors and officers, all employees in positions of leadership or trust, positions that require such training (*e.g.*, internal audit, sales, legal, compliance, and finance), positions that pose a particular corruption risk, and, where necessary and appropriate, certain agents and business partners; and (ii) corresponding certifications by these directors, officers, employees, agents, and business partners that they have complied with the firm's training requirements.
- **Internal Reporting and Investigation.** An effective system for internal and confidential reporting concerning potential anti-corruption violations. The firm should also maintain an effective, reliable, and sufficiently-resourced process for responding to, investigating, and documenting potential anti-corruption violations.
- **Enforcement and Discipline.** Mechanisms designed to effectively enforce the firm's compliance code, policies, and procedures, including appropriately incentivizing compliance and disciplining violations. The firm should also have appropriate disciplinary procedures to address anti-corruption violations. These procedures should be applied consistently and fairly, regardless of the position held by the director, officer, or employee who commits the violation. The procedures should also ensure

that where misconduct is discovered, reasonable steps are taken to remedy the harm resulting from such misconduct and prevent similar misconduct in the future.

- **Third-Party Relationships.** Appropriate risk-based due diligence and compliance requirements pertaining to the retention and oversight of agents and business partners. The firm should make sure to properly document its due diligence efforts. The firm should also inform its agents and business partners of its commitment to abiding by the anti-corruption laws, and its compliance code, policies, and procedures, while seeking reciprocal commitments from its agents and business partners. Where necessary or appropriate, the firm should include provisions in its contracts with agents and business partners that are reasonably calculated to prevent anti-corruption violations. Depending on the circumstances, these provisions may include anti-corruption representations and warranties, audit rights, and the right to terminate an agent or business partner as a result of any anti-corruption violation.
- **Mergers and Acquisitions.** Policies and procedures for mergers and acquisitions requiring that the firm conduct appropriate risk-based due diligence on potential new business entities, including anti-corruption due diligence by legal, accounting, and compliance personnel. The firm should also take steps to ensure that its anti-corruption compliance code, policies, and procedures apply as quickly as practicable following a merger or acquisition.
- **Monitoring and Testing.** Periodic reviews and testing of the firm's anti-corruption compliance code, policies, and procedures. The reviews should take into account relevant developments in the field and evolving international and industry standards.

In addition to the above, some of the requirements in an accompanying SEC order appear to be tailored specifically for the fund manager's private funds and warrant special consideration:

- **Enhanced Controls.** Enhanced controls over foreign private equity investments, including enhanced transactional and partner due diligence, increased monitoring of how the firm's funds are used in high-risk transactions, individual anti-corruption representations and warranties for principals, limited use of offshore holding companies as recipients for funds, and enhanced steps to identify beneficial owners of offshore holding companies being paid in connection with foreign private equity transactions.
- **Policy Addressing Use of Third-Party Placement Agents to Solicit Investors.** A policy forbidding use of third-party placement agents or middlemen in soliciting investors into managed funds unless their use is (i) approved by the firm's Business Risk Committee, and (ii) limited to regulated financial entities.
- **Policy Addressing Use of Third-Party Consultants in Foreign Private Equity Transactions.** A policy forbidding the use of third-party consultants, finders, agents, or other intermediaries in foreign private equity transactions unless the use is (i) consistent with local law, and (ii) approved by the firm's Chief Compliance Officer or Business Risk Committee.
- **Veto Power.** A veto right in all matters that come before the firm's Business Risk Committee for the firm's General Counsel and Chief Compliance Officer.
- **Investment Committee Structure.** An investment committee, with representation from the General Counsel and Chief Compliance Officer or their designees, to review all private equity transactions.

- **Investment Committee Approval.** Approval from the investment committee for all private equity transactions.

The SEC order also required the firm to separate its Chief Compliance Officer position from other officer positions. The manager will be required to designate a Chief Compliance Officer who does not simultaneously hold any other officer position at the firm. The SEC appears to be placing a strong emphasis on companies having an independent compliance function.

[An Expanding and Aggressive Enforcement Environment](#)

The government is dedicating more and more resources to enforcement of the FCPA. The DOJ has [announced](#) that it plans to dedicate additional resources to combatting foreign corruption. Recently, the Criminal Division's Fraud Section doubled the size of its FCPA unit, adding ten more prosecutors to its ranks, and the FBI established three new squads of special agents devoted to FCPA investigations and prosecutions.

The SEC and the DOJ, meanwhile, have continued to advance an expansive interpretation of the FCPA. As noted above, the FCPA prohibits corruptly offering or giving "anything of value" to a foreign official with the intent to obtain or retain business. The SEC and DOJ have interpreted this broadly, bringing enforcement actions this year against companies for providing employment and paid internships to foreign officials' family members and for making a donation to a charity identified by a foreign official.

Perhaps most alarming is the extraterritorial jurisdiction routinely exerted over activity with nominal connection to the U.S. The DOJ has not hesitated to investigate foreign nationals working for foreign companies who pay bribes to foreign officials in connection with wholly foreign transactions, even where there is only a single minor connection to the U.S.

In our [2015 Annual Review](#), we discussed *United States v. Hoskins*, No. 12 Cr. 238, 2015 WL 4774918 (D. Conn. Aug. 13, 2015), a case where the district court held that non-resident foreign nationals who are not agents of a "domestic concern" and do not commit acts while present in the U.S. cannot be subject to FCPA liability under an accomplice liability theory. This significantly curtailed the DOJ's expansive interpretation of the FCPA's jurisdictional reach. The DOJ subsequently appealed the decision, and the Second Circuit is now set to hear the case.

Even where the government lacks jurisdiction to bring charges under the FCPA, the DOJ and the SEC have employed other avenues, such as money laundering statutes or securities laws, to achieve the same end. For example, in 2015, the SEC brought an enforcement action against a London-based subsidiary of a South African bank. The underlying misconduct involved improper payments made to a foreign official in connection with a debt offering made by the Government of Tanzania, but the SEC did not have jurisdiction to bring charges under the FCPA because the bank was not an issuer. Instead, the SEC charged the bank with failing to disclose material facts about the bond offering in violation of Section 17(a)(2) of the Securities Act of 1933 (**Securities Act**).

Private funds now must also be conscious that the SEC and the DOJ are receiving increased cooperation from foreign regulators. According to Leslie Caldwell, Assistant Attorney General of the DOJ's Criminal Division, "we are strengthening our coordination with foreign counterparts – sharing leads, making available essential documents and witnesses, and more generally working together to reduce criminals' ability to hide behind international borders. The fruits of this approach can be seen in numerous recent successful prosecutions."

One example of this increased international cooperation is the enforcement action the SEC and DOJ brought this year against Dutch telecommunications provider, VimpelCom Ltd. In February 2016, VimpelCom entered into a [global settlement](#) with the DOJ, the SEC, and Dutch regulators. As part of the settlement, VimpelCom agreed to pay more than \$795 million to resolve allegations that it offered and paid bribes to government officials in Uzbekistan to secure government-issued licenses. Under the terms of the settlement, VimpelCom will pay \$167.6 million to the SEC, \$230.1 million to the DOJ, and \$397.5 million to Dutch regulators. Notably, the DOJ and the SEC received assistance from law enforcement agencies in the Netherlands, Sweden, Switzerland, Latvia, Belgium, France, Ireland, Luxembourg, and the U.K. when investigating VimpelCom's alleged misconduct.

The government has also sought to spur enforcement through the implementation of programs designed to encourage individuals and companies with knowledge of potential FCPA-related misconduct to come forward with that information. The whistleblower provisions under the Dodd-Frank Act provide employees with an incentive to come forward and report potential FCPA-related misconduct to the SEC. According to its [2015 Annual Report to Congress](#) on the Dodd-Frank Whistleblower Program, the SEC received 186 tips in FY2015 concerning potential FCPA violations. That number is up from 159 FCPA-related tips in FY2014, 149 in FY2013, and 115 in FY2012. The SEC also reportedly paid its first FCPA-related whistleblower award this year. Although the SEC does not identify whistleblowers, various media outlets reported that the SEC paid an employee \$3.75 million for information regarding the alleged bribery of foreign officials.

The DOJ and the SEC have also repeatedly emphasized company self-reporting of FCPA violations. In April 2016, the DOJ [announced](#) the launch of a new one-year pilot program designed to encourage companies to self-report potential FCPA violations. The DOJ's stated objective of the pilot program is to provide greater transparency into the DOJ's charging decisions and to provide an incentive for companies to self-disclose FCPA misconduct. The DOJ hopes, among other things, that the program will spur additional enforcement against individual bad actors.

Under the pilot program, companies that voluntarily self-disclose FCPA-related misconduct, cooperate with the government, and remediate flaws in their compliance programs will be eligible for enhanced mitigation credit. Where companies meet these requirements and agree to disgorge all profits resulting from the FCPA violation, they will be eligible for a 50% reduction off the bottom end of the Sentencing Guidelines and generally will not require appointment of a monitor. At the same time, where no voluntary self-disclosure has been made, the program provides that companies will receive, at most, a 25% reduction off the bottom end of the Sentencing Guidelines.

When the program was announced, one of the big questions was whether the DOJ would come through on its promise to give corporations meaningful credit when they voluntarily disclose FCPA-related misconduct. Now, six months into the pilot program, the DOJ has issued public declinations for five companies that have met the program's requirements.

Please see our [April 6, 2016](#) post on Proskauer's [Corporate Defense and Disputes Blog](#) for more information on the DOJ's new pilot program.

Key Risks for Private Funds

Hedge funds and private equity funds share many of the same anti-corruption risks. The fundamental differences between their business models, however, make some risks more acute than others.

As illustrated in the SEC's enforcement action, one of the greatest anti-corruption risks for hedge funds arises when securing capital from foreign officials and government entities, including sovereign wealth funds. Fundraising is often facilitated by local third-party agents who are familiar with the potential investing entities. Once a relationship is formed, local agents may be tasked with maintaining it. These interactions are a primary source of legal risk. A large number of FCPA enforcement actions in recent years have arisen from the use of third-party agents.

Private equity funds must also take care when using third-party agents to secure potential investments and maintain relationships. However, private equity funds' anti-corruption risks also arise out of portfolio investments themselves, even when limited to the private sphere. Many private companies in emerging markets have weak anti-corruption programs governing their own interactions with foreign government officials. Private equity funds can be held liable for those companies' past, present and future corrupt activities. Managerial control, board seats, voting rights and veto powers are some of the indicia of control that can confer additional liability for an investment's activities, even when holding a minority interest. Actions of joint venture partners can likewise create liability for a private equity fund. The fund can also inherit successor liability for an acquisition's past wrongs. Even absent liability for the corrupt activities of an investment, there are significant negative publicity risks. Any anti-corruption investigation or enforcement action can severely impact a private equity fund.

The SEC's enforcement action, the new pilot program, the increase in whistleblower reports, and the government's stated emphasis in these industries underscore the importance of having an effective compliance and ethics program – something hedge funds, private equity firms, and other financial institutions can take proactive steps to put in place and improve upon.

Anti-Money Laundering Updates

FinCEN Issues Final Rule on Beneficial Ownership

On May 11, 2016, the Financial Crimes Enforcement Network (**FinCEN**), a bureau of the U.S. Department of the Treasury (**Treasury Department**), issued a [final rule](#) that, among other things, requires "covered financial institutions" to collect and verify personal information about the beneficial owners of "legal entity customers" opening new accounts. Financial institutions covered under the new rule include banks, broker-dealers, mutual funds, futures commission merchants, and introducing brokers in commodities. Legal entity customers include corporations, limited liability companies (**LLCs**), and other entities created by filing a public document with a Secretary of State or similar office, as well as general partnerships and certain entities formed in foreign jurisdictions.

Under the rule, which goes into effect on May 11, 2018, covered financial institutions generally will be required to identify and verify the identity of two types of beneficial owners: (i) individuals who own 25% or more of the equity interests of the legal entity customer; and (ii) a single individual with "significant responsibility to control, manage, or direct" the legal entity customer.

However, the rule excludes certain customers from its identification and verification requirements. Customers that are not subject to the identification and verification requirements include:

- Financial institutions regulated by a federal functional regulator;
- Entities listed on the NYSE, NYSE MKT, or NASDAQ stock exchanges;
- Domestic subsidiaries of listed entities;

- Issuers with securities registered under Section 12 of the Exchange Act;
- Registered investment companies;
- Registered investment advisers;
- Any entity registered with the SEC under the Exchange Act;
- Certain entities registered with the CFTC;
- Pooled investment vehicles operated or advised by excluded financial institutions; and
- Foreign financial institutions established in jurisdictions where the regulator of such institutions maintains beneficial ownership information.

For pooled investment vehicles whose operators or advisers are not excluded from the beneficial ownership identification and verification requirements, financial institutions will only be required to collect beneficial ownership information regarding a single individual with “significant responsibility to control, manage, or direct the company.” Thus, under the rule, covered financial institutions are not required to identify or verify the identity of mere investors in pooled investment vehicles.

FinCEN Proposed Rule for Registered Investment Advisers

In our [2015 Annual Review](#), we reported that FinCEN had proposed a rule that would require registered investment advisers to establish anti-money laundering (**AML**) programs and report suspicious activity to FinCEN pursuant to the Bank Secrecy Act. The [proposed rule](#) also includes investment advisers in the general definition of “financial institution,” which, among other things, will require advisers to file Currency Transaction Reports and comply with various recordkeeping requirements. The comment period on the proposed rule ended on November 2, 2015. As of the date of publication of this Annual Review, we are still awaiting issuance of a final rule.

While commenters generally expressed support for the government’s efforts to combat money laundering, they criticized certain elements of FinCEN’s proposal. Namely, commenters expressed their belief that FinCEN should (i) geographically limit the reach of the rule to investment advisers in the U.S.; (ii) exclude certain low-risk advisory activities (*e.g.*, publication of research reports) from the rule’s AML program requirements; (iii) allow for AML program approval by senior management, but not necessarily require approval by a corporate officer; (iv) authorize investment advisers to share suspicious activity reports within their organizational structures; and (v) increase the implementation period to provide a reasonable timeframe for compliance.

Please see our [September 2, 2015](#) client alert for more information.

BEA Filing Updates

On October 20, 2016, the U.S. Department of Commerce Bureau of Economic Analysis (**BEA**) published a [final rule](#) to amend reporting requirements applicable to foreign direct investments for certain U.S.-domiciled private funds. Under the amended requirements, private funds will not have to report investments made by foreign persons, unless such foreign persons own 10% or more of the voting interests in an operating company indirectly through the U.S. private fund. Previously, the 10% or greater reporting threshold applied to a foreign person’s direct ownership interest in a U.S. private fund itself.

These reporting requirements are effectuated on BEA Surveys BE-13 (Survey of New Foreign Direct Investment in the United States), BE-605 (Quarterly Survey of Foreign Direct Investment in the United States), and BE-15 (Annual Survey of Foreign Direct Investment in the United States). These changes have the potential to generally affect all U.S. private funds owning less than a 10% interest in operating companies, and specifically affect both U.S. funds-of-funds and U.S. private equity funds investing in holding companies.

The BEA also adopted changes to the regulations and forms utilized in connection with BEA Survey BE-13. In summary, Form BE-13C (Report for Acquisition of a U.S. Business Enterprise That is Merged With an Existing U.S. Affiliate) will be discontinued, with the reporting requirements combined on Form BE-13A (Report for Acquisition of a U.S. Business Enterprise That Remains a Separate Entity). Additionally, Form BE-13B (Report for Establishment of a New U.S. Business Enterprise) no longer will be required when a new U.S. business enterprise is established to facilitate a single U.S. acquisition that takes place within 30 days. These amendments will be effective on November 21, 2016.

Please see the section [below](#) on BE-13 for more information.

Tax Updates

New Due Dates for Tax Returns

Pursuant to legislation enacted in 2015 (P.L. 114-41, a short-term highway funding measure), there will be changes in the income tax return filing deadlines for non-individual taxpayers commencing with returns filed in 2017 for the 2016 tax year. For calendar year taxpayers that are partnerships, the filing deadline will be March 15 rather than April 15, with the deadline including extensions remaining September 15. For calendar year taxpayers that are C corporations, the filing deadline will be April 15 rather than March 15, with the deadline including extensions September 15 (and, beginning in 2026, October 15).

Tax Treatment of Partnership Audits

Effective for audits of tax years that begin after December 31, 2017, the [Bipartisan Budget Act of 2015 \(BBA\)](#), which President Obama signed into law on November 2, 2015, significantly alters the U.S. tax rules applicable to audits of partnerships (including LLCs taxed as partnerships). The BBA creates new partnership-level audit rules under which the partnership itself will, in the year of IRS review, take into account any adjustments of partnership items for the reviewed year and generally assume liability for any deficiencies (including interest and penalties). One liberalizing change from these new audit rules is that the designated partnership representative who acts on behalf of the partnership and deals with the U.S. Internal Revenue Service (**IRS**) no longer will need to be a member of the relevant partnership or LLC, although such partnership representative must have a “substantial presence” in the U.S.

While many aspects of the details of BBA implementation remain unclear while the Treasury Department works on the relevant regulations (which the IRS hopes to release before January 1, 2018), the IRS released in August 2016 [temporary](#) and [proposed](#) regulations setting forth the procedures through which a partnership can opt into the new rules prior to the otherwise applicable January 1, 2018 start date. In general, it is unlikely to be beneficial to an investment fund to opt into these rules earlier than necessary.

Fund managers should review the operating agreements for their fund vehicles to ensure that such documents take into account these new audit rules. Among items to be addressed are the allocation of

any partnership-level taxes among partners, including the allocation of prior-year tax liabilities among current partners, and the appointment of a partnership representative.

Please see our [November 5, 2015](#) client alert for more information.

871(m) Regulations

On September 17, 2015, the IRS and the Treasury Department issued [final, temporary](#), and [proposed regulations](#) under Section 871(m) (collectively, the **New Regulations**) of the Code that provide rules for withholding on “dividend equivalent payments” on derivatives that reference U.S. equity securities. The New Regulations generally apply to transactions issued on or after January 1, 2017. However, regulations (accompanied by a transition notice) are expected by the end of 2016 that will postpone application of the New Regulations to certain transactions until 2018.

In response to the New Regulations, the International Swaps and Derivatives Association, Inc. (**ISDA**) published a new [protocol](#) enabling market participants to amend their ISDA master agreements to allocate any withholding tax under Section 871(m) to the party that takes the long position, and some parties have already started adhering to this protocol in 2016. A list of current adherents to this protocol is available [here](#) on the ISDA website.

In addition, in July 2016, the IRS issued [Notice 2016-42](#), which provides substantive and procedural guidance regarding the new “Qualified Derivative Dealer” (**QDD**) regime applicable to dividend equivalent payments under Section 871(m). The QDD regime will apply to all dividend equivalent payments received by an electing qualified intermediary on its principal transactions and will replace the “Qualified Securities Lender” regime that previously applied to substitute dividend payments received on stock loans, stock repurchases and substantially similar transactions. The QDD regime addresses the problem of over-withholding or cascading withholding on certain derivatives and securities lending transactions by providing that no withholding tax is required on certain payments made to a QDD when the QDD is acting as a principal.

Section 385 Regulations

In October 2016, the Treasury Department and the IRS released [final and temporary regulations](#) under Section 385 of the Code (**385 Final Regulations**) that treat certain interests between members of the same “expanded group” as stock, rather than debt, for U.S. federal income tax purposes. For these purposes, a corporation is a member of an expanded group if 80% of the vote or value of such corporation is owned by expanded group members and the parent of the expanded group (which must itself be a corporation) owns directly or indirectly 80% of the vote or value in at least one of the other corporations in the expanded group. Further, the 385 Final Regulations set forth documentation requirements in order for certain interests in a corporation between members of the same expanded group to be treated as debt for U.S. federal income tax purposes.

While theoretically targeting the perceived U.S. federal income tax avoidance of certain “inversion” transactions, the 385 Final Regulations are far broader in scope and will affect many transactions and arrangements that are part of the ordinary course of business for many investment funds and their portfolio companies, including certain aspects of blocker structures. Despite much criticism during the comment period, the Treasury Department declined to incorporate special rules for blockers in the 385 Final Regulations. However, the 385 Final Regulations are narrower than the proposed regulations in that debt issued by foreign issuers is excluded from the application of these new rules, and S corporations as

well as noncontrolled (*i.e.*, not controlled by members of the expanded group) regulated investment companies and real estate investment trusts are excluded from the definition of an expanded group.

The 385 Final Regulations apply to taxable years ending on or after January 19, 2017 with respect to debt instruments issued after April 4, 2016. The documentation requirements under the 385 Final Regulations, however, generally apply to debt instruments issued on or after January 1, 2018.

Proposed Regulations under Section 305(c)

In April 2016, the IRS issued proposed regulations (**Proposed Regulations**) interpreting deemed distributions under Section 305(c). Specifically, the Proposed Regulations would clarify the amount and timing of deemed distributions that result from an adjustment to the right to acquire stock. These Proposed Regulations will generally apply to deemed distributions occurring after they are finalized, but may be relied upon for deemed distributions occurring on or after January 1, 2016. It is unclear whether there are any implications for withholding agents that failed to withhold on deemed distributions in prior years.

Section 305 governs situations where a corporation distributes its own stock or rights to acquire such stock. Although stock dividends are generally not taxable to the shareholders of such a corporation, there are exceptions to this general rule. According to the Treasury Department, the current regulations under Section 305 are clear as to what constitutes a change that will be considered a taxable deemed distribution. However, after the promulgation of the New Regulations under Section 871(m) discussed [above](#) (regarding U.S. tax withholding on dividend-equivalent payments made to non-U.S. recipients), there was new attention focused on U.S. tax withholding applicable to financial instruments and the Treasury Department felt that the existing regulations under Section 305 were unclear as to the amount and timing of certain deemed distributions that could require withholding. The Proposed Regulations address these two areas, although uncertainty remains.

For example, under the current regulations under Section 305, an adjustment to the conversion ratio of convertible debt increasing the number of shares a holder would receive on conversion, made in connection with a corresponding taxable distribution to shareholders of the issuer of the convertible debt, will result in a deemed distribution. Under the Proposed Regulations, the amount of the deemed distribution is generally equal to the "option value" of the adjustment; however, it is not completely clear how to value this amount and, therefore, the amount on which withholding will be required.

Further, the Proposed Regulations impose withholding obligations even in situations where there is no cash payment. The requirements are somewhat more relaxed in the event the withholding agent is a foreign entity or is not the issuer of the security. There are also information reporting obligations for the issuer of the instrument.

PATH Act

Under the PATH Act, qualified foreign pension funds (**QFPFs**) generally would not be taxed under the Code provisions commonly referred to as "FIRPTA" on the sale of United States real property interests (**USRPIs**) on or after December 18, 2015. This change reduces the disparity between non-U.S. and U.S. pension funds investing in U.S. real estate. A non-U.S. pension fund is a QFPF if it is any trust, corporation, other organization or arrangement:

- Which is created or organized under the law of a country other than the U.S.;

- Which is established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees (or persons designated by such employees);
- Which does not have a single participant or beneficiary with a right to more than 5% of its assets or income;
- Which is subject to government regulation and provides annual information reporting about its beneficiaries to the relevant tax authorities in the country in which it is established or operates; and
- With respect to which, under the laws of the country in which it is established or operates, (i) contributions to such trust, corporation, organization or arrangement which otherwise would be subject to tax under such laws are deductible or excluded from the gross income of such entity or taxed at a reduced rate, or (ii) taxation of any investment income of such trust, corporation, organization or arrangement is deferred or such income is taxed at a reduced rate.

The above definition includes an entity wholly owned by a QFPF, even if the wholly-owned entity is located in different jurisdiction. While a QFPF would be exempt from tax under FIRPTA, if the QFPF is engaged in a U.S. trade or business or makes an election under 882(d) to be taxed on its U.S. source income on a net income basis, such QFPF may still be liable for U.S. federal income tax on its sales of any USRPI.

At first blush, the PATH Act may seem like an elimination of U.S. taxation for QFPFs that invest in U.S. real estate funds. However, while this may be true for certain funds that only generate FIRPTA gains, most U.S. real estate funds also generate non-FIRPTA ECI. In addition, some of the requirements for qualification as a QFPF are not entirely clear and some non-U.S. pension plan investors may not qualify.

Two additional changes under the PATH Act are that (i) the rate of gross withholding on dispositions of USRPIs under FIRPTA has increased to 15% (from 10%) and (ii) the maximum ownership permitted under the exemption from FIRPTA for publicly traded REITs has increased from 5% to 10% (while the maximum ownership for non-REIT, publicly traded “U.S. real property holding companies” remains 5%).

Continued FATCA Implementation and International Tax Information Exchange

Background. The Foreign Account Tax Compliance Act (**FATCA**) was enacted to help the IRS combat perceived tax evasion by U.S. persons holding assets through offshore accounts. FATCA generally requires “foreign financial institutions” (**FFIs**) to register with the IRS and either (i) enter into an agreement with the IRS to, among other things, report certain information to the IRS about their U.S. account holders and investors; or (ii) in the case of a “Model 1” jurisdiction with an intergovernmental agreement (**IGA**) in effect with the U.S. with respect to FATCA (as described further below), comply with local laws that implement that IGA and report similar information to their own government. FFIs that fail to comply with FATCA are subject to a 30% withholding tax on a wide range of U.S.-source payments.

There are currently two categories of IGAs, and the Treasury Department’s list of jurisdictions treated as having an IGA in effect can be found [here](#) (currently, 113 jurisdictions). An FFI in a Model 1 jurisdiction will be deemed compliant with FATCA and thus not required to enter into an FFI agreement or comply with the U.S. FATCA regulations. Instead, the FFI must only register with the IRS, comply with local law implementing the IGA and report directly to its own government. The Model 1 jurisdiction will, in turn, exchange information directly with the U.S. government. An FFI in a “Model 2” jurisdiction still must register and enter into an FFI agreement with the IRS, and generally must comply with the U.S. FATCA regulations and report information directly to the IRS.

Compliance. FATCA withholding on fixed, determinable, annual or periodical (**FDAP**) income (e.g., U.S.-source dividends and interest) paid to FFIs and “non-financial foreign entities” (**NFFEs**) that fail to comply with FATCA is generally currently in effect; withholding on gross proceeds from the sale of property that produces U.S.-source dividend or interest income is now set to begin on January 1, 2019. Additionally, pre-FATCA Forms W-8 can no longer be accepted. Further, as of November 1, 2016, the April 2016 version of the Form W-8BEN-E must be submitted in connection with any new accounts. There was also a new Form W-8IMY released in September 2016, although the prior version of the form will be acceptable until March 31, 2017.

In order to register with the IRS for FATCA purposes, an FFI must register via the IRS’s online FATCA portal and obtain a Global Intermediary Identification Number, unless an exemption applies. The IRS updates its list of registered FFIs monthly, and FFIs must register and appear on the FFI list in order to avoid FATCA withholding. For FFIs in Model 1 jurisdictions, registration with the local government is also required.

“Non-U.S. FATCA” and CRS. Jurisdictions outside the U.S. have also implemented, or are in the process of implementing, their own tax information exchange regimes and IGAs with which funds may have to comply. The U.K., for example, has established an automatic exchange of tax information relating to U.K. tax resident persons and entities. While in effect for 2016, this regime will be replaced starting in 2017 by the “Common Reporting Standard” (**CRS**). The Organisation for Economic Co-operation and Development (**OECD**) has published the CRS, pursuant to which a Multilateral Competent Authority Agreement has been signed by over 80 countries. Notably, the U.S. is not participating in CRS at this time. The first requirements to collect information under CRS went into effect on January 1, 2016.

BEPS and Country by Country Reporting

On a more global scale, the OECD is moving forward with its Base Erosion and Profit Shifting (**BEPS**) project, which will include certain additional reporting requirements like Country by Country Reporting (**CbCR**). Country by Country (**CbC**) reports, although not limited to the transfer pricing context, are a part of the new approach to transfer pricing documentation intended to increase transparency and reduce informational asymmetry between taxpayers and tax authorities (competent authorities). All multinational enterprises (**MNEs**) with revenues of €750 million or greater would file a CbC report with the competent authority in the tax jurisdiction of their ultimate parent entity. Revenue is a broadly defined term that includes essentially all amounts earned, generated or received. In the fund context, revenue would include fees, sales of securities, and payments of dividends by unrelated parties. Some amounts that would result in double counting (such as dividends received by certain permanent establishments of a MNE) or amounts only recognized for tax purposes (such as deemed dividends) would not be included in calculating revenue.

CbC reports will contain a wide array of information about a MNE, such as revenues, profit and loss before tax, income tax paid on a cash basis in all jurisdictions (including withholdings on payments received), income tax accrued (excluding deferred taxes and provisions for uncertain tax positions), stated capital, accumulated earnings, number of employees on a full-time equivalent basis, and net book value of tangible assets (not intangibles or financial assets) other than cash or cash equivalents. These CbC reports will be shared with other jurisdictions with which the competent authority of the ultimate parent jurisdiction has information exchange agreements. In a narrow number of situations, where the ultimate parent jurisdiction does not require CbCR, or it does not have an information exchange agreement, or it has failed to exchange CbC reports under an existing information exchange agreement despite notice, surrogate filing may be required. In these circumstances, the tax jurisdiction of a constituent entity of the

MNE may require surrogate filing, whereby that constituent entity would file a CbC report on behalf of the MNE as a whole. While facilitating maximum exchange of CbC reports across a global network of competent authorities is critical in achieving the intended goal, such an exchange of information raises confidentiality concerns.

Concerns regarding confidentiality are (at least in part) addressed by the OECD model legislation, domestic legislation and information exchange agreements in two ways. Firstly, competent authorities are limited in their use of CbC reports as a basis for making further inquiries into base erosion arrangements and not as conclusive evidence that tax laws have or continue to be violated. Secondly, CbC reports will benefit from confidentiality protections in the relevant domestic law and the confidentiality protections typically found in information exchange agreements. However, confidentiality protections across jurisdictions may vary. For example, the European Commission has proposed changes to Accounting Directive 2013/34/EU, which if passed would require some of the information contained in a CbC report to be publicly disclosed for a five year period on the MNE's website.

On June 30, 2016, the IRS and the Treasury Department issued final CbCR regulations. All U.S. MNEs with revenues of \$850 million or more must file a CbC report with their tax return. A U.S. MNE is one with an ultimate parent entity tax resident in the U.S. and with at least one constituent entity tax resident in a foreign jurisdiction. The U.S. regulations closely follow the OECD model, with the exception that the IRS and Treasury Department have chosen not to require surrogate filing. However, given that the IRS and the Treasury Department released final regulations after a number of other jurisdictions, such as the U.K., there is a timing mismatch, which means that U.S. MNEs have to be aware of the surrogate filing requirements of other jurisdictions in which one of their constituent entities is tax resident. For the first year, only those U.S. MNEs with an annual accounting period that begins on or after June 30, 2016 would need to file a CbCR report. However, U.S. MNEs with constituent entities in other jurisdictions that require filings beginning on or after January 1, 2016 may require surrogate filing. In other words, the U.S. MNE's constituent entity would have a filing obligation even if the U.S. MNE itself is not required to file in the U.S. To address this issue, the IRS and Treasury Department are allowing voluntary filing of CbC reports that may allow constituent entities of the U.S. MNE to forgo the foreign reporting requirement. Further details on voluntary compliance are forthcoming.

The U.S. regulations, like the OECD model, also provide broad definitions of terms like "full time equivalent employee" in order to facilitate a system of reporting that is not limited to any one jurisdiction's definition. The IRS and Treasury Department have also indicated that doing so appropriately balances the aim of CbCR and the burden to U.S. MNEs. While there is a degree of flexibility in how U.S. MNEs can apply the broadly defined terms in completing their CbC reports, there is a requirement of consistency going forward. In other words, decisions with respect to how a U.S. MNE is going to determine how many full time equivalent employees it has in year one, for example, will be the method that the U.S. MNE uses going forward. Therefore, U.S. MNEs (and MNEs generally) should give considerable thought to their CbCR filings especially in the first year, given the additional considerations from interpreting key broadly defined terms to surrogate filing requirements and voluntary compliance.

It is also important to note that there is no exception to CbCR requirements for tax-exempt organizations. Therefore, tax-exempt organizations that are the ultimate parent entity of a U.S. MNE or a part of a U.S. MNE potentially could be subject to CbCR in the U.S. or to the surrogate filing requirements of other jurisdictions (including, in some cases, when such organizations do not meet the \$850 million annual

revenue threshold applicable under the U.S. regulations but operate in other countries that require direct local reporting and do not have as high a revenue threshold).

Deferred Compensation under Section 457A

Under Section 457A of the Code, enacted in 2008, nonqualified deferred compensation generally must be included in the income of a service provider (such as a fund manager) when it vests, regardless of when it is paid. In the case of deferred compensation attributable to services performed prior to 2009, these amounts must be included in income no later than the last taxable year starting before 2018.

Some fund managers and tax practitioners considered whether some relief for the impending deadline for including these deferred compensation amounts in income might be available by electing to change the taxpayer's method of accounting from cash basis to accrual basis, such that any positive adjustments required to be taken into taxable income would be taken into account ratably over a four-year period beginning in the year of the election. Many practitioners were doubtful that this approach would work, and thought the Section 457A transition rules would likely trump the otherwise applicable rules regarding certain adjustments after a change in accounting method.

In a Chief Counsel Advice dated August 3, 2016 ([CCA 2016-003](#)), the IRS Office of Chief Counsel confirmed that this approach will not work and concluded that a service provider will not be able to avoid the transition relief deadline of December 31, 2017 for including deferred compensation in income under Section 457A by changing its method of accounting.

For more background on Section 457A generally, please see our [June 2014](#) and [June 2009](#) client alerts.

ERISA Updates

Private Investment Fund Managers and Other Investment Advisers May Be Affected by the U.S. Department of Labor's New Fiduciary Rules

On April 6, 2016, the U.S. Department of Labor (**DOL**) issued its highly anticipated [final rule](#) addressing when a person is considered to be a fiduciary under the Employee Retirement Income Security Act of 1974 (**ERISA**) and the Internal Revenue Code (**Code**) as a result of providing investment advice.

The final rule's definition of fiduciary investment advice significantly expands the group of people who would be considered fiduciaries under ERISA and the Code, and might cover certain marketing and other related activities common to the investment management industry (including the private investment fund industry). The DOL also finalized a new Best Interest Contract Exemption (**BICE**), a new Principal Transactions Exemption and amended other prohibited transaction class exemptions that would allow certain broker-dealers, insurance agents and others who provide investment advice to continue to engage in certain transactions and to receive common forms of compensation that otherwise would be prohibited as conflicts of interest under the final rule.

Although the final rule will not apply until April 10, 2017, private investment fund managers and other investment advisers should review their current marketing and other related activities relating to ERISA plan and/or individual retirement account (**IRA**) investors, prospective investors, clients and/or prospective clients (**Targeted ERISA/IRA Parties**) prior to the applicability date to determine whether such activities will result in fiduciary status and to begin preparation of their plan for compliance or avoidance of such status (as applicable). Even if a private investment fund manager or other investment adviser is already acting as a "fiduciary" under current law, these new rules may still impact its activities.

The Final Rule. The final rule details the types of “recommendations” provided to a plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner, which, when provided for a fee or other compensation, directly or indirectly, and given under certain circumstances, would be considered “investment advice” and thus subject the advice provider to fiduciary standards and certain prohibited transaction rules intended to address conflicts of interest. The final rule also describes certain types of communications and situations that are specifically not intended to constitute “recommendations” or otherwise result in the provision of fiduciary “investment advice.”

Practical Impacts. Certain ordinary marketing activities involving ERISA plans and/or IRAs may be considered “investment advice”:

- If a fund manager’s or other investment adviser’s marketing materials (*e.g.*, offering memorandum and/or pitch book), pitch practices and/or periodic distributions (*e.g.*, “newsletters”) are considered a “recommendation,” such as a recommendation to purchase or hold a security (*e.g.*, an equity interest in a private investment fund) or continue a separately managed account arrangement, then the investment adviser would most likely be considered to be providing fiduciary “investment advice” to Targeted ERISA/IRA Parties to purchase or continue to hold an interest in the adviser’s own funds and/or establish or continue a separately managed account arrangement with the adviser (and to pay any related management or other fees), as the case may be, potentially constituting “conflicted” investment advice that could result in a violation of fiduciary duty and/or a prohibited transaction absent an exemption.
- When dealing with most ERISA-covered plans, fund managers and other investment advisers might be able to avail themselves of an “expert fiduciary exclusion.” However, such exclusion is likely not available for recommendations provided to an IRA owner that is not being separately advised by an independent expert fiduciary in connection with the fund investment or separately managed account arrangement.
- If the fund manager or other investment adviser is considered to be providing fiduciary “investment advice” to Targeted ERISA/IRA Parties, a prohibited transaction exemption for the conflicted investment advice and the receipt of the related compensation (*e.g.*, the BICE) may be available in certain cases, but compliance may be somewhat complicated and burdensome (particularly in regard to the BICE).

Accordingly, fund managers and other investment advisers should consider revising their fund or account documents and marketing and offering materials before the new rule goes into effect (for new funds or existing funds that may accept new investments following the effective date of the new rule and separately managed accounts to be established on or after such date). For example, fund managers and other investment advisers may want to require each Targeted ERISA/IRA Party to provide representations consistent with the fund manager’s or investment adviser’s desire to avoid being treated as a fiduciary in connection with such Targeted ERISA/IRA Party’s investment in the fund or separately managed account arrangement with the adviser to the extent such investment may be made or such separately managed account arrangement may be established on or after the effective date of the new rule.

IRAs and Small Plans May See a Reduction in Opportunities to Invest in Private Investment Funds or Establish Separately Managed Account Arrangements. Given the lack of an “expert fiduciary exclusion” for advice given to IRAs and small plans that are not separately managed by expert fiduciaries and the complexity and impracticality of complying with an existing or new exemption (*e.g.*, the BICE or a

streamlined version of the BICE), private investment fund managers and other investment advisers may determine simply not to pitch their products to IRAs or such plans.

Please see our [April 19, 2016](#) client alert for more information.

***Sun Capital* Court Finds Co-Investing Funds Part of Controlled Group and Liable for Portfolio Company's Pension Liabilities**

In *Sun Capital*, the U.S. Court of Appeals for the First Circuit held in 2013 that a private investment fund was engaged in a "trade or business" under ERISA and could therefore be part of a "controlled group" with one of its portfolio companies and potentially liable for the portfolio company's underfunded pension liabilities. The *Sun Capital* case was remanded to the U.S. District Court of Massachusetts for further proceedings on whether a related private investment fund that invested in the portfolio company also was engaged in a "trade or business" and whether the two funds were under "common control" with the portfolio company. On March 28, 2016, the District Court determined that the second private investment fund was engaged in a "trade or business" and that the two funds' co-investment in the portfolio company constituted a "partnership-in-fact" (resulting in the aggregation of their ownership interests in the portfolio company) that also was engaged in a "trade or business." The result is that both funds are jointly and severally liable for the portfolio company's underfunded pension liabilities.

Controlled Group Liability. ERISA imposes joint and several liability for certain defined benefit pension plan liabilities (including termination liability for underfunded single employer pension plans and multiemployer plan withdrawal liability) on plan sponsors and each member of their "controlled group." A "controlled group" is generally two or more "trades or businesses" that are under "common control":

- "Trade or Business." Prior to *Sun Capital*, courts generally applied a two-part test under which an entity's activity is a "trade or business" if it engages in the relevant activity (i) for the primary purpose of income or profit and (ii) with continuity and regularity.
- "Common Control." An entity (such as a private investment fund) is typically under "common control" with another entity (such as a private investment fund's portfolio company) if the entities are considered to be in a "parent-subsidiary" relationship. Generally, two entities will be considered to be in a "parent-subsidiary" relationship if one entity owns 80% or more of the other entity.

Sun Capital. This case began when a multiemployer pension plan sought to assert withdrawal liability against three private investment funds managed by Sun Capital Advisors, Inc. The withdrawal liability was incurred by Scott Brass, Inc (**SBI**). The funds owned 100% of SBI's ultimate parent, Sun Scott Brass, LLC (**SSB**), with 30% of SSB held by Sun Fund III (which actually consisted of two parallel funds that were treated as one fund for purposes of this case) and 70% of SSB held by Sun Fund IV. SBI withdrew from the multiemployer plan and owed withdrawal liability to the plan, but ceased making payments after SBI went bankrupt.

Each of Sun Fund III and Sun Fund IV (**Sun Funds**) ultimately was held to constitute a "trade or business" under the so-called "investment plus" approach developed by the Pension Benefit Guaranty Corporation (**PBGC**) in a 2007 Appeals Board decision, which was a more expansive approach than that typically applied by courts prior to *Sun Capital*.

In making such determination, the courts focused on (among other things) the significant involvement that Sun Capital personnel had in the management of SBI, and the fact that the Sun Funds were entitled

to certain management fee offsets and carryforwards which created a “direct economic benefit” to them that an ordinary, passive investor would not derive.

In regard to the question of whether the Sun Funds were under “common control” with SBI, neither fund individually owned more than 80% or more of SBI. Nonetheless, based in large part on their joint activity prior to making the investment, the District Court determined that the Sun Funds created a limited “partnership-in-fact” with respect to the funds’ investment in SSB.

The District Court then went on to hold that the “partnership-in-fact” was also a “trade or business,” and was under “common control” with SBI because it was the 100% owner of SSB (and, therefore, the 100% indirect owner of SBI). Accordingly, the “partnership-in-fact” was part of SBI’s “controlled group” and jointly and severally liable for SBI’s withdrawal liability – furthermore, since the Sun Funds were general partners of such “partnership-in-fact”, they too were jointly and severally liability for SBI’s withdrawal liability.

Implications for Private Investment Funds. This decision could have far-reaching implications for private investment funds, including the following:

- The PBGC and multiemployer pension plans may use this decision to further bolster their efforts to collect plan termination and withdrawal liability from private investment funds (and their other portfolio companies) that might be considered a part of a portfolio company’s “controlled group.”
- Although likely intended to apply only where there is an overlap in regard to the management of co-investing funds, the District Court’s holding was not clearly so limited. In fact, it could apply to two or more completely separate and independent private investment funds that co-invest in a portfolio company even though each fund owns less than 80% of the portfolio company and has different underlying investors and managers.

Accordingly, private equity fund sponsors should be aware that acquiring an 80% (or more) interest in a portfolio company, whether within one private equity fund or pursuant to a “joint venture” between related (and maybe even unrelated) funds, may trigger joint and several liability for the portfolio company’s underfunded pension or withdrawal liabilities.

Please see our [April 5, 2016](#) client alert for more information.

Employment Law Updates

New Federal Overtime Rule to Become Effective on December 1, 2016

The [revised federal regulations](#) on overtime pay are scheduled to take effect on December 1, 2016. The new regulations increase the minimum salary that most executive, administrative, and professional employees must receive in order to be exempt from the overtime rules from \$455 a week to \$913 a week (\$47,476 per year). The new rules also increase the compensation threshold for exemption under the federal overtime law as a “highly compensated employee” from \$100,000 to \$134,004 per year. The DOL will update the new minimum levels every three years, starting on January 1, 2020, on 150 days’ advance notice. As always, employers will have to comply with any applicable state overtime laws.

Please see our [May 17, 2016](#), [August 23, 2016](#), [September 29, 2016](#) and [October 11, 2016](#) posts on Proskauer’s [Law and the Workplace Blog](#) for more information.

EEOC Releases New Guidance on Unpaid Leave as a Reasonable Accommodation

On May 9, 2016, the Equal Employment Opportunity Commission (**EEOC**) released [new guidance](#) on unpaid leave as a reasonable accommodation under the Americans with Disabilities Act (**ADA**). The guidance makes clear that employers must not only provide disabled employees with access to leave as an accommodation on the same basis as similarly situated employees without disabilities, but also may be required to modify their policies to provide leave for a disability even where the employer does not offer leave to other employees. The guidance also addresses common issues for employers including analyzing undue hardship, requests for “indefinite” leave, maximum leave policies, and return to work issues, including so-called “100% healed” policies and reassignment.

The guidance states that if an employee requests leave related to a disability and the leave falls within the employer’s existing leave policy, it should treat the employee making the request the same as an employee who requests leave for reasons unrelated to a disability.

Further, the guidance stresses that because “the purpose of the ADA’s reasonable accommodation obligation is to require employers to change the way things are customarily done to enable employees with disabilities to work,” an employer must consider unpaid leave as a possible reasonable accommodation even when:

- The employer does not offer leave as an employee benefit;
- The employee is not eligible for leave under the employer’s policy; or
- The employee has exhausted the leave the employer provides as a benefit (including leave under the Family and Medical Leave Act or similar state or local laws or under a workers’ compensation program).

However, the guidance states that the ADA does not require an employer to provide paid leave beyond what it provides as part of its paid leave policy. Further, and as is the case with all other requests for accommodation, an employer can deny a request for leave if it can show that providing the accommodation would impose an undue hardship.

The guidance reiterates the EEOC’s longstanding position that requests for “indefinite” leave—that is, where an employee cannot say whether or when he or she will be able to return to work at all, as opposed to where a definitive or approximate date or range of dates can be provided—constitutes a per se undue hardship under the ADA and does not need to be provided as a reasonable accommodation. However, employers are cautioned to carefully consider any state and local laws regarding reasonable accommodation that may apply before rejecting a request for an “indefinite” leave, as some laws provide greater protections for employees and may require an employer to demonstrate that extending leave “indefinitely” would pose an undue hardship in order to reject such a request.

The guidance states that while employers “are allowed to have leave policies that establish the maximum amount of leave an employer will provide or permit,” the ADA requires that employers may nevertheless be required to “grant leave beyond this amount as a reasonable accommodation to employees who require it because of a disability, unless the employer can show that doing so will cause an undue hardship.”

With regard to 100% healed policies – that is, policies requiring employees to return to work only if they can demonstrate that they have no medical restrictions – the guidance states that an employer will violate the ADA if it prohibits an employee with a disability from returning to work unless he/she has no medical

restrictions if the employee can perform his or her job with or without reasonable accommodation (unless the employer can show that providing the accommodation would cause an undue hardship).

As to reassignment, the EEOC takes the position that if reassignment is required as a reasonable accommodation because the disability prevents the employee from performing one or more essential functions of the current job (even with a reasonable accommodation) or because any accommodation in the current job would result in undue hardship, an employer “must place the employee in a vacant position for which he is qualified, without requiring the employee to compete with other applicants for open positions.” However, the guidance notes that “reassignment does not include promotion, and generally an employer does not have to place someone in a vacant position as a reasonable accommodation when another employee is entitled to the position under a uniformly-applied seniority system.”

Please see our [May 11, 2016](#) post on Proskauer’s [Law and the Workplace Blog](#) for more information.

[President Signs Defend Trade Secrets Act into Law](#)

On May 11, 2016, President Obama signed the [Defend Trade Secrets Act \(DTSA\)](#) into law, for the first time creating a federal cause of action for trade secret misappropriation. The law has sweeping implications and is expected to have a noticeable impact on trade secret jurisprudence. In addition, the law adds new obligations for employers hoping to benefit from the DTSA’s protections. Below are the law’s key attributes:

Uniformity Created by a Federal Private Right of Action. Traditionally, lawsuits for misappropriation of trade secrets have been fought in state court and under state law. Forty-eight of the fifty states (New York and Massachusetts are the only outliers) have adopted the Uniform Trade Secrets Act (**UTSA**). While this near uniform statutory base provides for some commonality among state trade secret laws, there are significant differences as (i) the UTSA was adopted in many variations, and (ii) state courts developed their own, individual jurisprudence for interpreting the state versions of the UTSA. This has resulted in significant inconsistencies across the country.

Creating a private right of action under DTSA in federal court allows companies and individuals to seek relief nationwide without having to account for the various differences found under state law. This uniformity should make it easier for companies and individuals to determine what information or property is protectable and to better predict the outcome of any cause of action they may bring.

Civil Seizure. Perhaps the most exceptional option afforded by DTSA is the right to seek a civil seizure for misappropriation of trade secrets. DTSA provides that in “extraordinary circumstances” a court may order the civil seizure of property “necessary to prevent the propagation or dissemination of the trade secret that is the subject of the action.” DTSA does not intend the seizure application to be headline news. Rather, the application is conditioned on the requirement that the “applicant has not publicized the requested seizure.”

DTSA recognizes that seizures may involve electronically stored information and thoughtfully contemplates that (i) law enforcement officials (who have responsibility for all seizure actions) may request the assistance of “independent experts” who are unaffiliated with the seizure applicant, and (ii) special masters may be appointed by the courts to locate and isolate misappropriated trade secrets. Further, DTSA prohibits the seizure applicant (or any of the applicant’s representatives) from playing any role in the seizure or from being given access to the seized property.

If an individual whose property has been seized suffers damage as a result of a wrongful or excessive seizure, DTSA provides that individual with a private right of action against the person who sought the seizure. Recovery is not limited to the security required to obtain the order of seizure.

Remedies Available. The remedies available beyond civil seizure are familiar. They include: (i) an injunction; (ii) an award of damages; (iii) an award of exemplary damages; and (iv) an award of attorneys' fees.

DTSA specifies that its scope is limited to "prevent[ing] any actual or threatened misappropriation" of a trade secret. Injunctions sought under DTSA may not prevent a person from entering into an employment relationship. DTSA specifies that if restrictions are placed on an employee via an injunction, those restrictions must actually be tailored to the potential misappropriation and not simply based upon the information known by the employee. Thus, while DTSA does allow for injunctions, an injunction will not be permitted as a back door to a non-compete provision, particularly in jurisdictions that are hostile to the enforcement of non-competes. Moreover, exemplary damages of two times the amount of damages and attorneys' fees can be awarded in cases where there is proof that the misappropriation was "willful and malicious."

Immunity for Lawful Disclosure. Consistent with recent developments in the whistleblowing arena, DTSA provides that an individual cannot be held criminally or civilly liable for disclosure of a trade secret made in confidence to a government official (federal, state, or local) or to an attorney for the sole purpose of reporting or investigating a suspected legal violation. DTSA also protects against liability for disclosure of a trade secret in a complaint or other lawsuit-related document if the filing is made under seal.

No Preemption. DTSA provides that U.S. District Courts will have original jurisdiction over civil actions. DTSA is clear, however, that it does not replace or override any state laws regarding trade secrets. This provides the potential for forum shopping as claims can still be brought under state law, and may not be subject to removal if only state causes of action are pled. This is similar to the dynamic found in employment discrimination cases brought under state or local laws as opposed to federal law. In some circumstances, depending on the facts, state law and local judges, there may be advantages to including state law claims with DTSA claims in federal court or bringing state law claims in state court.

What Should Employers Do? For employers who possess and protect trade secrets, DTSA should be a welcome addition in the quiver as it will likely provide increased predictability and consistency in the protection of trade secrets. That being said, interested parties should be mindful that it will take time to develop an approved process for handling the various provisions under DTSA, particularly those associated with civil seizure. In addition, keep in mind that the best strategic move in some situations may be to forego federal court and DTSA, and instead pursue state law claims in state court.

Please see our [May 11, 2016](#) post on Proskauer's [Law and the Workplace Blog](#) for more information.

[Trend of Laws Restricting Background Checks Continues](#)

Although federal law permits employers to conduct conviction and credit history checks on applicants and employees so long as they follow the procedures set forth in the Fair Credit Reporting Act, states and municipalities continue to pass laws restricting these types of background checks. Many states and municipalities restrict conviction history screens or the extent to which convictions can be the basis for withdrawing an offer of employment or terminating employment.

Beginning in 2017, Vermont and Connecticut will become the eighth and ninth states, respectively, to “ban the box” for private employers. [Effective January 1, 2017](#), Connecticut employers will be prohibited from requesting criminal history information on an initial application form. Exceptions apply if:

- The employer is required by federal or state law to inquire about criminal history; or
- A security, fidelity or equivalent bond is required for the position.

[Effective July 1, 2017](#), Vermont employers, subject to certain exceptions, also will be prohibited from requesting criminal history information on an initial application form. The exceptions require application questions to be limited to inquiries about the types of criminal offenses creating the disqualification or obligation. In addition, if an employer inquires about criminal history information at any point during the hiring process, the candidate must be given the opportunity to provide additional information regarding any convictions, including post-conviction rehabilitation. The law provides that employers will be assessed a civil penalty of up to \$100 for each violation.

Please see our [August 3, 2016](#) post on Proskauer’s [Law and the Workplace Blog](#) for more information.

Caregiver Discrimination and Family Leave Laws

New York City. On January 5, 2016, Mayor Bill de Blasio signed into law a New York City Council [bill](#) that prohibits employment discrimination based on an individual’s actual or perceived status as a caregiver.

Under the New York City Human Rights Laws (**NYCHRL**), it is an unlawful discriminatory act for an employer to refuse to hire, terminate, or discriminate against an employee in compensation or in relation to terms, conditions or privileges of employment, based on an employee’s actual or perceived status as a member of a protected class. The bill adds “caregiver” as a protected class, thereby prohibiting employment discrimination based on an individual’s actual or perceived status as a caregiver.

The bill defines “caregivers” as those who provide direct and ongoing care for a child under the age of 18 or a care recipient. “Child” includes a biological, adopted or foster child, or a child for whom the caregiver has assumed a primary parental role. “Care recipient” means anyone who: (i) has a disability and relies on the caregiver for medical care or to meet the needs of daily living; and (ii) is in a relationship with the caregiver as follows: child (including children over the age of 18); spouse; domestic partner; parent (including a biological, foster, step- or adoptive parent, a legal guardian of a caregiver, or a person who acted as the caregiver’s parent when the caregiver was a child); sibling (including a brother, sister, half-siblings, step-siblings, and siblings related through adoption); grandchild or grandparent; the child or parent of the caregiver’s spouse or domestic partner; an individual who resides in the caregiver’s household; or any individual in a familial relationship with the caregiver as designated by the New York City Commission on Human Rights.

New York State. In what is being called one of the most comprehensive programs of its kind in the U.S., New York State has enacted a [paid family leave law](#) that will ultimately require employers to provide eligible employees with up to 12 weeks of paid, job-protected leave per year to care for a new child or for a family member with a serious medical condition, as well as when a family member is called to active military service. The program, which will be funded entirely through employee payroll deductions, was approved as part of a hotly debated state budget agreement that also includes a statewide incremental increase to a \$15 minimum wage. Beginning on January 1, 2018, the new program will require employers to provide all full-time and part-time employees who have been working for the employer for at least 6

months with up to 8 weeks of paid leave at a rate of 50% of the individual's average weekly wage (capped at 50% of the statewide average weekly wage).

Illinois. Effective January 1, 2017, the [Illinois Employee Sick Leave Act \(Illinois Act\)](#) will allow employees to use employer-provided personal sick leave benefits to care for an ill or injured family member or attend a medical appointment with a family member. The Illinois Act defines an eligible family member – *i.e.*, an individual the employee is taking leave to care for – as a child (biological, adopted, step-relation, or legal ward), spouse, sibling, parent, mother-in-law, father-in-law, grandchild, grandparent, or stepparent in need of care during bouts of illness or injury or requiring transportation or other assistance related to a medical appointment.

Please see our [January 26, 2016](#), [April 5, 2016](#) and [August 26, 2016](#) posts on Proskauer's [Law and the Workplace Blog](#) for more information.

EEOC Announces Revised EEO-1 Rule

The EEOC requires employers to complete and file an EEO-1 form categorizing their employment data by race/ethnicity, gender and job category. The rule applies to companies subject to Title VII with 100 or more employees, companies that are owned by (or corporately affiliated with) another company where the entire enterprise employs 100 or more employees, and federal government contractors or subcontractors with 50 or more employees and \$50,000 or more in contracts or subcontracts. The EEOC uses this information to support civil rights enforcement and to analyze employment patterns, such as the representation of women and minorities within companies, industries or regions.

On January 29, 2016, President Obama announced new pay equity reporting requirements that would require employers to disclose information concerning compensation and hours worked with their annual EEO-1 reports. According to an [EEOC publication](#) in the Federal Register, starting in 2017, employers with more than 100 employees will be required to report "W-2 earnings and hours worked" on their annual EEO-1 reports. Employers with fewer than 100 employees will not be required to submit this additional information.

Please see our [January 29, 2016](#), [February 2, 2016](#) and [June 24, 2016](#) posts on Proskauer's [Law and the Workplace Blog](#) for more information on this development.

On July 14, 2016, the EEOC published its [revised EEO-1 Rule](#), responding to a number of comments submitted following the issuance of its [proposed rule](#) in February 2016.

First, beginning with work year 2017, the EEO-1 filing deadline will be March 31 to coincide with the issuance of W-2s for the prior year. As such, the first EEO-1 under the revised rule must be filed on March 31, 2018. Secondly, the EEOC modified the "Workforce Snapshot Period" during which employers must identify the workforce that must be included on the EEO-1 report. In light of the changed submission date, starting in work year 2017, the EEOC will modify the snapshot period to include employment data for any one pay period between October 1 and December 31 (*i.e.*, the fourth quarter).

Employers are encouraged to consider the impact that the additional reporting may have on their current business practices. Given the Administration's continuing emphasis on pay equity, employers should consider undertaking a privileged audit of their pay policies and practices. Part of this process should include identifying whether any "red flags" would be identified by the EEOC or the Office of Federal Contract Compliance Program in connection with the analyses contemplated by the new reporting

requirements. It is critical that employers address any problem areas or compliance issues before the reporting obligation becomes mandatory.

Please see our [July 14, 2016](#) post on Proskauer's [Law and the Workplace Blog](#) for more information.

OSHA Issues Final Rule Regarding Injury and Illness Reporting

On May 11, 2016, the Occupational Safety and Health Administration (**OSHA**) issued its long-anticipated [final rule](#) regarding injury and illness reporting. The final rule generally requires employers to submit electronically certain injury and illness information. OSHA will place that information on an online searchable database. The final rule also enhances anti-retaliation protections regarding reporting injuries and illnesses in the workplace.

The final rule requires the electronic submission – depending on the establishment's size – of certain types of information regarding workplace injuries and illnesses found on OSHA forms already maintained by employers. Establishments with 250 or more employees must provide the most information while establishments with 20-249 employees must provide a more limited set of information. OSHA is phasing in the full reporting requirements over the next three years, with the first submissions due on March 2, 2017.

OSHA will make the information public in an online searchable database but will exclude any personally identifiable information. OSHA claims that as a result of the final rule, "employers, employees, employee representatives, the government, and researchers may be better able to identify and mitigate workplace hazards and thereby prevent workplace injuries and illnesses." OSHA also stated that the final rule will allow it "to more effectively target its enforcement resources to establishments with high rates or numbers of workplaces with injuries or illnesses, and better evaluate its interventions."

The final rule also requires employers to (i) inform employees of their right to report work-related injuries and illnesses free from retaliation, and (ii) implement reasonable reporting methods that do not deter or discourage employees from reporting. OSHA included an enhanced anti-retaliation provision in the final rule forbidding employers from discharging or "in any manner" discriminating against an employee for reporting a work-related injury or illness. The final rule allows OSHA to proceed against an employer even if the employee did not file a complaint of retaliation. During the rulemaking process, some commenters expressed concerns that such an anti-retaliation provision may interfere with employee discipline for violating safety rules or certain drug testing policies. OSHA provided some guidance as to when such policies would not run afoul of the final rule. Employers should begin now to assess their ability to process and submit the applicable reports in electronic form. They should also begin to assess policies related to reporting injuries and illnesses to determine whether any of them may discourage reporting.

Please see our [May 12, 2016](#) post on Proskauer's [Law and the Workplace Blog](#) for more information.

Liability Insurance Updates

The insurance market for private fund shops has been extremely competitive over the past year as more fund managers have begun to recognize that insurance can serve not only to protect managers and funds against significant claims, but can also serve as a valuable asset to increase fund returns and improve investor satisfaction. This has placed significant pressure on insurance companies to offer lower prices and more favorable coverage terms in order to gain and retain business. Moreover, this has created

significant opportunities to obtain enhanced coverage at lower prices for funds, managers and their key individuals.

Below are a few key trends we saw in 2016 along with our thoughts on where we see things headed in 2017:

Enhancing Coverage for Government Investigations

The risk of SEC and other government investigations remained the most significant concern for private investment funds in 2016. The past year has seen the SEC continue to investigate and bring actions with respect to issues such as fees and expenses, allocation practices, disclosure, conflicts of interest, valuation and marketing. While these regulatory risks have continued to persist and evolve, the opportunity to protect against these risks through insurance has significantly expanded. Traditionally, the coverage offered by management liability policies for government investigations has been limited in that coverage was not triggered until late in the investigation (after significant costs had already been incurred) and was often subject to exclusions for insider trading, fee and compensation claims, and other conduct that is often the focus of government investigations. However, because of the competitive directors and officers liability insurance (**D&O**) market in the fund space, policyholders who explore the market and engage insurers in negotiation are now often able to obtain insurance that covers the costs of defending government investigations from the very earliest stages with limited exclusions. It is anticipated that the opportunity for such enhanced coverage for government investigations will continue into 2017.

Protecting Against Cyber Risks

Cyber-attacks have become a front-page risk in almost every industry, and the SEC has made clear that it expects private investment fund managers to take steps to protect against cyber risks. Along with implementing more rigorous cyber procedures and policies, many private fund managers also have begun seeking insurance to protect against cyber risks. Those that do so have unfortunately learned that the market has not yet developed a single product that fully and comprehensively protects against all of the cyber risks faced in the private fund space. These risks include business interruption, loss of use of trading platforms, theft of assets and social engineering. Instead, private fund managers seeking to maximize their protection are forced to address different types of cyber risks through a combination of products, such as standalone cyber policies (that cover some, but not all, risks) and endorsements to crime policies and fidelity bonds that cover other types of cyber risks, such as social engineering. The insurance market for cyber risks generally, and specifically in the private fund space, is still developing. It seems likely that the competitive market will lead to an insurer developing and offering a comprehensive product that more fully addresses cyber risks in the private fund space.

Focus on Protecting Key Individuals

During the past year, there has been an increased focus on ensuring adequate protection of key individuals against the legal and regulatory risks they face for managing private investment funds. As the risks these individuals face continue to grow – including an increased government focus on pursuing claims against individuals such as chief compliance officers – more individuals have become appropriately concerned with backstopping their indemnification rights with insurance. Not all claims are indemnifiable and indemnification is sometimes unavailable due to solvency issues or other financial and legal constraints. Accordingly, the market has seen an increased emphasis on obtaining dedicated insurance limits for individuals as well as efforts to limit the insurer's contractual ability to deny coverage for non-indemnifiable claims. Individual protection has long been the key focus in the public company D&O

space. It is expected that the increasing focus on individual protection in the private fund space will continue as the risks faced by individuals in the space continue to grow.

Increased Attention to Portfolio Company Risk and Insurance

It has become common for lawsuits against portfolio companies to name as defendants both individuals from the sponsor private equity firm (who serve as directors of the portfolio company) as well as the sponsor private equity firm itself. Due to this litigation trend, along with regulatory risk, private equity firms have begun focusing more closely on both their own insurance policies as well as those at the portfolio company level. There has been a growing recognition of the importance of coordinating indemnification and coverages at the portfolio company level and fund level to ensure that risks associated with portfolio companies are adequately addressed. It is expected that this focus will continue to grow in 2017.

Looking Ahead to 2017

Fortunately for policyholders, the competitive insurance market in the fund space appears poised to continue into 2017. If this trend holds true, there will be continued opportunities for private investment fund managers to obtain enhancements in their coverage if they explore the market and negotiate with potential insurers. Additionally, if the soft market continues, there likely will be greater acceptance by insurers of using manuscripted policy forms (*i.e.*, forms drafted by the policyholder's counsel/broker) rather than simply making changes to the insurer's standard form. Private investment fund managers that take advantage of these developments will obtain competitive advantages over peer firms and will be better positioned than their counterparts to obtain coverage if/when they face claims from regulators, investors or other parties.

Activist Investing Updates

Proposed Amendments to Regulation 13D-G

On March 17, 2016, Senators Tammy Baldwin and Jeff Merkley introduced legislation to amend aspects of Regulation 13D-G under the Exchange Act. Known as [the Brokaw Act](#), the legislation's co-sponsors included Senators Bernie Sanders and Elizabeth Warren. [According to Senator Baldwin](#), the amendments are aimed at "increasing transparency and strengthening oversight of activist hedge funds." While Congress has not taken any formal action on the Brokaw Act since its introduction, and we do not expect any formal action to be taken, at the earliest and if at all, until the Congressional session that begins in January 2017, the Brokaw Act's proposals, if implemented, will have significant implications for funds and their advisers that transact in publicly traded securities.

The Brokaw Act proposes three significant changes to Regulation 13D-G:

- **Time period to make an initial Schedule 13D filing is shortened.** Currently, a person that makes an acquisition causing it to beneficially own more than 5% of a company's outstanding shares has ten days to file a Schedule 13D after its acquisition. The Brokaw Act would shorten the ten-day period to two business days.
- **Short positions to be subject to Regulation 13D.** Currently, absent unique circumstances, short sales do not affect a person's beneficial ownership of the subject securities. For example, a person that directly holds 3% of a company's shares and has a short position with respect to 6% of the company's shares should not need to file a Schedule 13D or 13G. The Brokaw Act would require a

person that holds a short position representing more than 5% of a company's shares to file a Schedule 13D after acquiring the short position that caused it to exceed the 5% threshold. While there is some ambiguity in the legislation, the Brokaw Act does not appear to permit the use of a Schedule 13G to report a more than 5% short position.

- **Determination of beneficial ownership to include pecuniary interest.** Currently, Regulation 13D-G determines beneficial ownership based on a person's voting and/or dispositive power over the company's shares. The Brokaw Act would expand the concept of beneficial ownership to include pecuniary (or economic) interest, in addition to voting and dispositive power. The Brokaw Act would import some, but not all, of the Section 16 definition of pecuniary interest. Accordingly, a person that is the long party to a cash-settled swap may need to count the shares underlying the instrument in determining whether it beneficially owns more than 5% of the company's shares, even if it does not have the power to vote or sell such underlying shares.

In addition to the changes above, the Brokaw Act also defines the term "derivative instrument" and clarifies how to count shares subject to a derivative instrument for purposes of the 5% beneficial ownership and 5% short position triggers. The Brokaw Act also clarifies that the concept of a "group" includes persons acting together for the purposes of seeking to control or influence the company's board, management or policies, as well as those seeking to evade Regulation 13D-G.

We expect that SEC rulemaking will be required to implement some of the Brokaw Act's provisions, while others will become effective with the legislation's enactment. Additionally, guidance from SEC staff may be required to clarify any ambiguous provisions. Ultimately, to the extent it is enacted, the Brokaw Act will significantly affect disclosure by private funds and their advisers with respect to publicly traded securities.

Estate Planning Updates

Proposed Regulations Seek to Curtail Valuation Discounts

The most successful estate planning techniques pass significant value from one generation to the next by freezing or establishing an appreciating asset's value and shifting the asset's growth to a younger generation (a "freeze technique"), resulting in significant gift, estate and generation-skipping transfer tax savings. These freeze techniques can provide even greater transfer tax savings if the asset transferred to the younger generation is eligible for valuation discounts. Historically, such valuation discounts have been achieved by funding a family limited partnership with the appreciating asset and then gifting or selling limited partner interests to the younger generation.

Section 2704 of the Code is designed to eliminate perceived abuses by taxpayers in artificially reducing the transfer tax cost of intra-family transfers of interests in family limited partnerships and closely held corporations through the use of valuation discounts. Nevertheless, through careful navigation of the current rules under section 2704, taxpayers still have been able to achieve valuation discounts in transferring interests in family limited partnerships and closely-held corporations.

However, on August 2, 2016, the IRS issued the long-awaited [proposed regulations](#) under section 2704 of the Code, which further limit the availability of valuation discounts. Specifically, these proposed regulations are designed to prevent taxpayers from lowering the estate and gift tax value of transferred assets – a tax loophole taxpayers have used to achieve valuation discounts in transferring interests in

family limited partnerships and closely-held corporations for estate, gift and generation-skipping transfer tax purposes.

In particular, the proposed regulations seek to expand the types of interests that would be subject to section 2704 so that taxpayers cannot receive discounts on their interests in family-controlled LLCs and other entities beyond family limited partnerships and closely-held corporations. Additionally, the proposed regulations narrow the class of restrictions that will be recognized for discount purposes by prescribing a new class of “disregarded restrictions” that apply specifically to restrictions on the ability to force the liquidation or redemption of an individual partner’s interest in the partnership in certain cases. Furthermore, the proposed regulations seek to eliminate some of the other techniques that taxpayers have utilized to continue to benefit from valuation discounts, such as giving a small interest in the entity to a non-family member (such as a charity), which currently prevents section 2704 from applying to an intra-family transfer.

However, the proposed regulations are not effective until they are published in final by the Treasury Department in the Federal Register (or thirty days thereafter in some cases). A public hearing is scheduled for December 1, 2016, so the earliest the regulations are expected to be published in final is sometime in 2017. It is possible that the proposed regulations could be revised before they are published in final, but even considerable revisions will still likely significantly curtail the use of valuation discounts. Thus, any planning that seeks to take advantage of valuation discounts available under current law should be done immediately.

Lifetime Estate, Gift and GST Tax Exemptions

The U.S. American Taxpayer Relief Act, which was signed into law in 2013, has made the following permanent: (i) the reunification of the estate and gift tax regimes; and (ii) the \$5 million estate, gift and generation-skipping transfer (**GST**) tax exemptions, as increased for inflation. Below are the tax exemption inflation increases for 2017:

- There will be a \$5,490,000 federal estate tax exemption (increased from \$5,450,000 in 2016) and a 40% top federal estate tax rate.
- There will be a \$5,490,000 GST tax exemption (increased from \$5,450,000 in 2016) and a 40% top federal GST tax rate.
- The lifetime gift tax exemption will be \$5,490,000 (increased from \$5,450,000 in 2016) and a 40% top federal gift tax rate.
- The annual gift tax exclusion will be \$14,000 (no increase from 2016).

These increased exemptions create opportunities to make larger lifetime gifts, leverage more assets through a variety of estate planning techniques (such as a sale to a grantor trust) and shift income producing assets to individuals such as children or grandchildren, who may be in lower income tax brackets and/or reside in states with a low income tax rate or no state income tax.

Gift Tax Annual Exclusion

In 2017, the gift tax annual exclusion amount per donee will remain \$14,000 for gifts made by an individual and \$28,000 for gifts made by a married couple who agreed to “split” their gifts. To take advantage of any remaining 2016 gift tax exclusion amount, gifts must be “completed” before December 31, 2016.

In lieu of cash gifts, donors also may consider gifting securities or interests in privately held companies or other family-owned entities. The assets that are given away now may be worth significantly less than they once were, and their value hopefully will increase in the future. Thus, the \$28,000 gift that a married couple makes in 2016 may have a built-in discount that the IRS cannot reasonably question. That discount will inure to the benefit of beneficiaries if the value of those assets rises.

Annual exclusion gifts may be made directly to beneficiaries or to trusts that are established for their benefit. It is important to note, however, that gifts to trusts will not qualify for the gift tax annual exclusion unless the beneficiaries have certain limited rights to the gifted assets (commonly known as “Crummey” withdrawal powers). If a trust has been created that contains beneficiary withdrawal powers, it is essential that the trustees send Crummey letters to the beneficiaries whenever a trust contribution is made.

If an insurance trust has been created, it is important to remember that any amounts contributed to the trust to pay insurance premiums are considered additions to the trust. As a result, the trustees should send Crummey letters to the beneficiaries to notify them of their withdrawal rights over these contributions. Without these letters, transfers to the trust will not qualify for the gift tax annual exclusion.

2016 Gift Tax Returns

Gift tax returns for gifts that are made in 2016 are due on April 18, 2017. However, the due date can be extended to October 16, 2017 if a timely filed request is made for an automatic extension of time to file the 2016 income tax return (the deadline for filing a gift tax return will also be extended).

For trusts created in 2016, accountants should be directed to elect to have the GST tax exemption either allocated or not allocated, as the case may be, to contributions to that trust. It is critical that this step not be overlooked, which must be taken even if gifts do not exceed the annual gift tax exclusion and would, therefore, not otherwise require the filing of a gift tax return.

Reorganization and Chapter 11 Developments

Over the past year, important decisions have been rendered by federal courts (i) curtailing a lender’s ability to create bankruptcy remoteness for its borrower by the use of a so-called “blocking member” whose consent is required for any bankruptcy filing, (ii) rendering “cause” to deprive a lender of its right to credit bid more difficult to establish, and (iii) ruling that the applicable contract rate (if any) – and not the federal judgment rate – is the proper post-petition interest rate to apply to unsecured contract claims in solvent chapter 11 cases, absent equitable considerations to the contrary. Although these decisions were not rendered by federal circuit courts of appeal, and therefore are not binding on other courts faced with similar issues, it would be wise for private funds to understand their implications when structuring and pricing their investments, and when considering restructuring alternatives.

Use of “Blocking Members” to Insulate a Borrower from Bankruptcy

For some time, lenders have required various legal structures designed to limit or prevent their borrowers from filing for bankruptcy. One common structure mandates borrowers to include in their corporate governance documents a provision requiring unanimous member or director consent to authorize a bankruptcy filing, together with a provision granting the lender the right to appoint a director or granting the lender non-economic voting shares or membership interests. In effect, such provisions give the lender an affirmative consent (or, viewed from the opposite perspective, a blocking right) to a bankruptcy

filing. A recent decision from the U.S. Bankruptcy Court for the District of Delaware in *In re Intervention Energy Holdings, LLC*, 553 B.R. 258 (Bankr. D. Del. 2016) and another from the U.S. Bankruptcy Court for the Northern District of Illinois in *In re Lake Michigan Beach Pottawattamie Resort LLC*, 547 B.R. 899 (Bankr. N.D. Ill. 2016) examine the enforceability of these structures. Both declined to dismiss bankruptcy filings where the consent of the lender member or designee was not obtained, finding the pre-bankruptcy consent provisions in these cases void as against federal public policy.

The issue in each case concerned whether a provision in an LLC operating agreement requiring unanimous consent of all members for the LLC to file bankruptcy was void as against public policy. There is a well-established federal public policy that assures individuals and business entities the congressionally enacted right to seek bankruptcy relief, and courts will generally void any contractual waiver of that right provided to a creditor. At the same time, bankruptcy law recognizes that corporate governance requirements, including proper authorization, must be satisfied when commencing a bankruptcy case. When these clash, as the *Lake Michigan* court explained, “the long-standing policy against contracting away bankruptcy benefits is not necessarily controlling when what defeats the rights in question is a corporate control document instead of a contract.”

The *Lake Michigan* Decision. In *Lake Michigan*, the debtor, a Michigan LLC, had one asset, a vacation resort in Coloma, Michigan. The debtor granted its lender a mortgage on the property and an assignment of rents to secure a \$1.336 million loan and a \$500,000 line of credit. The debtor subsequently defaulted on the loan. The lender agreed to enter into a forbearance agreement on the condition that the debtor appoints the lender as a “Special Member” and amend its operating agreement to require the consent of the Special Member for any material actions, including the filing of a bankruptcy petition. Notably, as a Special Member, the LLC operating agreement provided that the lender was “entitled to consider only such interests and factors it desires, including its own interests” and had “no duty or obligation to give any consideration to any interests of or factors affecting the Company or the Members.” The lender had no other rights under the LLC operating agreement other than its consent rights; the lender did not share in distributions, had no rights to tax benefits, and was not required to make capital contributions. Shortly after amending its operating agreement, the debtor again defaulted and filed for chapter 11 protection without obtaining the lender’s consent. The lender sought to dismiss the bankruptcy case for lack of authorization and as a bad faith filing.

The bankruptcy court ruled the Special Member consent requirement was invalid and not enforceable. The court explained there is a fundamental difference between preventing a bankruptcy filing through a contractual bankruptcy waiver (which is always invalid) as opposed to the use of a blocking director under corporate governance principles (which the court states can be valid). A contractual waiver is invalid because it binds the debtor to a specific future action without considering the impact on the bankruptcy estate, parties-in-interest, and the debtor’s own fiduciary duties. In contrast, a blocking director, though appointed by a lender, will generally still have to adhere to his or her general fiduciary duties mandated under Michigan law. As the *Lake Michigan* court stated, “the essential playbook for a successful blocking director is this: the director must be subject to normal director fiduciary duties and therefore in some circumstances vote in favor of a bankruptcy filing, even if it is not in the best interests of the creditor that they were chosen by.”

Under Michigan law, LLC members have a duty to consider the interests of the LLC and cannot act solely in the member’s own interests. As noted, however, the LLC operating agreement in *Lake Michigan* purported to absolve the lender of any fiduciary duties and thus the lender could vote based solely on its

own interests. Because of this, the bankruptcy court held the consent provision violated public policy and was unenforceable.

The *Intervention Energy Holdings* Decision. Shortly after *Lake Michigan* was decided, a Delaware bankruptcy court reached a similar conclusion in *Intervention Energy Holdings*. Intervention Energy Holdings, LLC (**IE Holdings**) and its wholly-owned subsidiary (collectively, the **IE Debtors**) were Delaware LLCs. In January 2012, the IE Debtors entered into a secured note purchase agreement with EIG Energy Fund XV-A, L.P. (**EIG**). Following defaults under the note purchase agreement, the IE Debtors and EIG entered into a forbearance agreement. Among other things, the forbearance agreement (i) provided that EIG would waive all defaults if the IE Debtors raised additional capital to pay down a portion of EIG's claims by a specified date, and (ii) required IE Holdings to amend its LLC agreement to grant EIG a single common membership unit and to require approval of all common unit holders prior to any bankruptcy filing. Thereafter, IE Holdings sold a single common membership unit to EIG for \$1.00. Several months later, the IE Debtors commenced chapter 11 cases in Delaware without seeking or obtaining EIG's consent.

EIG sought to dismiss the bankruptcy cases arguing the debtors lacked authorization to file without EIG's consent. EIG attempted to distinguish the holding in *Lake Michigan* by arguing Delaware limited liability company law (unlike Michigan law which was at issue in *Lake Michigan*) expressly permits the elimination of member fiduciary duties and, therefore, its consent right was valid and should be respected. The bankruptcy court declined to consider the enforceability of the disclaimer of fiduciary duties under Delaware law. Instead, the court held that even if the disclaimer of fiduciary duties and consent right were valid under Delaware law, the consent right at issue was "tantamount to an absolute waiver" obtained through contract and therefore violated federal public policy. The bankruptcy court looked beyond the fact that the consent right was contained in the LLC operating agreement and instead focused on the circumstances by which the consent right was obtained. As the court explained:

"A provision in an LLC company governance document obtained by contract, the sole purpose and effect of which is to place into the hands of a single, minority equity holder the ultimate authority to eviscerate the right of that entity to seek federal bankruptcy relief, and the nature and substance of whose primary relationship with the debtor is that of creditor – not equity holder – and which owes no duty to anyone but itself in connection with an LLC's decision to seek federal bankruptcy relief, is tantamount to an absolute waiver of that right, and, even if arguably permitted by state law, is void as contrary to federal public policy."

The bankruptcy court further distinguished EIG's actions from a line of cases upholding member consent rights where the voting members purchased their membership interests in a separate transaction. The bankruptcy court noted that although EIG may have "bought and paid for its Common Units," it did so under a forbearance agreement that required IE Holdings to issue the common unit and amend its LLC operating agreement. Based on this fact, it found EIG's intent was to restrict IE Holding's ability to file for bankruptcy, which was improper.

Attention to Drafting and Careful Planning May be Critical to Using Blocking Directors. Both *Lake Michigan* and *Intervention Energy Holdings* demonstrate that bankruptcy courts may carefully scrutinize restrictions on an entity's right to file for bankruptcy. Although both cases invalidated bankruptcy consent provisions contained in LLC operating agreements, neither held such provisions are per se invalid. As the *Lake Michigan* case indicates, public policy considerations of recognizing state law are strengthened where a creditor-appointed director or member is not restricted in fulfilling his or her fiduciary duties. Drafters of bankruptcy consent provisions should heed the guidance offered by *Lake*

Michigan and Intervention Energy Holdings and weigh the impact such provisions may have on federal bankruptcy policy. Additionally, the lenders in *Lake Michigan and Intervention Energy Holdings* rendered it particularly easy for the courts to override the lenders' governance rights because the lenders had no economic interests as equity holders. Thus, it was clear the governance documents were serving as additional restrictions in a loan agreement. If the lenders had separately held equity interests with economic rights, the courts' ability to override the governance requirements would have been far more questionable.

[SDNY Bankruptcy Court Denies Debtors' Motion to Equitably Subordinate or Recharacterize Secured Lenders' Claim, and Refuses to Eliminate or Limit Credit Bid Rights](#)

In August 2016, Judge Sean Lane of the U.S. Bankruptcy Court for the Southern District of New York issued an opinion in the chapter 11 cases of Aéropostale, Inc. and its affiliates that denied a motion by Aéropostale to: (i) equitably subordinate the claims of term lenders that were affiliated with a private equity sponsor; (ii) prohibit the term lenders from credit bidding their secured claims at a bankruptcy auction for the company; and (iii) re-characterize the term lenders' secured claims as equity investments. The decision is an important victory for private funds (and secured creditors generally), as Judge Lane refused to find that aggressive pre-petition creditor enforcement actions alone will suffice to deny credit bidding rights or to equitably subordinate or recharacterize secured debt.

Aéropostale's Multifaceted Relationship with its Private Equity Investor. At the time of its chapter 11 filing, Aéropostale was a retailer of young adult casual apparel and accessories with over 800 stores located throughout the U.S. and Canada. The core of the dispute centered on the many relationships among Aéropostale, Sycamore Partners (**Sycamore**), a private equity firm that specializes in retail investments, and various Sycamore affiliates.

In late 2013, an affiliate of Sycamore acquired \$54 million (roughly 8%) of Aéropostale's publicly traded common stock, making it one of Aéropostale's largest shareholders. In 2014, in the face of declining performance, Aéropostale and two Sycamore affiliates (**Term Lenders**) entered into a loan and security agreement whereby Aéropostale borrowed \$150 million from the Term Lenders. Two additional relationships sprung from the term loan facility: (i) Sycamore's co-founder and managing director was appointed to Aéropostale's board pursuant to an investor rights agreement, and (ii) Aéropostale entered into an inventory sourcing agreement with another Sycamore affiliate, MGF Sourcing US LLC (**MGF**). As a result of these transactions, a Sycamore affiliate or related person was now a shareholder, director, lender and major supplier of Aéropostale.

The relationship between Aéropostale and Sycamore soured. Aéropostale's pre-petition financial performance deteriorated and its stock declined significantly from the time Sycamore's affiliate acquired its 8% stock interest. In early February 2016, Sycamore's affiliate sold all its Aéropostale stock for a little over \$1 million, representing a \$53 million loss. Later that month, MGF shortened payment terms under the sourcing agreement. Payment terms were typically "net 30," meaning payment was due 30 days after delivery of the product. However, pursuant to the parties' agreements, if Aéropostale's liquidity dipped below \$150 million, then a credit review period could be triggered permitting MGF to, among other things, change payment terms. In late February 2016, MGF informed Aéropostale that it believed a credit review period had been triggered and demanded cash in advance on all future orders. A few days later, MGF also demanded cash in advance on all pending orders (instead of the net 30 terms that previously governed those orders), causing immediate liquidity concerns for Aéropostale. Aéropostale disputed that a credit review period had been triggered and demanded MGF reinstate the prior credit terms, although

Aéropostale never made any effort to demonstrate that the minimum liquidity covenant had not been breached. Thereafter on May 4, 2016, Aéropostale filed for bankruptcy and sought to sell all its assets through a bankruptcy auction and sale process. During the sale process, Aéropostale challenged the Term Lenders' secured claims because only allowed secured claims are permitted to credit bid.

A credit bid is the ability of a secured creditor to use its secured debt as cash in an auction. Section 363(k) of the Bankruptcy Code provides when a debtor seeks to sell an asset subject to a lien "that secures an allowed claim," the secured creditor may bid at the auction of that asset the secured "claim against the purchase price of such property." 11 U.S.C. § 363(k). The right to credit bid is not absolute, however, as section 363(k) limits credit bidding rights if "the court for cause orders otherwise." The Bankruptcy Code does not define what constitutes "cause," leaving courts to determine cause on a case-by-case basis.

Aéropostale's Basis for its Motion. Aéropostale's claims were grounded in its allegations that Sycamore and its affiliates had taken unfair advantage of their many interrelationships with the company (including misusing material, nonpublic information acquired on a confidential basis) and engaged in a pattern of inequitable conduct, all as part of an improper scheme to force the company into bankruptcy to acquire the company at a discount through a credit bid that would discourage active bidding by third parties. According to Aéropostale, the alleged inequitable conduct included (i) MGF's intentional breach of the sourcing agreement by improperly declaring a credit review period, and thereafter by unilaterally changing the terms of approximately \$80 million of pending purchase orders from net 30-day terms to payment in advance – which Aéropostale alleged was "objectively" unreasonable, not permitted under the sourcing agreement and not consistent with industry practice; (ii) embarking on a secret plan to lower Aéropostale's value by pushing it into bankruptcy so Sycamore could buy it "on the cheap"; and (iii) trading in Aéropostale's stock while in possession of material, nonpublic information. Aéropostale also argued that potential bidders for Aéropostale's assets would not bid if the court did not restrict the Term Lenders' credit bid rights.

The Bankruptcy Court Ruled Against Aéropostale. Following a multi-day trial, the bankruptcy court issued an 86-page decision denying each of Aéropostale's claims.

In denying Aéropostale's request for equitable subordination, the court found MGF had properly declared a credit review period had been triggered and therefore was within its contractual rights to amend Aéropostale's payment terms based on Aéropostale's financial condition, expressly finding that Aéropostale was attempting to impose on MGF an "objective reasonableness" standard not contained in the parties' contract. The court also found that, given MGF's own financial issues (including the prospect of defaulting on its own debt), MGF acted reasonably in imposing new credit terms after the credit review period was triggered. Additionally, the court concluded that Aéropostale's allegation of a secret plan to push the company into bankruptcy to "buy the company on the cheap" was not credible. To the contrary, the court found that, given Sycamore and its affiliates had over \$200 million invested through loans and equity, and had incurred substantial startup costs in connection with the sourcing agreement, Sycamore had every incentive to keep Aéropostale out of bankruptcy. The court also found the mere fact that Sycamore wore multiple hats in its relationship with Aéropostale was insufficient to support a conspiracy, as those relationships sprung out of arms-length negotiations that were "not forced upon" Aéropostale. Finally, the court found no harm to Aéropostale's creditors resulted from the stock sale.

In denying Aéropostale's motion to limit the Term Lenders' credit bid rights, the court found no evidence "of collusion, undisclosed agreements, or any other actions designed to chill the bidding or unfairly distort the sale process." Without any evidence of lender misconduct, the court ruled there was no "cause" to

limit the Term Lenders' right to credit bid. The court also rejected Aéropostale's argument that a chilling effect existed because potential bidders may not participate in the auction. As Judge Lane explained, "all credit bidding chills an auction process to some extent" and the court "did not believe that the chilling effect of credit bids alone should suffice as cause under section 363(k)." The court also found it notable that, despite Aéropostale's claims of chilled bidding, several parties were actively pursuing a bid for the company's assets.

Finally, the bankruptcy court ruled that there was no basis to recharacterize the term loan as an equity investment as the loan was documented properly, contained typical loan terms, required Aéropostale to give a security interest in collateral and was obtained through a process whereby Aéropostale actively solicited loan proposals from other third parties.

Other Courts Have Denied Credit Bidding in the Absence of Clear Inequitable Conduct. The decision in *Aéropostale* is in contrast to the decision in *In re Fisker Automotive Holdings, Inc.*, 510 B.R. 55, 59 (Bankr. D. Del. 2014), but only superficially in contrast. In *Fisker*, Hybrid Tech Holdings, LLC (**Hybrid**) purchased the debtor's secured debt of \$168.5 million at a discount for \$25 million. The debtor subsequently filed for bankruptcy and sought to sell substantially all its assets to Hybrid on a truncated schedule imposed by Hybrid—with only 24 business days between the filing of the motion and the sale hearing. In addition, Hybrid had a security interest in only a subset of the assets being sold. In response to a motion to limit Hybrid's right to credit bid, the bankruptcy court held that Hybrid could credit bid up to \$25 million for the debtor's assets, representing the amount Hybrid paid for the debt. Relying on a prior Third Circuit decision that did not require inequitable conduct to restrict credit bidding rights as long as it would be in the "interest of any policy advanced by the Code," the *Fisker* court concluded that "there will be no bidding – not just the chilling of bidding – if the Court does not limit the credit bid." The lender's lack of a security interest in some assets being sold, together with its attempt to force the court to schedule the sale on relatively short notice by fabricating a drop dead date, creates cause for curtailing the credit bid that did not exist in *Aéropostale*.

Aéropostale asked the court to follow the portion of *Fisker* that denied credit bidding rights because no one else would appear at the auction. Judge Lane refused to do so, noting that he "is unaware of any cases where the chilling of bidding alone is sufficient to justify a limit on a credit bid." In distinguishing *Fisker*, Judge Lane emphasized that (i) it appeared the bidder in *Fisker* had engaged in inequitable conduct by requiring a truncated sale process while the validity of its liens remained unresolved, and (ii) there would be no bidding at the *Fisker* auction.

Private Funds Should Manage Their Relationships Carefully. *Aéropostale* is a victory for private fund lenders against the efforts of debtors to restrict or limit secured lenders' credit bid rights as lenders continue to push to truncate chapter 11 cases with quick sales. Judge Lane's opinion recognizes that it is not inequitable for private funds to take permitted actions pre-petition to protect their own interests, even if those actions may have adverse effects on the debtor.

However, *Aéropostale* is also a cautionary tale on the lengths to which a debtor may go to restrict credit bid rights or otherwise impair the secured claims of creditors. The *Aéropostale* trial lasted over one week, involved 14 live witnesses (including experts), 6 declarations, an expedited discovery process and over 400 exhibits entered into evidence. The evidence never produced a smoking gun that gave any credence to Aéropostale's theories. Yet it is not hard to foresee a situation where a private fund is not as cautious in its pre-petition actions and gives the debtor a better factual record than in *Aéropostale*. To avoid having

rights invalidated or impaired, private funds that “wear multiple hats” need to carefully manage those relationships to avoid coming out on the wrong end of a judge’s opinion.

District Court Awards Unsecured Creditors Post-petition Interest at the Contract Rate

The U.S. District Court for the Northern District of Illinois in *In re Dvorkin Holdings, LLC*, 547 B.R. 880 (D. N.D. Ill. 2016) held that there is a presumption in cases where the debtor is solvent that unsecured claimholders are entitled to post-petition interest at the rate set forth in their respective contracts with the debtor, not the lower federal judgment rate. The issue in the case stems from the Bankruptcy Code’s prohibition on the payment of “unmatured interest” – interest not yet due and payable at the time the bankruptcy petition was filed – on unsecured claims. 11 U.S.C. § 502(b). Courts generally are in agreement, however, that unsecured claimholders are entitled to post-petition interest if the debtor is solvent by operation of sections 1129(a)(7) and 726(a)(5) of the Bankruptcy Code. Section 1129(a)(7), also known as the “best interests” test, provides that a chapter 11 plan cannot be confirmed unless creditors receive at least as much as they would if the debtor were liquidated under chapter 7. Section 726(a)(5), in turn, provides that, in a solvent debtor’s chapter 7 case where all allowed unsecured claims are to be paid in full, unsecured creditors are entitled to “interest at the legal rate from the date of the filing of the petition.”

The court in *Dvorkin* addressed the meaning of the phrase “interest at the legal rate.” The plan proponents sought to pay all unsecured claimholders post-petition interest at the federal judgment rate (at the time of the case, 0.17%). An unsecured note holder objected to the plan, arguing the legal rate meant the contract rate set forth under its promissory notes. The bankruptcy court ruled in favor of the plan proponents and applied the federal judgment rate. On appeal, the district court sided with the creditor, holding that in a solvent chapter 11 case, there is a presumption that creditors who have contracts with the debtor should receive post-petition interest at the rate set forth in their contract. The district court further ruled that this presumption can be rebutted based on any equitable considerations that the bankruptcy court deems relevant, and remanded the case back to the bankruptcy court to determine whether any such equitable considerations existed.

Dvorkin is an encouraging victory for unsecured claimholders as the difference between the federal judgment rate and the contract rate is often significant. Yet the case law on the appropriate interest rate for unsecured claims in a solvent chapter 11 case is far from clear. Until a circuit court provides a definitive ruling on the matter, private funds should carefully consider these risks and litigation uncertainties when computing their investment theses.

European Union Regulatory Updates

ESMA Issues Advice on Extension of AIFMD Third Country Passport to Non-EU Countries

On July 19, 2016, the European Securities and Markets Authority (**ESMA**) published its final advice (**ESMA Advice**) on extending the application of the marketing passport under the Alternative Investment Fund Managers Directive (**AIFMD**) to non-European managers.

The AIFMD applies to alternative investment fund managers (**AIFMs**) seeking to manage or market alternative investment funds (**AIFs**) in the European Union (**EU**). Currently, the application of AIFMD to AIFMs not established in the EU (**non-EU AIFMs**) is relatively limited and, as a consequence, these non-EU AIFMs do not have the same freedom as their European counterparts when seeking to market their funds across the EU.

Background. Currently under AIFMD, an EU AIFM that wishes to market an EU AIF must do so using the AIFMD marketing passport. This requires the AIFM to provide its home country regulator with (i) a notification setting forth specific information on the AIF to be marketed and (ii) a list of the other EU countries into which marketing will take place. Within twenty working days after the submission of this notification, the AIFM is permitted to market the AIF to professional investors in the specified EU countries. It should be noted that some EU countries have a “gold-plated” AIFMD, such that even with a passport, an AIFM may nevertheless be subject to local representative and fee requirements.

The AIFMD marketing passport is not currently available for: (i) non-EU AIFMs wishing to market AIFs in the EU, (ii) EU AIFMs marketing non-EU AIFs in the EU, or (iii) EU AIFs that are feeder funds to non-EU master AIFs.

Instead, these managers must comply with the national private placement regime (**NPPR**) requirements for each EU country they wish to market in. NPPR requirements differ across EU countries. For instance, managers relying on the reverse solicitation “exemption” under AIFMD face the issue of differing country interpretations of marketing behavior that may constitute a valid reverse solicitation. In some cases (such as in the U.K. and Luxembourg) the NPPR requirements are relatively light, in others (such as in France and Germany) the requirements are more extensive, while marketing under the NPPR is not available at all in some EU countries (such as in Italy).

The overall impact of AIFMD has been to limit the access that non-EU AIFMs have in raising capital from European investors. In circumstances where NPPR notifications have been made, non-EU AIFMs are subject to ongoing requirements (*e.g.*, periodic reporting) which have further increased the cost and regulatory burden of marketing in the EU.

ESMA’s Advice. Under AIFMD, ESMA has been tasked with assessing and advising on the possible extension of the marketing passport to: (i) non-EU AIFMs and (ii) AIFs currently subject to the NPPRs. In addition to the threshold criteria for cooperation arrangements for each country, ESMA also assessed whether there were significant obstacles that would impede the application of the AIFMD passport regarding:

- Investor protection;
- Competition;
- Market disruption; and
- Monitoring of systemic risk.

A summary of the ESMA Advice regarding each country assessed is provided below:

- **United States.** ESMA determined that there are no significant obstacles regarding investor protection and the monitoring of systemic risk which would impede the application of the AIFMD passport to the U.S. With respect to competition and market disruption, ESMA determined that there are no significant issues for funds marketed by managers to professional investors that do not involve a public offering. On the other hand, ESMA determined that in the case of funds marketed by managers to professional investors that do involve a public offering, a potential extension of the AIFMD passport to the U.S. risks an unlevelled playing field between EU and non-EU AIFMs. The market access conditions which would apply to these U.S. funds in the EU under an AIFMD passport would be different from, and potentially less onerous than, the market access conditions applicable to EU funds

in the U.S. involving a public offering. ESMA suggested, therefore, that EU legislators may wish to consider possible alternatives including granting the AIFMD passport only to:

- U.S. funds dedicated to professional investors to be marketed in the EU by managers that do not involve any public offering;
- U.S. funds that are not mutual funds; and
- U.S. funds that restrict investment to professional investors as defined under AIFMD.

It should be noted that these issues appear to be less relevant to the offering of private investment funds which tend to be offered by way of private placement.

- **Canada, Guernsey, Japan, Jersey and Switzerland.** ESMA determined that there are no significant obstacles regarding investor protection, competition, market disruption and monitoring of systemic risk impeding the application of the AIFMD passport.
- **Hong Kong and Singapore.** ESMA only considered the position in relation to AIFs, and not AIFMs, in Hong Kong and Singapore, and concluded that there are no significant obstacles regarding investor protection, competition, market disruption and the monitoring of systemic risk impeding the application of the AIFMD passport.
- **Australia.** ESMA determined that there are no significant obstacles regarding investor protection, monitoring systemic risk, market disruption and obstacles to competition impeding application of the AIFMD passport, provided that (with respect to market disruption and obstacles to competition) the Australian Securities and Investment Commission extends to all EU Member States the “class order relief,” which is currently available only to some EU Member States.
- **Bermuda and Cayman Islands.** ESMA determined that there are no significant obstacles regarding competition, market disruption and the monitoring of systemic risk impeding application of the AIFMD passport. However, with respect to investor protection, ESMA indicated that it will not be able to issue definitive advice until AIFMD-like regimes referenced in the ESMA Advice are adopted, and specifically, a review of regulations (in the case of Bermuda) is completed and a legislative amendment (in the case of the Cayman Islands) is adopted.
- **Isle of Man.** ESMA determined that there are no significant obstacles regarding competition, market disruption and monitoring of systemic risk impeding application of the AIFMD passport. However, ESMA indicated in the absence of plans to put in place AIFMD-like regimes with respect to investor protection, it was difficult for ESMA to assess the investor protection criterion.

In addition to the non-EU jurisdictions identified above, ESMA also provided a list of other non-EU countries that may be included in future assessments of whether the AIFMD passport should be extended to them. These countries are: the Bahamas, Brazil, the British Virgin Islands, Curacao, Mexico, Mauritius, South Africa, South Korea, Thailand and the U.S. Virgin Islands.

ESMA also gathered intelligence on investor protection, competition, potential market disruption and monitoring of systemic risk with respect to the following non-EU countries: Malaysia, Egypt, Chile, Peru, India, China and Taiwan. ESMA noted that these countries have not been assessed in any detail at this stage due to (i) a lack of a memorandum of understanding between national regulators in the EU countries and the national regulators of the aforementioned non-EU countries, or (ii) a lack of management and/or marketing activity linking these countries to the EU.

Next Steps in the Legislative Process. The ESMA Advice is addressed to the European Council, the European Parliament and the European Commission. Under AIFMD, the European Commission must adopt a delegated act within three months of having received a positive opinion from ESMA, specifying the date on which the third country passporting rules will apply. ESMA has indicated that the European Council, the European Parliament and the European Commission should consider waiting until ESMA has delivered positive advice on a sufficient number of non-EU countries before triggering the extension of the passport to non-EU countries. So it is of particular interest that ESMA has noted that the ESMA Advice in some cases cannot be considered positive. However, given the delays to the extension of the AIFMD passport, the European Commission may feel that it is unable to agree to further delays. Though, of course, this would need to be balanced against the adverse impact of extending the passport only in respect of a limited number of non-EU countries. Thus, the timetable for extension of the AIFMD passport to non-EU countries remains otherwise unclear at this stage.

Next Steps for Managers. Managers should continue to monitor whether the European Commission will set a date for extending the passport to non-EU countries. For the time being, in practice, non-EU AIFMs and EU AIFMs of non-EU AIFs likely will need to market AIFs under each EU country's NPPR or, where available, pursuant to reverse solicitation.

However, if a date is set for extending the passport to non-EU countries, managers will need to analyze their position in terms of (i) accessing the AIFMD passport, and therefore likely needing to comply with nearly all of AIFMD, or (ii) continuing to utilize NPPRs, to the extent that these regimes are available.

It is not known what approach may be taken by EU countries to the availability of NPPRs in the event that the AIFMD passport is extended to non-EU countries. However, it is believed that in Germany's case, NPPRs will be incompatible with the passport, and therefore, non-EU AIFMs may be forced to use the passport to access the German market. Also, it should be noted that, if the European Commission decides to extend the AIFMD passport to non-EU countries, a three-year period is triggered after which AIFMD NPPRs may be switched off.

Please see our [July 19, 2016](#) client alert for more information.

Brexit: No Short-Term Regulatory Change but Significant Longer-Term Implications

In February 2016, David Cameron, the then current Prime Minister of the U.K., announced that there would be a referendum on the U.K.'s membership in the EU. This referendum was a fulfillment of a promise made in the 2015 general election campaign.

The referendum vote took place on June 23, 2016. On June 24, 2016, it was officially announced that the U.K. had voted by 51.9% to 48.1% to leave the EU.

Short-Term Considerations. The referendum was an advisory referendum and the result has no direct legal effect. Therefore, from a legal and regulatory perspective, the result changes nothing in the short term. The U.K. remains a member of the EU and continues to benefit from the EU free trade area. From a financial services perspective, firms authorized in the U.K. and that benefit from an EU "passport" under one or more EU Directives (such as the Second Markets in Financial Instruments Directive (**MiFID II**) or AIFMD), which allow such firms to carry out cross-border activities (be this the provision of financial services or the marketing of financial products), will be able to continue to do so in the short term. Also, firms that access the U.K. market from outside the U.K. under EU legislation, such as AIFMD, may continue to do so in the near term.

Longer-Term Considerations and the Legal Framework for Withdrawal. There are mechanics in place under EU law for a Member State to leave the EU, which are set out in Article 50 of the 2009 Lisbon Treaty. The first step under Article 50 is for the Member State to notify the other EU Member States of its intention to withdraw from the EU. Activation of Article 50 obligates the EU to try to negotiate a withdrawal agreement with that EU Member State. The withdrawal agreement must be agreed to within a period of two years from the activation date unless all other EU Member States unanimously agree to extend the period of negotiation. If a withdrawal agreement were reached, a more comprehensive agreement between the U.K. and the continuing EU likely would ensue.

The precise date on which the U.K. might activate Article 50 is unclear. However, on October 2, 2016, Theresa May, the incumbent Prime Minister of the U.K. appeared to set a deadline of March 2017 when addressing a Conservative Party conference. May also suggested that legislation (known as the “Great Repeal Bill”) would be introduced to the U.K. parliament that would have the effect of repealing some legislation and regulation that had their genesis in the EU governing bodies while maintaining other such legislation and regulation, if desirable.

Nevertheless, the U.K. will remain a member of the EU, and remain subject to all resulting laws and regulations, until such time as the withdrawal agreement is agreed upon, or the two-year period following the Article 50 activation date has lapsed and there is no unanimous agreement to extend the negotiation period.

In the meantime, legal challenges were commenced in both the High Court of Northern Ireland and in the High Court of England and Wales in respect of the U.K. exiting the EU. The High Court of Northern Ireland has rejected the arguments of the Brexit challengers. Meanwhile, on November 3, 2016, the High Court of England and Wales [ruled](#) that a vote in Parliament must precede any decision to trigger Article 50. Given the current composition of Parliament, a vote in either direction cannot be guaranteed. Prime Minister Theresa May’s office vowed to argue against the ruling in an appeal to be heard on December 5th-8th, and a ruling on the appeal is expected to be issued in January 2017.

Looming Issues for Private Investment Funds. Assuming that the U.K. does not become a member of the European Economic Area, the third country provisions in MiFID II and AIFMD would become applicable to the U.K. That is, the third country provisions would apply to the U.K. in the same way as such provisions apply to the U.S., for example. Consequently, U.K. AIFMs would need to access EU markets under the AIFMD third country passport should it become available, for example, rather than being eligible to market funds under the EU passport by virtue of its membership in the EU, or market under NPPRs of individual EU countries.

If the U.K. becomes a third country under AIFMD and MiFID II, it remains to be seen whether the EU would treat the U.K. as being an “equivalent country” under applicable criteria. AIFMD is in effect and has been implemented around the EU, except for third country passport provisions, so the U.K. is to a large degree embedded in the AIFMD regulatory matrix and therefore it is hoped that equivalence status for the purpose of the extension of the third-country passport may not be problematic. With respect to MiFID II, there are still significant portions of MiFID II that may not be implemented for a few years and therefore attaining equivalence status may be not be straightforward.

For U.S. managers raising funds in the U.K. market, it remains to be seen whether the U.K. retains the AIFMD regime or elements of it, or alternatively whether the U.K. reverts to the old marketing regime that, for example, did not involve notification of the fund to the U.K. Financial Conduct Authority (**FCA**) and the

filing of regulatory reports but relied instead on marketing to investment professionals and other forms of sophisticated investors. While liberalization of the marketing laws would be welcomed, it may impact the U.K.'s equivalence status for the purposes of the third country provisions of AIFMD discussed above.

For U.S. managers looking to utilize the third country passport under AIFMD, should it become available, they would not be able to look to the U.K. as its member state of reference – essentially looking to the FCA as its “regulator” for AIFMD purposes – but rather would need to look to other European countries.

Developments following the U.K.'s vote to leave the EU should be monitored closely and firms potentially impacted should consider commencing scenario testing and contingency planning regarding the potential longer-term effects of the U.K.'s vote to leave the EU.

Please see our [June 24, 2016](#) client alert for more information.

MiFID II and MiFIR Updates

Current status of MiFID II and MiFIR. The texts of the [MiFID II](#) and [Markets in Financial Instruments Regulation \(MiFIR\)](#) were published in the Official Journal on June 12, 2014 and were effective on July 2, 2014. Member states are required to adopt measures to transpose MiFID II by July 3, 2017 and those measures must be effective as of January 3, 2018 (with some minor exceptions). As MiFIR is a regulation, it does not need to be transposed and will be effective (with limited exceptions) on January 3, 2018. The only exceptions relate to the provisions transposing Article 65(2) (which will be effective on September 3, 2019), the measures referred to in Article 92 (which became effective July 3, 2015), certain provisions detailed in Article 55 (which became effective immediately on MiFIR's entry into force) and Article 37(1), (2) and (3) (which will be effective January 3, 2020).

Postponement of application of MiFID II. On July 1, 2016, (i) the deadline for member states to transpose the MiFID II into national legislation was postponed to July 3, 2017 and (ii) the date of application of both MiFID II and MiFIR was postponed to January 3, 2018. This extends the original transposition deadline of MiFID II, and the application of MiFID II and MiFIR, by one year. Specifically, the following legislation and regulation became effective to postpone the application of MiFID II and MiFIR:

- [Directive](#) amending the MiFID II (2014/65/EU) (2016/1034) (**MiFID II Amending Directive**); and
- [Regulation](#) amending Regulation (EU) No 600/2014 on markets in financial instruments, Regulation (EU) No 596/2014 on market abuse and Regulation (EU) No 909/2014 on improving securities settlement in the European Union and on central securities depositaries (**MiFIR Amending Regulation**).

The application of all delegated and implementing acts, reports, reviews and transitional provisions is also deferred, and the repeal of MiFID will be postponed for the same period of time.

The postponement of MiFID II and MiFIR was required due to the challenges of implementation that ESMA faced.

Additional amendments to MiFID II and MiFIR. The MiFID II Amending Directive extends the exemption in Article 2(1)(d)(ii) of MiFID II to include non-financial entities who are members of or participants in a regulated market or a multilateral trading facility (**MTF**), or have direct electronic access to a trading venue when executing transactions on a trading venue that are objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of those non-financial entities or their groups. The MiFID II Amending Directive also amends the provision in Article

25(4)(a) relating to equivalent third country regulated markets in the context of the exclusion from the appropriateness requirements in Article 25(3).

The MiFIR Amending Regulation implements the following changes to the trade transparency regime in MiFIR: (i) it specifies the circumstances when the pre-trade transparency rules do not apply to certain packaged transactions or to any individual component of those orders, and adds new definitions for “exchange for physical”, “package order” and “package transaction” and (ii) it excludes securities financing transactions from the trade transparency requirements for trading venues, systematic internalizers and investment firms.

Amendments to other Directives and Regulations. The MiFIR Amending Regulation also amends the Market Abuse Regulation (596/2014) and the regulation on improving securities settlement in the European Union and on central securities depositories and amending the Settlement Finality Directive (98/26/EC), MiFID II Directive and the Short Selling Regulation (236/2012) (909/2014). In each case, these consist of consequential amendments relating to the date of application of MiFID II to align the relevant provisions in these Regulations with the new date of January 3, 2018.

Market Abuse Regulation

The EU’s new Market Abuse Regulation (**MAR**) took effect on July 3, 2016. Although MAR incorporates many principles from prior EU law, the new legislation demands the attention of all investors dealing with EU-listed securities.

EU rules on insider trading differ significantly from the rules familiar to U.S. market participants. Unlike the U.S., the EU has adopted a parity-of-information paradigm: MAR prohibits the use of material, nonpublic information if the user knows or should have known that the material information is nonpublic.

Certain defenses available in U.S. insider-trading proceedings are not available under MAR. For example, it is irrelevant whether (i) the discloser of the information had a duty not to disclose, (ii) the discloser received a personal benefit for disclosing material, nonpublic information (*i.e.*, the issue discussed [above](#) in connection with the *Salman* and *Newman* cases), or (iii) the recipient of the information owed a duty to the discloser not to use or disclose the information. Under MAR, a person who knows or should have known that he or she has material, nonpublic information cannot use it – period.

MAR’s promulgation appears to have opened a debate about whether a private right of action exists for market abuse. If such a cause of action exists, a MAR violation could lead not only to regulatory enforcement proceedings, but also to private claims by injured market participants.

MAR can apply to securities transactions anywhere in the world. The test is whether the security at issue is admitted for trading on an EU market. If the security is traded in the EU, the location of the particular transaction involving allegedly material, nonpublic information is irrelevant. Thus, if a U.S. trader uses material, nonpublic information in a transaction with a U.S. counterparty on a U.S. market, MAR applies if the security is also admitted for trading in the EU.

ESMA will publish a list of all financial instruments traded or admitted to trading in the EU. That list, however, will not be available until January 13, 2018, and will not limit MAR’s scope. The list’s failure to include a particular security will therefore not exempt traders from compliance with MAR.

Because MAR can apply to so many U.S. transactions, compliance efforts should focus on whether the trader possesses material, nonpublic information. By focusing on the nature of the information, rather

than on the existence of a duty or the receipt of a personal benefit, a trader can avoid violating EU law even if he or she is complying with U.S. law.

MAR provides specific rules for market participants involved in “market soundings,” which involve the communication of pre-transaction information to gauge potential investors’ interest in a possible transaction, including the size and pricing of any such transaction. The discloser of market-sounding information must obtain the recipient’s consent to keep the information confidential, and the recipient must so consent. But MAR also prescribes procedural and recordkeeping requirements for both the discloser and the recipient of that information.

Any hedge fund involved in – or considering whether to participate in – a market sounding should pay careful attention to MAR’s requirements, as laid out in the statute and in ESMA’s Guidelines. Because a hedge fund seems more likely to be a recipient than a discloser of inside information, the rules applicable to recipients are particularly important. Some key rules include the following:

- The recipient must make its own assessment of whether it has obtained inside information and, if so, whether and when the information is no longer nonpublic. The recipient should keep a record of its assessment for five years;
- The recipient should designate a specific person to receive market-sounding information and should so notify the discloser of the information;
- The recipient should ensure that market-sounding information is communicated only through established internal channels;
- The recipient must compile a list of persons working for it under an employment contract or otherwise performing tasks through which they have access to market-sounding information; and
- If the market-sounding information is conveyed in an unrecorded meeting or phone call, the discloser must prepare minutes or notes of the meeting or conversation and provide those notes to the recipient, and the recipient must sign the minutes or notes within five business days if it agrees with them.

Securities Financing Transactions Regulations

The regulation on transparency of securities financing transactions and of reuse (**SFTR**) came into force on January 12, 2016 (subject to various transitional provisions as set out below). However, as ESMA is required to produce regulatory technical standards (**RTS**) and implementing technical standards (**ITS**) specifying further detail in relation to some areas of SFTR, certain details will not be clear until the RTS and ITS are finalized.

SFTR aims to enhance transparency and enable regulators to better monitor risks by introducing (i) limitations on the reuse of collateral (not just in relation to securities financing transactions (**SFTs**), and (ii) reporting requirements for SFTs.

Reuse of Collateral. Article 15 of the SFTR sets out restrictions on the reuse of financial instruments received as collateral under a collateral arrangement. A “collateral arrangement” is a security financial collateral arrangement or a title transfer financial collateral arrangement, in each case, as defined in the Financial Collateral Directive. Under Article 15, a right of reuse of financial instruments received as collateral is subject to the following two conditions: (i) risks and consequences must be communicated in writing by or on behalf of the collateral taker; and (ii) prior express consent of the collateral provider must

be granted. Moreover, in order to exercise a right of reuse, (A) reuse must be undertaken in accordance with the terms specified in the relevant collateral arrangement; and (B) financial instruments must be transferred from the account of the counterparty providing the collateral.

The restrictions on reuse of collateral became effective on July 13, 2016 for collateral arrangements existing as of such date as well as to any new collateral arrangements. Standard disclosure wording has been developed by industry bodies (*e.g.*, ISDA) for use in trading documents.

It should be noted that SFTR has extra-territorial effect and applies to fund managers or brokers outside of the EU that (i) have a right of reuse over non-cash collateral received from counterparties that are either (A) counterparties established in the EU, or (B) counterparties acting through a branch in the EU; or (ii) are acting through a branch in the EU and have a right of reuse over non-cash collateral.

Reporting and Recordkeeping. SFTR creates a framework under which counterparties of an SFT have to report details of the transaction to trade repositories. This information will be centrally stored and will be directly accessible by relevant authorities, such as ESMA and the European Systemic Risk Board, for the purpose of identifying and monitoring financial stability risks caused by shadow banking activities.

Article 4 of the SFTR sets forth the transaction reporting and recordkeeping requirements. The conclusion, modification or termination of an SFT must be reported to a trade repository (**TR**) which is registered or recognized in accordance with the SFTR. The actual start date for transaction reporting depends on the relevant RTS relating to the reporting requirements. These RTS must be submitted by ESMA to the European Commission by January 13, 2017 and will then undergo a process of adoption by the European Commission. The reporting obligation will apply on a phased-in basis from the date that is 12, 15, 18 or 21 months after the effective date of the RTS (**Start Date**), in each case, depending on counterparty type. The intention behind phased-in reporting is for larger market participants to begin reporting first.

The reporting requirements will not only apply to SFTs concluded on or after the Start Date, but some SFTs will also be required to report retroactively. SFTs that were concluded before the applicable Start Date and remain outstanding on such date must be reported within 190 days after that Start Date, if (i) the remaining maturity of the SFTs on the Start Date exceeds 180 days, or (ii) the SFTs have an open maturity and remain outstanding 180 days after the Start Date.

Counterparties subject to the SFTR are required to keep a record of any SFT that they have concluded, modified or terminated for at least five years following the termination of a relevant transaction. The recordkeeping requirements do not have the benefit of the delayed implementation and were effective as of January 12, 2016. Thus, market participants need to ensure that they have the appropriate processes in place to facilitate compliance with these recordkeeping requirements or risk being in breach of regulatory requirements.

FCA Rule Changes Arising from the SFTR. On May 19, 2016, the FCA consulted on rule changes in its [consultation paper](#) (CP16/14) to reflect certain measures in the SFTR. The FCA explained that the new rules relate to the SFTR requirements for managers of AIFs to disclose their use of SFTs and total return swaps in the AIFs' pre-contractual documents and periodic reports to investors. These requirements supplement existing disclosure requirements in the Collective Investment Scheme sourcebook (**COLL**) and Investment Funds sourcebook (**FUND**). The FCA proposed to incorporate the relevant SFTR provisions into COLL and FUND to help firms comply with the new disclosure requirements. The FCA did not address other provisions in SFTR that are directly applicable to managers of AIFs.

On September 23, 2016, the FCA published the [Investment Funds \(Securities Financing Transactions\) Instrument 2016](#) (FCA 2016/65) (**SI**), which is designed to clarify the application of SFTR and signpost readers toward relevant provisions. Part of the SI became effective on September 23, 2016 and the remainder will become effective on January 13, 2017.

Regulations on Transparency of Securities Financing Transactions and of Reuse. The [Financial Services and Markets Act 2000 \(Transparency of Securities Financing Transactions and of Reuse\) Regulations 2016 \(SI 2016/715\)](#) (**FSMA Regulations**) came into force on July 13, 2016. The FSMA Regulations, which were accompanied by an [explanatory memorandum](#), implement in part the SFTR. They amend the Financial Services and Markets Act 2000 (**FSMA**) and other secondary legislation, confer powers on the FCA to enforce SFTR in respect of counterparties not regulated under FSMA and provide powers to the FCA and the Bank of England, supplementing those in FSMA where necessary.

In summary, the FSMA Regulations enable regulators to:

- Direct or require a counterparty to cease conduct resulting in a breach of an SFT FSMA Regulation;
- Impose financial penalties;
- Publicly censure a counterparty for breach of SFTR;
- Temporarily prohibit a person responsible for breach of a SFTR from being concerned in the management of a counterparty; and
- Impose a criminal penalty for misleading the regulator.

FCA Guidance and Updates

FCA Peers into Dark Pools. On July 21, 2016, the FCA published a [thematic review](#) of the U.K. equity market dark pools (**FCA Review**). The FCA uses thematic reviews to assess a current or emerging risk relating to an issue or product across a number of firms within a sector or market.

The FCA Review examined (i) the promotional activities undertaken by dark pool operators, where the FCA sought to assess actual delivery versus promises and/or promotional materials proffered; and (ii) the quality of the identification, management and disclosure of conflicts of interest by pool operators. In the FCA Review, a “dark pool” is defined as a trading venue with no pre-trade transparency such that all orders are hidden as to price and volume and are anonymous (*e.g.*, a broker crossing network (**BCN**) might be considered a dark pool).

Key findings of the FCA Review are summarized below:

- Asset managers should be clear about their rationale for using or not using dark pools (why, how and when). It is important that asset managers conduct adequate due diligence to thoroughly understand the operating model of a pool before commencing trading activity and be able to monitor ongoing activity and outcomes directly attributable to their use of a dark pool.
- Asset managers and operators should remain alert as markets evolve (*e.g.*, infrastructure changes at the firm or industry level, the emergence of new participants and the shift of technological advantages among participants can give rise to significant new risks).
- Asset managers and operators should carefully consider the new MiFID II rules (that will apply beginning on January 3, 2018) and the impact on existing and prospective business models.

- Dark pool operators must provide clear detail as to the design and operation of a dark pool – particularly how it interacts with other activities on the operator’s wider electronic trading platform, and ensure that disclosure is comprehensive, clear, fair and not misleading.
- Dark pool operators should improve the monitoring of their pool(s). The review and reporting on trading activity in a pool should reflect the relative sophistication and complexity of the features offered. The onus is on the operator to have adequate controls and oversight to ensure that all services, features and/or options made available to users consistently operate as designed and intended.
- Dark pool operators should do more to identify and manage conflicts of interest, including both client vs. client and operator vs. client.

The FCA also published a list of good and bad practices by dark pool operators, some of which are set forth below:

- Good practices include: (i) detailed and focused due diligence on proposed activity in the pool by prospective clients; (ii) onboarding discussions focused on clients’ trading style, strategies, activity volumes and goals; (iii) dynamic reassessment of routing logic based on market activity (*e.g.*, price volatility, liquidity); (iv) monitoring the latency of price feeds on a real-time basis; and (v) having a clear process with defined thresholds for identifying and acting on stale prices.
- Bad practices include: (i) conducting generic due diligence that does not appropriately identify the risks posed by a client on an electronic trading platform; (ii) stale assessments of client classifications and risk profiles not subject to review and updating; and (iii) monitoring of pricing feeds on a post-trade basis only.

Asset managers that are dark pool users should carefully review the contents of the FCA Review and its key messages, and review and update their operations and practices accordingly.

Please see our [July 22, 2016](#) client alert for more information.

FCA Assesses Whether Fund Managers Are Meeting Investor Expectations. On April 7, 2016, the FCA published a [report](#) (**FCA Report**) containing its conclusions regarding a thematic review announced in its 2015/2016 business plan. The review focused on three main areas of asset manager activity and investor expectations:

- Disclosure of investment strategies and mandates;
- Use and content of marketing materials; and
- Distribution of funds.

Nineteen U.K. firms responsible for twenty-three U.K. authorized funds and four segregated mandates were reviewed. All funds were undertakings for collective investment in transferable securities (**UCITS**). A UCITS fund is commonly used as a marketing vehicle to retail investors in the EU. The asset classes and strategies of the funds reviewed were diverse and included equities, derivatives, corporate and government bonds. Twenty of the funds were commonly available on third-party platforms. The total value of the funds included in the review was approximately £50 billion (US \$60.8 billion).

The FCA Report provided examples of good and poor practices in the areas of:

- **Clarity of Product Descriptions.** Good practices include: (i) giving detailed explanations of investment strategy (e.g., broad disclosure of investment objectives and policies); (ii) signposting complexity by including a strong recommendation for investors to seek advice in marketing materials of highly complex funds; and (iii) being specific in offering documents about the instruments that will be used, rather than setting out in broad terms the instruments that may be used but are in fact unlikely to be used.

Poor practices include: (i) providing unclear product descriptions (e.g., a broad investment mandate without a description of how a fund manager might use the mandate); and (ii) not disclosing passive investments (or closet tracking) in offering materials (e.g., not stating that, as part of an actively managed fund's overall strategy, a fund's assets are passively invested to track an index).

- **Providing Adequate Governance and Oversight.** An example of a good practice is ensuring that the fund is managed in line with how the fund has been communicated to investors. An example of a poor practice is inconsistent product review.
- **Ensuring Appropriate Distribution.** Good practices include: (i) using indicators to monitor unusual patterns in distribution and obtaining information on the profiles of investors; (ii) conducting significant due diligence on new financial advisers and providing extensive training to make sure financial advisers have a good understanding of the investment characteristics and philosophy that are driving the fund's composition; and (iii) testing financial advisers about complex funds to assess their understanding of the product.

In light of the FCA Report, the following next steps should be considered:

- All fund management firms, including those that sponsor or manage hedge and other private funds, should review the findings in the FCA Report and their own arrangements accordingly.
- Funds should be described clearly and with enough information about the investment strategy for investors to understand the approach used by the fund manager. Relevant risks should be identified and their potential consequences made clear.
- Authorized fund managers need to oversee funds effectively, even if the funds are no longer being actively promoted to investors.
- Distributors should consider their responsibilities in light of the FCA's findings and ensure that appropriate information is provided to investors.
- Senior management and those involved in fund governance should consider whether any of the concerns raised in the FCA Report are reflected within their own firm's operations, and take any action necessary to minimize the risk of poor outcomes to customers.

Please see our [May 6, 2016](#) client alert for more information.

FCA Guidance on Fund Suspensions. On July 8, 2016, the FCA issued [guidance](#) to fund managers in respect of their obligations to investors in the context of suspension of fund redemptions. Key takeaways include:

- If a fund has to dispose of underlying assets in order to meet an unusually high volume of redemption requests, the manager must ensure these disposals are carried out in a way that does not disadvantage investors who remain in the fund or who are newly investing in it.

- In exceptional circumstances, fund managers should consider whether it would be in the best interests of investors to suspend dealing in a fund or range of funds. The FCA requested that managers of authorized funds contact the FCA in advance of any proposed suspension.
- Where fund managers have chosen temporarily to suspend dealings in funds, they will need to consider when to resume dealings in the interest of investors. Funds holding a large proportion of assets that may be, in certain circumstances, illiquid or hard to value such as commercial property may consider that the suspension should be lifted and investors given the opportunity to redeem at a revised valuation of the units in the fund. This redemption price might reflect the price at which illiquid assets can be realized in a shorter than usual timeframe. In these circumstances, fund managers should ensure that:
 - The revised redemption price and the opportunity to cancel are clearly communicated to investors who have submitted a request to redeem their investment before or during the fund's suspension;
 - This communication explains the options that are available to investors and includes details of how to cancel the redemption requests; and
 - Investors are given sufficient time to make their decision and to seek appropriate advice. This timeframe should take into account the types of investors in the fund and whether communications to these investors need to take place through an intermediary.

The Impact of the U.K. Modern Slavery Act 2015 and Supply Chain Transparency on Private Investment Funds

The [U.K. Modern Slavery Act 2015](#) (**Modern Slavery Act**) is legislation introduced in the U.K. with the intention of combating slavery and human trafficking. Continuing the trend of legislation with extra-territorial reach, as illustrated by the U.K. Bribery Act, it can apply to entities based outside of the U.K.

Of particular importance to businesses is Section 54, which requires certain businesses to provide a statement annually that publicly states the steps they have taken to ensure that their business and supply chains (*i.e.*, those they engage with to provide goods and services) are free from human trafficking and slavery (**Section 54 Statement**).

Who is required to issue a Section 54 Statement? Section 54 applies to any entity that:

- Is a commercial organization (irrespective of where incorporated, such that both U.K. and non-U.K. entities are covered by the legislation);
- Supplies goods or services;
- Has a turnover (globally and not just in the U.K.) of at least £36 million (US \$43.8 million) per year; and
- Carries on a business (or part of a business) in the U.K. ([guidance](#) issued indicates that whether a business (or part of a business) is carried on in the U.K. will turn on whether the business in question has a "demonstrable business presence" in the U.K).

Many private fund managers will satisfy these conditions and be required to issue their own Section 54 Statements. However, this legislation is more likely to have direct impact on their portfolio companies. In most cases, a portfolio company would not be part of the "supply chain" of a private investment fund because the relationship between a fund and a portfolio company is one of investor to investee and not a

relationship based on the supply of goods or services. Therefore, private investment funds generally will not be directly responsible for making Section 54 Statements about their portfolio companies. However, as discussed below, private investment funds should still take care to consider (or even approve) the contents of Section 54 Statements issued by their portfolio companies.

When must a business make its first Section 54 Statement? An initial Section 54 Statement must be made within six months of the relevant entity's first fiscal year that falls after March 31, 2016. For example, if the relevant entity has a fiscal year ending on December 31, 2016, the first Section 54 Statement must be published by June 30, 2017. The legal sanction for failing to publish a Section 54 Statement is a court order compelling the entity to do so, which, if ignored, would constitute a criminal offense punishable by a fine. In addition, it is likely that such a failure would trigger hostile campaigns by investors and adverse publicity.

Content of a Section 54 Statement. It is recommended that a Section 54 Statement be succinct and written in simple language to ensure that it is easily accessible to everyone but must cover all relevant points and link to relevant publications, documents or policies.

As to the contents, the Section 54 Statement must either (i) set forth the measures the entity has taken during the financial year to ensure that slavery and human trafficking is not taking place in any of its supply chains and in any part of its business; or (ii) state that the entity has taken no such steps (which may be justified in circumstances where there is an extremely low risk of slavery and human trafficking).

There is no prescribed form or length to the Section 54 Statement, but guidance suggests that it could include information on:

- The entity's structure, business and supply chains;
- The policies regarding slavery and human trafficking;
- The due diligence processes in relation to slavery and human trafficking in its business and supply chains;
- The parts of its business and supply chains where there is risk of slavery and human trafficking occurring, and the steps the entity has taken to assess and manage that risk;
- The effectiveness in ensuring that slavery and human trafficking are not taking place, measured against performance indicators; and
- The training on slavery and human trafficking available to staff.

Approval of a Section 54 Statement. The Board of Directors (or equivalent) of the relevant entity must approve the Section 54 Statement and it must be signed by a director (or equivalent).

Publication of a Section 54 Statement. A Section 54 Statement must be published on the website most appropriate for its U.K. business and include a link to it on a "prominent" place on the homepage of that website. A prominent place may mean a link that is directly visible on the home page or part of an obvious drop-down menu on the home page. The link should be clearly marked so that the contents are apparent (*e.g.*, guidance suggests that the link could say "Modern Slavery Act Transparency Statement").

Impact on Private Investment Funds. The Modern Slavery Act is a symptom of the increasing prominence and awareness of supply chain issues. Increasingly, consumers, trade unions and other groups are campaigning to ensure that those at the top of the supply chain take responsibility for what

occurs further down the chain, irrespective of where the legal responsibility actually falls. Because portfolio companies are generally not part of the supply chain of a private investment fund, funds and their managers will not generally be legally responsible for the acts of their portfolio companies. However, in order to protect their investments, fund managers should take active measures to ensure that portfolio companies comply with the provisions of the Modern Slavery Act.

In many respects, protection against supply chain issues is analogous to steps commonly taken to combat risks of bribery and corruption. Practical steps that fund managers can take to protect themselves against the risks of their portfolio companies experiencing supply chain issues throughout the lifecycle of an investment include:

- Adding supply chain issues to the pre-acquisition due diligence process and the ongoing monitoring of investments;
- Seeking the verification of Section 54 Statements prior to their publication (and even requiring their prior approval);
- Identifying particular investments that may be especially susceptible to supply chain risk (based on factors such as location and the type of business); and
- Devising tailored audits (such as site visits, requests for information and means of verifying the information provided) to mitigate the risk of supply chain issues, especially investments that are high-risk.

Please see our [January 25, 2016](#) and [May 26, 2016](#) client alerts for more information.

[New U.K. Income-Based Carried Interest Rules Introduced](#)

The [U.K. Finance Act 2016](#) introduced new rules on income-based carried interest (**IBCI**). Under the new IBCI rules, effective April 6, 2016, certain amounts of carried interest allocated to certain investment management executives are taxed as ordinary income, rather than as capital gains or investment income. The introduction of these rules follows two other major changes affecting the taxation of fund management executives' compensation which we covered in our [2015 Annual Review](#): (i) the disguised investment management fee rules (which require taxation on amounts received by investment management executives other than co-investment returns and carried interest); and (ii) the introduction of stricter rules for the calculation of capital gains on carried interest.

The new rules operate by restricting the amount that is excluded from being taxed as income under the disguised investment management fee rules by virtue of being carried interest (the restricted amount being IBCI). In most cases, the amount of IBCI is calculated by reference to the weighted average holding period of the investments, by reference to which the carried interest is calculated. If the average holding period is 40 months or longer, none of the carried interest is considered IBCI. If the average holding period is less than 36 months, the whole amount of any carried interest is considered IBCI and subject to tax as ordinary income. If the holding period is between 36 and 40 months, a sliding scale applies. Any amount of carried interest that is not IBCI continues to be subject to the new capital gains tax rules for carried interest. Under these new capital gains tax rules, carried interest that is not IBCI is taxed at a minimum of 28% (rather than the new, lower rate of 20% that applies to all other gains from April 6, 2016 onwards), subject to any available relief and exemptions.

The new IBCI rules include detailed computational provisions for determining the average holding period, as well as relaxations for certain types of funds (*e.g.*, direct lending funds, real estate funds, funds-of-funds, and controlling equity stake funds) and certain investments (*e.g.*, unwanted short-term investments, and “loan to own” investments). Under the relaxations, investments that were acquired or exited in stages are treated as a single investment for purposes of calculating the average holding period. The rules also provide for a conditional exemption for amounts of carried interest arising in the early years of a fund’s life when the average holding period is shorter than 40 months, but there is an expectation that the average holding period will ultimately be greater than 40 months. Carried interest from certain types of direct lending funds is automatically treated as IBCI without regard to the average holding period of the fund.

Since IBCI falls under the disguised investment management fee charge, it is taxed as U.K. source trading income. Individuals who are U.K. residents but not domiciled in the U.K. are therefore subject to tax in the U.K. on all amounts of IBCI arising to them regardless of whether they use the remittance basis. Subject to any available treaty relief, individuals who are not U.K. residents are subject to tax in the U.K. on IBCI to the extent they have performed investment management services in the U.K.

Generally, the IBCI rules do not apply where the partnership interest (or other security from which the right to receive amounts of carried interest derives) was acquired in connection with employment, although the employment-related securities income tax rules will continue to apply. Broadly, this means that carried interest received by employees will not be affected by the IBCI rules. However, the U.K.’s economic and finance ministry, HM Treasury, has the power to repeal or restrict this exemption.

The introduction of the IBCI rules is the latest in a series of developments under which fund executives’ participation in the funds they manage are subject to special tax rules in the U.K., rather than being taxed in line with the general principles of U.K. tax law. These developments have resulted in carried interest and other fund participations held by fund executives being taxed in the U.K. under very prescriptive rules. The rigid nature of the new rules has the potential to create uncertainties or anomalous results. The tax authority, HM Revenue & Customs, is expected to issue guidance that will hopefully address issues stemming from the new IBCI rules.

China Regulatory Updates

New AMAC Regulations on the Registration and Conduct of Private Fund Managers

The Asset Management Association of China (**AMAC**), a self-regulatory organization authorized by the China Securities Regulatory Commission (**CSRC**) to regulate the private investment fund industry in China, released the Announcement on Certain Issues Concerning Further Regulation of Manager Registrations for Privately-Placed Funds and the Administrative Measures on Fundraising Activities of Privately-Placed Funds on February 5, 2016 and April 15, 2016, respectively (collectively, **New AMAC Regulations**). The New AMAC Regulations apply to all private funds and private fund managers domiciled in China, including wholly-owned subsidiaries of international private fund managers in China. Compared to existing regulations, the New AMAC Regulations provide more onerous requirements on the registration and conduct of private fund managers.

Under the New AMAC Regulations:

- All private fund managers (including those that were registered with AMAC before the release of the New AMAC Regulations) must launch and register their first fund within six months of registration of

the private fund manager (or before a specified date in the case of those private fund managers that were already registered prior to the release of the New AMAC Regulations). Failure to do so will result in the manager being deregistered by AMAC;

- All senior management (*e.g.*, the legal representative, general manager, deputy general manager and compliance officer) of a registered private fund manager must obtain the proper qualification to conduct fund business (by passing an exam organized by AMAC on a regular basis or by possessing the requisite experience in investment management);
- Registered private fund managers must submit ad hoc, quarterly and annual reports to AMAC within the specified timeframe;
- Private fund managers must submit a formal legal opinion at the time of (i) its initial registration, (ii) any subsequent material change or (iii) making a filing for a managed fund. The legal opinion must address the corporate registration, team qualification, risk management policies and practices and certain other matters of the manager; and
- Any placement agent of a private fund must hold a fund distribution license issued by the CSRC and be a member of AMAC.

Restriction on Foreign Ownership of Private Securities Investment Fund Management Companies Lifted

On June 30, 2016, AMAC released the Tenth FAQs in Relation to the Registration and Filing of Private Funds (**10th FAQs**). AMAC's responses in the 10th FAQs indicate that international financial institutions are permitted to engage in the privately-placed securities investment fund (also known as a "sunshine fund") management business in China by setting up a wholly-owned subsidiary or a joint venture with a PRC partner. This is a product of recent commitments made by the Chinese government, during its dialogues with the U.S. and U.K., to further open up its private fund management market to foreign capital. Prior to the 10th FAQs, international financial institutions were generally (with certain exceptions, *e.g.*, securities investment fund management companies set up under the Mainland China and Hong Kong Closer Economic Partnership Arrangement) subject to a 49% foreign ownership cap in the privately-placed securities investment fund management business. The 10th FAQs are only applicable to managers of privately-placed securities investment funds, while publicly-raised securities investment fund managers (also known as "retail fund managers") remain subject to the 49% foreign ownership cap.

Hong Kong Regulatory Updates

Shenzhen-Hong Kong Stock Connect Approved

As discussed in our [2014 Annual Review](#), the first phase of connecting China's stock markets with the Hong Kong Stock Exchange commenced in November 2014 with the launch of the Shanghai-Hong Kong Stock Connect, which created a facility for mutual stock market access between the Shanghai Stock Exchange and the Hong Kong Stock Exchange. On August 16, 2016, the Securities and Futures Commission of Hong Kong (**SFC**) and the China Securities Regulatory Commission of Mainland China jointly [announced](#) their approval of the second phase, known as the Shenzhen-Hong Kong Stock Connect, to create an equivalent facility between the Hong Kong Stock Exchange and the Shenzhen Stock Exchange.

Non-Mainland Chinese eligible investors will be able to trade eligible shares using the Northbound Shenzhen Trading Link, which will give them access to: (i) any constituent stock of the SZSE Component Index and SZSE Small/Mid Cap Innovation Index with a market capitalization of RMB6 billion or above, and (ii) all SZSE-listed shares of companies which have issued both A shares and H shares. During the initial stage of the Northbound Shenzhen Trading Link, investors eligible to trade shares listed on the ChiNext Board of SZSE (a separate board for high growth high-tech starts ups) will be limited to institutional “professional investors” as defined in the Securities and Futures Ordinance. Otherwise, eligible investors will be the same as those eligible to invest in the Shanghai-Hong Kong Stock Connect, namely Hong Kong Stock Exchange Participants and their clients (*i.e.*, any non-Mainland Chinese investor).

Although there will be a daily quota of RMB13 billion for the Northbound Link and RMB10.5 billion for the Southbound Link (which may be adjusted in light of actual operational performance), there will be no aggregate quota. The aggregate quota that existed under the Shanghai-Hong Kong Stock Connect was abolished as of August 16, 2016.

Other issues, such as applicable trading, clearing and listing rules, clearing arrangements, and cross-boundary regulatory and enforcement cooperation and liaison mechanisms, will be addressed by reference to the [joint announcement](#) on the Shanghai-Hong Kong Stock Connect.

Expansion of the Short Position Reporting Regime

On February 24, 2016, the SFC published its [consultation conclusions](#) for expanding the existing regime for reportable short positions so that reporting will be required for reportable short positions in all securities (**Designated Securities**) that can be sold short under the rules of the Hong Kong Stock Exchange. This expansion is a move away from the current reporting requirement that applies only to the much shorter list published by the SFC (referred to as the “specified shares”). This change will be effective March 15, 2017. The reporting threshold trigger for Designated Securities that are stocks will remain unchanged. However, for collective investment schemes, the reporting threshold trigger will be set at \$30 million.

The current regime has been in place since June 2012 and was introduced to increase the SFC’s understanding of any stock-specific or market-wide risks on a weekly (and, if necessary, daily) basis and to enable the SFC to assess whether it would need to take any regulatory action to prevent disruption to the market. Short positions reported for each stock are published on the SFC’s website in the aggregate, with no disclosure of the names or positions of individual short sellers. This reporting regime is separate from that for disclosure of interests in voting shares of listed companies and their equity derivatives, the purpose of which is to require reporting that will inform the market of substantial “long” and “short” positions on an individual and named basis.

SFC Publishes Consultation Paper on Proposed Enhancements to the Open Position Limit Regime

On September 20, 2016, the SFC published a [consultation paper](#) on proposed enhancements to the open position limit regime for stock options (**SFC Consultation Paper**). Generally, this paper is intended to take forward the recommendations of the conclusions to the [consultation paper](#) of Hong Kong Exchanges and Clearing Limited (**HKEX**). The SFC proposes to raise the statutory position limit for stock options from 50,000 contracts to 150,000 contracts to facilitate the introduction of a three-tier system proposed by HKEX.

In addition, the SFC proposes a new excess position limit under which the SFC may authorize asset managers to hold or control Hang Seng Index (**HSI**) and Hang Seng China Enterprises Index (**HHI**) futures and options contracts in excess of the statutory prescribed limit (**Asset Manager Excess Position Limit**). The Asset Manager Excess Position Limit is intended to address the need of asset managers to use stock index futures and options contracts to facilitate portfolio management. The cap on the Asset Manager Excess Position Limit will be set at 300% of the statutory position limit, which will provide asset managers with greater flexibility in using HSI and HHI futures and options contracts to manage different funds under their control.

However, given the SFC's concern that the build-up of substantial positions in HSI and HHI futures and options could have a significant impact on market stability, an asset manager must satisfy the following minimum criteria in order to be eligible for the Asset Manager Excess Position Limit. The asset manager must:

- Be an intermediary licensed or registered for Type 9 (asset management) regulated activity under the SFC, and its total value of assets under management should be no less than HK\$100 billion (approximately US \$13 billion);
- Demonstrate that it has a genuine business need to use HSI and HHI futures and options contracts to facilitate its asset management activity; and
- Have effective internal control procedures and risk management systems to manage the potential risks arising from the excess position.

The SFC will issue separate guidance on how it will determine whether the assets under management of the asset manager meets the HK\$100 billion threshold.

In order to facilitate monitoring by the SFC, the SFC may require, as a condition of authorization, that the asset manager submit regular reports to demonstrate how HSI and HHI futures and options contracts are utilized for each of the funds under management.

SFC Imposes New Client Agreement Requirements

On December 8, 2015, the SFC published [consultation conclusions](#) on a proposed new clause to be inserted into client agreements entered into between any licensed intermediary and its client. The proposed clause aims to address the lack of recourse open to a client for breach of the Suitability Requirement (**Suitability Requirement**) under the SFC's Code of Conduct for Persons Licensed by or Registered with the SFC (**Code of Conduct**). When intermediaries are making a recommendation or solicitation, the Suitability Requirement requires that the intermediaries ensure that the suitability of the recommendation or solicitation for the client is reasonable under all circumstances. Currently, while a breach of the Suitability Requirement can result in disciplinary action, such disciplinary action does not give the client a right of recourse against the intermediary for compensation. The proposed clause will give such client a contractual remedy against the intermediary in case of breach. The proposed clause will be effective under the Code of Conduct on June 9, 2017.

The text of the proposed clause reads:

"If we [the intermediary] solicit the sale of or recommend any financial product to you [the client], the financial product must be reasonably suitable for you having regard to your financial situation, investment experience and investment objectives. No other provision of this agreement or any other

document we may ask you to sign and no statement we may ask you to make derogates from this clause.”

A locally-based fund manager that is licensed by the SFC as an intermediary typically has clients that are either (i) offshore funds that it directly manages (investors in the fund will not be treated as clients), or (ii) offshore managers of the funds, to which it provides asset management and advisory services. While these services will be provided on a discretionary basis and not uncommonly only to a single client, the SFC’s position is that the proposed clause must nonetheless be included in the client agreement. Existing client agreements will therefore have to be amended prior to the effective date to include the clause.

One way of avoiding inclusion of the proposed clause is to dispense with the client agreement, which is permitted under the Code of Conduct if: (i) the client qualifies as a “Professional Investor”, and (ii) the client has consented to its treatment under the Code of Conduct as a Professional Investor. If the parties have agreed that Professional Investor treatment will be given, but an agreement is nonetheless entered into, the SFC has stated that the agreement need not include the new clause. If the consent for Professional Investor treatment is not obtained, the new clause must be incorporated verbatim with no modification to its original wording, apart from minor and inconsequential drafting amendments (*e.g.*, to adapt it to references to the parties). Properly documenting either of these steps is important as the SFC will check for this during its site inspections once the new clause takes effect. Nonetheless, dispensing with a client agreement, however short it may be, may not be a feasible option for regulatory, tax, compliance or commercial reasons.

[SFO Ordinance Provides for Use of Open-ended Fund Companies as Investment Fund Vehicles](#)

In June 2016, the [Securities and Futures \(Amendment\) Ordinance 2016 \(Ordinance\)](#) was enacted to provide for the use of Hong Kong incorporated open-ended fund companies (**OFCs**) as investment fund vehicles. Prior to the Ordinance, there was no provision in Hong Kong legislation for corporate funds vehicles and a Hong Kong company limited by shares formed under the local companies legislation was not suitable for this purpose because it is subject to a strict regime on the return of capital to shareholders. OFCs will be free of these restrictions. Currently, in Hong Kong, options for onshore fund vehicles are limited to the unit trust. The purpose of introducing this new fund vehicle is to attract greater fund management activities onshore. The Ordinance has not yet taken effect.

Before the legislation can become law, the SFC must formulate both the subsidiary legislation and a new code to provide guidance on the incorporation, management, operation, administration, procedures and business of OFCs, and to consult the market on its views on the drafts of the subsidiary legislation and the new code. At the time of publication of this Annual Review, the SFC has yet to publish its consultation paper.

An OFC may be set up as a public or private fund, and may also be created as an umbrella fund. While publicly offered OFCs will be subject to the same regulatory requirements applicable to existing publicly offered funds, some flexibility is given to privately offered funds to pursue their investment strategies subject to compliance with certain criteria. The text of the legislation draws no distinction between publicly offered and privately offered OFCs, but it is expected that the differences between them will ultimately be set out in both the subsidiary legislation and the new code.

Specific features that will apply to privately offered OFCs (and in some cases to publicly offered OFCs) include:

- All OFCs will be subject to the ultimate supervision of the SFC;
- Privately offered OFCs will not be required to file their offering documents with the Companies Registry nor have their offering documents authorized by the SFC;
- The scheme property of the OFC must be managed by an investment manager that is an SFC licensed intermediary, licensed for Type 9 (asset management) regulated activity;
- The OFC must have a custodian to whom all the scheme property of the OFC must be entrusted for safe keeping for segregation purposes; and
- The investment scope of the OFC will be limited to investments falling within the definition of “securities” under the Securities and Futures Ordinance. The term “securities” is defined broadly but does not include shares in a private company (as defined under the Hong Kong Companies Ordinance). It is proposed that some flexibility would be given to privately offered OFCs to allow them to make investments in other asset classes by allowing a 10% de minimis limit (*i.e.*, a maximum of 10% of the total gross asset value of the fund) for investing in these other asset classes. Holdings of cash deposits and currencies would not be subject to this 10% limit.

Brazil Regulatory Updates

Introduction to the Legal Framework of Brazilian Funds

Brazilian fund administrators, portfolio managers, investment funds (both closed-ended and open-ended funds) and distributions of funds are regulated by, and subject to registration with, the Brazilian Securities and Exchange Commission, the *Comissão de Valores Mobiliários (CVM)*.

Under Brazilian law, Brazilian investment funds are considered as a pool of assets incorporated under the form of a condominium. A condominium is a type of unincorporated entity, meaning the fund itself does not constitute a legal entity nor does it have an existence separate from that of the investors who hold interests in it. The participation of each investor in a fund is evidenced by “quotas,” which ultimately represent the percentage each investor holds in the pool of assets. In addition to economic rights, holders of quotas also have voting rights (pursuant to the rules set forth in the bylaws of the fund), with the general principle being one quota, one vote.

Every fund must have an administrator who is responsible for the back office functions of the fund. The administrator may or may not also be responsible for portfolio management activities. It is rather common to outsource portfolio management to a separate entity, namely, the portfolio manager. Brazilian funds also may have investment committees comprised of quotaholders. It is worth noting that despite the existence of an investment committee, the ultimate investment or divestment decision on any specific asset is incumbent on the administrator or the investors in the fund.

Regardless of whether or not a fund has a portfolio manager or an investment committee, a Brazilian fund is always represented by its administrator when entering into any transaction or performing any act.

The frequency of distributions of profits of a Brazilian fund will depend on the rules established in the fund’s bylaws. The investors in a fund are always responsible for the fund’s liabilities, including capital deficiencies. In the normal course of business (*i.e.*, absent gross mismanagement or fraud perpetrated by the fund administrator or portfolio manager, among other similar circumstances), neither the fund administrator nor the portfolio manager will be held liable for the losses and liabilities of the fund.

During the life of a fund, fund assets are kept inside the pool and are managed by the administrator as if they were owned by a distinct entity rather than by the investors.

New Regulatory Framework for Brazilian Funds

Beginning in 2014, the CVM introduced a number of changes to the regulatory framework of Brazilian funds with a view to, among other things, bring it closer in line with international standards of marketing and distribution, corporate governance and valuation and accounting of assets.

On December 17, 2014, the CVM enacted:

- CVM Instruction no. 554 (**Instruction 554**), which amended the Brazilian definition of “accredited investor” and created a new category of investor, the so-called “professional investor”; and
- CVM Instruction no. 555 (**Instruction 555**), which replaced, in its entirety, the regulatory framework of investment funds contained in CVM Instruction no. 409.

On August 30, 2016, the CVM enacted:

- CVM Instruction no. 578 (**Instruction 578**), which replaced the regulatory framework for private equity investment funds – *Fundos de Investimento em Participações (FIPs)*, revoked CVM Instructions 209, 391, 406 and 460 and consolidated the rules governing the various types of FIPs; and
- CVM Instruction no. 579 (**Instruction 579**), which established a new accounting standard for the valuation of FIP assets and the preparation of financial statements.

Below is an overview of the most relevant provisions of Instructions 554, 555, 578 and 579:

Professional Investor. Instruction 554, which came into effect on July 1, 2015, (i) created the new “professional investor” classification (which is conceptually similar to the U.S. definition of “qualified institutional buyers”) and (ii) amended the definition of “accredited investors.” Under Instruction 554, all non-Brazilian investors are deemed to be professional investors and all professional investors are accredited investors. Professional investors, however, are permitted to invest in more complex and higher-risk investments than accredited investors.

Investment Funds Regulatory Framework. Instruction 555 sought to update and modernize the regulatory framework of Brazilian investment funds. Specifically, Instruction 555 amended (i) fee regulations, (ii) fund classifications, and (iii) the rules on overseas investments to permit investment funds to increase their allocation of offshore investments. Under Instruction 555, the concentration limits for investments in non-Brazilian assets were increased as follows:

- Retail funds²: Increased from 10% to 20%;
- Investment funds offered to accredited investors: Increased from 20% to 40% in most cases; and
- Investments funds offered exclusively to professional investors have no limits for investing abroad.

Private Equity Investment Funds: FIPs. Instruction 578 introduced several changes to the regulatory framework of FIPs, which are one of the most commonly used vehicles by non-Brazilian investors for investments in Brazil. Instruction 578 consolidated the different types of FIPs and created the following new categories of FIPs based on the composition of a FIP’s portfolios:

² Retail funds are funds offered to the general public (*i.e.*, non-accredited and non-professional investors). Therefore, these funds tend to be less risky and have lower returns.

- **FIP – Seed Capital.** FIPs focused on investing in corporations or LLCs with annual gross revenues of up to R\$16 million. These FIPs cannot be controlled directly or indirectly by a group with assets over R\$80 million, or annual gross revenues in excess of R\$100 million, in the fiscal year preceding the fund’s first capital contribution. In the event a target company is not considered an investment entity under Instruction 578, the target company’s financial statements must be audited by an independent accountant registered with the CVM.
- **FIP – Emerging Companies.** FIPs focused on investments in corporations or LLCs with annual gross revenues of up to R\$300 million. These FIPs cannot be controlled directly or indirectly by a group with assets over R\$240 million, or annual gross revenues in excess of R\$300 million, earned in the fiscal year preceding the fund’s first capital contribution.
- **FIP – Infrastructure and Intensive Economic Production in Research, Development and Innovation.** FIPs that must keep their net equity invested in bonds, warrants, equity, debentures (convertible or not) and other securities issued by corporations pursuant to terms and conditions set forth in Instruction 578, or companies that invest in new infrastructure projects or intensive economic production regarding research, development and innovation in Brazil in the energy, transport, water and basic sanitation, irrigation and other sectors deemed as priorities by the Federal Executive Branch.
- **FIP – Multi-Strategy.** FIPs that do not fit into the other categories and that may invest in companies from several different industries at different development stages. Multi-Strategy FIPs dedicated only to professional investors can invest up to 100% of their net equity in overseas private equity assets, subject to the following conditions: (i) investing abroad is expressly permitted under the bylaws of the fund; (ii) such bylaws expressly indicate the percentage of fund investments permitted abroad; (iii) the bylaws expressly permit only professional investors; and (iv) the name of the fund contains the term “Offshore Investment.”

Instruction 578 also introduced the following changes:

- **Investments.** FIPs are now permitted to have non-convertible debentures (up to 33% of the subscribed capital of the fund), securities and bonds representing equity in Brazilian LLCs (the most common entity in Brazil), as part of their portfolios. The invested companies are exempted from several governance requirements under Instruction 578. In the event that these requirements are not met, the company will have a two year window to meet all governance requirements under Instruction 578.

FIPs must maintain at least 90% of their net worth invested in the eligible assets. FIPs can invest in quotas of other FIPs and equity funds to comply with the minimum 90% threshold.

FIPs are permitted to invest up to 20% of their subscribed capital in overseas private equity assets and Multi-Strategy FIPs dedicated only to professional investors can invest up to 100% of their subscribed capital in overseas private equity assets, subject to the conditions discussed above.

- **Borrowing and Loans.** FIPs may obtain financial support from development agencies (borrowings and loans) up to 30% of the FIP’s assets. Such borrowing can be used as a substitute for subscribed but unpaid quotas by quotaholders.
- **Governance.** FIPs are permitted to engage in Advances for Future Capital Increase – *Adiantamentos para Futuro Aumento de Capital (AFAC)* in corporations, provided, among other conditions, that the

FIP holds an equity interest in the invested company and AFACs are expressly permitted under the bylaws of the fund.

A FIP is not required to participate in the decision-making process of the invested companies when the amount invested in such company (i) has been reduced to less than 50% of the percentage originally invested, and (ii) represents less than 15% of the invested company's capital. The CVM's intention was to make it unnecessary for FIPs to participate in the decision-making process when disinvesting.

- **Rights of Quotas.** FIPs are permitted to issue different classes of quotas with varying economic rights, including differing management and performance fees and order of preference in the payment of distributions to investors. FIPs offered only to professional investors have even further flexibility in establishing different rights to different classes of quotas.
- **Quorums/Votes.** Quotaholders must now exercise the right to vote. In the event quotaholders default on their obligation to pay their subscribed quotas, the defaulting quotaholders will lose their right to vote with respect to their respective subscribed for but unpaid quotas. Bylaws may impose additional penalties, such as impeding the right to vote with respect to quotas paid in and held by the defaulting quotaholder. A FIP may establish in its bylaws circumstances other than those set forth under Instruction 578 that would be subject to a qualified voting quorum.
- **Committees/Boards and Management.** Quotaholders' meetings resolutions do not exempt the administrator and/or manager of their duties in regard to the FIP's operations. It is worth noting that the manager's duties and obligations increased regarding the procurement of services related to investment or disinvestment, as well as its influence on the pricing of the FIP's investments.

Under Instruction 578, fund managers and administrators are no longer jointly liable for their obligations to the fund and investors. Nevertheless, it is still unclear if and to what extent this new rule will be applied by Brazilian courts since, in addition to CVM rules, such liability has been applied by courts based on Brazilian consumer protection laws.

The compensation of members of boards and committees of the FIP may not be paid directly by the FIP, but a portion of the administration fee may be allocated to such payment.

Instruction 578 also sets forth the specific duties of portfolio managers, stating portfolio managers are authorized to (i) negotiate and acquire assets on behalf of the fund; (ii) negotiate and hire, on behalf of the FIP, third parties for advisory and consulting services; and (iii) monitor the assets invested by the FIP and exercise voting rights arising from these assets.

Instruction 578 established a 12-month period from August 30, 2016 for current FIPs to comply with the new rules.

Accounting. Instruction 579 details the accounting criteria for recognition, classification and measurement of assets and liabilities of FIPs, as well as the criteria for revenue recognition, appropriation of expenses and disclosure of information in financial statements. In general, FIPs must use the accounting criteria for recognition, classification and measurement of assets and liabilities and recognition of revenues and expenses set forth in CVM regulations applicable to public companies. Moreover, in order to make accounting principles more consistent with internal standards, FIPs qualified as investment entities are required to mark their portfolio assets according to their fair value. In the event of a material

change in the fair value of their invested companies during the fiscal year, FIPs must (i) report such change to their investors and (ii) submit to their investors and to CVM an audited financial statement.

Investment Opportunities

Infrastructure Projects. In September 2016, the Brazilian government announced the Investment Partnership Program-PPI, the *Programa de Parcerias de Investimentos (PPI)*. The PPI has been widely perceived as a significant departure from the infrastructure model adopted by the previous federal administration, which relied on heavily regulated concessions instead of the privatization of infrastructure projects. The PPI program involves infrastructure projects such as airports, roads, railroads, distribution companies, power plants, sanitation companies, oil fields and mining assets.

Potential Lifting of Restrictions on the Ownership of Rural Land by Foreigners. The Brazilian government is considering changing the limits imposed on foreigners to acquire rural land in Brazil. Based on the Attorney General's current interpretation of applicable Brazilian laws, foreigners are currently subject to several restrictions on their ability to acquire rural land in Brazil. If approved by Brazil's Congress, draft bill 4059/2012 may extinguish such restrictions, thereby allowing foreign investors to acquire rural land.

Gambling. Banned in Brazil for the past 70 years, gambling may be legalized by Brazil's Congress. If approved by Congress, draft bill 186 will legalize casinos and bingos.

Annual Compliance Review and Filing Requirements

Offering Document Updates

As part of their ongoing compliance reviews, investment advisers should regularly assess their private fund offering materials and determine if updates are required or appropriate. Among other things, an investment adviser should consider if there have been any material changes in the investment adviser's or the private fund's business (including, among other things, investment objectives and strategies, risks, conflicts of interest and service provider arrangements) and/or any relevant regulatory changes (including, among other things, changes in tax and ERISA) since the most recent documents update. Before amending a private fund's offering documents, an investment adviser should evaluate if any investor, advisory board and/or director consent and/or other actions or items would be necessary or appropriate for approving the amendments. The adviser should also consider whether the revised offering documents would need to be filed with or approved by any regulatory authority.

Compliance Policies and Procedures Review and Employee Training

The Advisers Act requires investment advisers to review their compliance policies and procedures annually. This annual review should include, among other things, an assessment of any compliance issues (including, in particular, any known defects from prior years or noted in any SEC examinations), as well as any relevant regulatory changes or guidance and any other changes in the investment adviser's business that may require or otherwise call for changes to the investment adviser's compliance policies and procedures. Investment advisers should document any such reviews in writing.

Investment advisers should adopt and implement employee training policies to educate firm personnel on the investment adviser's compliance programs and procedures, including, among other things, programs and procedures relating to conflicts of interest, insider trading and anti-money laundering. Training should be provided to firm personnel periodically so that they are familiar with the investment adviser's obligations and policies.

In addition to topics already highlighted elsewhere in this Annual Review, below are certain other topics that investment advisers should consider in their compliance review:

Rule 506(d) Bad Actor Due Diligence

Under Rule 506(d) of Regulation D, a private fund will be precluded from conducting a private offering under Rule 506 if the private fund or any of its covered persons are subject to a disqualifying event occurring on or after September 23, 2013. In addition, the private fund must disclose any pre-September 23, 2013 disqualifying events to prospective investors within a reasonable time before they invest. To comply with Rule 506(d), investment advisers to private funds should implement a program to determine on an ongoing basis whether any covered person is subject to any pre-September 23, 2013 disqualifying events (which again must be disclosed to prospective investors), and any post-September 23, 2013 disqualifying events (which again would disqualify the private fund from relying on Rule 506). Due diligence measures may include, among other things, conducting checks on public databases, requiring covered persons to complete periodic questionnaires or certifications and requiring covered persons to notify the investment adviser and the private fund of any disqualifying events and any facts that may lead

to a disqualifying event.³ Frequency of due diligence checks will depend on the nature of the private fund's and the investment adviser's business, but should be conducted at least annually.

Broker-Dealer Registration Issues

A number of activities commonly conducted by private fund advisers may raise potential broker registration issues under the Exchange Act. As discussed in the "SEC Enforcement Developments" section [above](#), on June 1, 2016, the SEC settled an action with a private equity fund adviser which one of the agency's Assistant Regional Directors described as "the first case of a private-equity adviser violating section 15(a) of the [Securities Exchange Act of 1934] for acting as a broker and failing to register as a broker." The definition of a "broker" under the Exchange Act is quite broad and includes any person "engaged in the business of arranging securities transactions for the account of others." In general, any person engaged in such activities is required to be registered as a broker under the Exchange Act unless a specific exemption applies.

For private fund advisers, types of activities that may trigger broker-dealer registration requirements include, for example:

- Capital-raising activities, particularly in circumstances (i) where employees of the investment adviser may be compensated based on how successful they are in selling interests in the investment adviser's private funds (*i.e.*, "transaction-based" compensation); or (ii) where an employee's sole or primary function is to sell interests in the private funds; and
- Receipt of transaction fees relating to one or more of a private fund's portfolio companies for services that could be characterized as investment banking or other broker activities, including investment banking-type services in connection with the acquisition, disposition or recapitalization of the portfolio companies (such as negotiating transactions, identifying and soliciting purchasers and sellers of a portfolio company's securities or structuring transactions).

The determination of whether an investment adviser or its employees are engaged in broker activities can be highly fact-specific. Investment advisers should periodically review their business activities to assess whether any broker-dealer registration requirements are implicated. In addition, investment advisers should be aware that questions related to these issues may be raised in SEC examinations.

Identity Theft Red Flags Policies

Under the identity theft red flags rules jointly issued by the SEC and CFTC in 2013, certain SEC- and CFTC-regulated entities are required to adopt written identity theft programs designed to detect, prevent and mitigate identity theft. The red flags rules apply to certain "financial institutions"⁴ (including registered investment advisers) and "creditors" that offer or maintain "covered accounts." The identity theft program must include at minimum the following elements:

- Identification of relevant "red flags" that may be indicators of potential identity theft;
- Detection of the relevant red flags;

³ If a disqualifying event is discovered, an investment adviser that is required to file Form ADV may be required to amend its Form ADV (see [below](#)).

⁴ In general, "financial institutions" include an entity that holds a transaction account belonging to an individual, whereby the individual may make payments or transfers of money from the account to third parties (or direct the entity to make such payments or transfers); "creditors" include an entity that advances or loans money to consumers; and "covered accounts" include an account that a financial institution or creditor offers or maintains, primarily for personal, family or household purposes, that involves or is designed to permit multiple payments or transactions, or any other account that poses a reasonably foreseeable risk to consumers of identity theft.

- Appropriate responses to any red flags that are detected; and
- Periodic review and updates to the identity theft program.

Investment advisers should review their business practices to determine whether they might fall within the definition of a “financial institution” or “creditor” (for more details on the red flag rules, please see our [May 31, 2013](#) client alert). Although the red flags rules typically will not apply to investment advisers to private funds, it is nevertheless advisable for all investment advisers to consider adopting an identity theft red flags policy and to periodically review the risk of identity theft with respect to investors in the private funds they advise.

Business Continuity and Disaster Recovery Plans

Under the Advisers Act, the SEC has stated that an investment adviser’s fiduciary obligation includes taking steps to protect clients’ interests from being placed at risk as a result of the investment adviser’s inability to provide advisory services after a natural disaster or other emergencies. As discussed in the “SEC Rulemaking Developments & Other Guidance” section [above](#), on June 28, 2016, the SEC proposed a [new rule](#) that would require registered investment advisers to adopt and implement written business continuity and transition plans reasonably designed to address operational and other risks related to a significant disruption in their operations. The rule proposal is sufficiently detailed with respect to SEC staff’s expectations for the content and coverage of investment advisers’ business continuity and transition plans. Accordingly, investment advisers would be well served by comparing their current business continuity and transition plans to the SEC’s rule proposal and updating them as necessary. Please see [above](#) for more information on the SEC’s proposed rule.

Anti-Money Laundering Policies

Investment advisers should review their AML policies and procedures at least annually and update such policies and procedures to account for changes in requirements imposed by the trade and economic sanction programs administered by the Treasury Department’s Office of Foreign Asset Control and any applicable non-U.S. requirements. Investment advisers should also provide training to personnel to ensure that they are familiar with the investment adviser’s AML obligations and practices. Investment advisers should also periodically check with their private fund administrators, if applicable, to ensure that the administrators are properly following their AML policies and are conducting sufficient investor due diligence. As noted in the “Anti-Money Laundering Updates” section [above](#), on August 25, 2015, FinCEN had also [proposed AML rules](#) which would be applicable to registered investment advisers and enforced by the SEC through its examination program. At the time of publication of this Annual Review, this proposal remains outstanding.

Annual and Other Periodic Filing Requirements

Below is a summary of certain key filing requirements applicable to investment advisers to private funds. We note that this list of filings discussed below is not intended to be exhaustive. In addition to the requirements discussed in this Annual Review, investment advisers should examine the nature of their business and operations and determine whether any other filings or actions will be required pursuant to applicable federal, state and non-U.S. laws and regulations.

Form ADV

Registered investment advisers must file an updated Form ADV Part 1 and Part 2A with the SEC within 90 days after the investment adviser's fiscal year-end (by **March 31, 2017** for investment advisers with a December 31 fiscal year-end). Registered investment advisers must deliver the updated Form ADV Part 2A, or a summary of the changes made, to clients within 120 days following the investment adviser's fiscal year-end (by **April 30, 2017** for investment advisers with a December 31 fiscal year-end). Although underlying investors of private funds managed by the investment advisers are not "clients" of the investment advisers under the Advisers Act, it is generally considered best practice to deliver the updated Form ADV Part 2A to these underlying investors on an annual basis.

In addition to the annual amendments, Form ADV Part 1 must be promptly amended where certain types of information reported, such as the disciplinary history of the investment adviser and/or its personnel, becomes inaccurate or, in certain cases, materially inaccurate. Form ADV Part 2A and Part 2B must be amended promptly whenever information reported becomes materially inaccurate. If the change relates to a disciplinary event, then the updated Form ADV Part 2A and/or Part 2B, as applicable, also must be delivered to clients. While Form ADV Part 2B is not required to be filed with the SEC, investment advisers must maintain copies in their records.

"Exempt reporting advisers" are subject to similar reporting requirements with respect to sections in Form ADV Part 1 that apply to them. If the exempt reporting adviser is exempt from SEC registration under the "private fund adviser" exemption, the exempt reporting adviser must register with the SEC once it reports in its annual amendment to Form ADV that its regulatory assets under management (**RAUM**) attributable to private funds have reached \$150 million (or, in the case of an adviser based outside of the U.S., if the RAUM attributable to private fund assets managed at a place of business in the U.S. have reached \$150 million). The exempt reporting adviser must apply for registration within 90 days of filing the amendment. If the exempt reporting adviser is exempt from SEC registration under the "venture capital fund adviser" exemption, the exempt reporting adviser must register with the SEC *prior* to the time it may no longer rely on such exemption.

Certain states impose "notice filing" requirements, requiring investment advisers to file their Form ADV with the relevant state securities authorities. Investment advisers may also be subject to additional state requirements where, for example, the investment adviser has a place of business in the state and/or has over five non-exempt clients in that state. Investment advisers may also be subject to certain "blue sky" requirements, as [discussed below](#). An investment adviser should review its business on a periodic basis to determine whether any additional state requirements have been triggered.

Form PF

A registered investment adviser that advises one or more private funds and has at least \$150 million in RAUM attributable to private funds is required to file Form PF with the SEC to report certain information regarding the private funds under its management. The frequency of the reporting obligation and the amount of information that must be reported on Form PF will vary depending on the size of the investment adviser and the type of private funds managed by it.

In general, a registered investment adviser that has at least \$150 million in RAUM attributable to private funds is required to file Form PF within 120 days after the end of the investment adviser's fiscal year (by **May 1, 2017** for investment advisers with a December 31 fiscal year-end). However, the reporting

requirements for investment advisers with larger RAUMs will be more frequent and/or more extensive. In particular:

- **Large Hedge Fund Advisers.** An investment adviser with at least \$1.5 billion in RAUM attributable to hedge funds as of any month-end during the preceding fiscal quarter is subject to more comprehensive quarterly reporting requirements with respect to hedge funds under its management. In addition, the Large Hedge Fund Adviser is required to provide fund-specific information with respect to any “qualifying hedge funds” (*i.e.*, hedge funds with more than \$500 million in net asset value). A Large Hedge Fund Adviser must file Form PF within 60 days of each quarter-end (by **March 1, 2017** for the quarter ending December 31, 2016).
- **Large Private Equity Fund Advisers.** An investment adviser with at least \$2.0 billion in RAUM attributable to private equity funds as of the end of the most recent fiscal year will be subject to more comprehensive annual reporting requirements with respect to private equity funds under its management. Large Private Equity Fund Advisers must file Form PF within 120 days of fiscal year-end (by **May 1, 2017** for investment advisers with a December 31 fiscal year-end).
- **Large Liquidity Fund Advisers.** An investment adviser with at least \$1.0 billion in RAUM attributable to private liquidity funds and registered money market funds as of any month-end during the preceding fiscal quarter will be subject to more comprehensive quarterly reporting requirements with respect to private liquidity funds under its management. Large Liquidity Fund Advisers must file Form PF within 15 days of each quarter-end (by **January 17, 2017** for the quarter ending December 31, 2016).

For purposes of determining whether an investment adviser meets any of the large adviser classifications above, the investment adviser may disregard a private fund’s equity investments in other private funds.

Exempt reporting advisers are not required to file Form PF.

Form D and Blue Sky Filings

Form D. A private fund conducting an offering under Rule 506 must file a Form D with the SEC on its filer management system, EDGAR, within 15 days of the initial sale of securities in such offering (*i.e.*, the date on which the first investor is irrevocably contractually committed to invest). For any ongoing offering for which a Form D was filed after March 16, 2009, Form D must be amended annually on or before the first anniversary of the last notice filed. Form D must also be amended as soon as practicable to correct a material mistake of fact or error or to reflect a change in the information provided in the previously filed notice. For certain specified types of changes in information, however, such as a change in the amount of securities sold in the offering or the number of investors who have invested in the offering, the private fund is not required to amend Form D until the next annual filing (if any) is due (but may choose to do so at any time).

Blue Sky Filings. Compliance with Rule 506 is very important for compliance with state securities or “blue sky” laws, since, under Section 18 of the Securities Act, the states are pre-empted from regulating offerings that comply with Rule 506. Without such compliance, unless an applicable self-executing state exemption is available, a state where an investor purchases the issuer’s securities can require a pre-sale filing and regulate the required disclosure and other aspects of the offering.

Provided that an offering is made in compliance with Rule 506, the blue sky laws of many states currently require that a hard copy of Form D be filed with the relevant state authority within 15 days following the

initial sale of securities in that state, along with the state's required filing fee. In addition, some states' blue sky laws require that copies of amended SEC filings also be filed with the state. A handful of states require annual renewal filings and, in a couple of cases, the payment of annual renewal fees for ongoing offerings. Please note that the states now have a central electronic filing system for Rule 506 offerings, which is currently required to be used for filings in a few states, and possibly will be mandatory for all or most states in the not-too-distant future.

Private funds should be aware of requirements that may be triggered when sales of securities are made to investors in states where sales have not been made in the past, and sales in states in which a Form D has not yet been filed. The penalties for failing to make timely filings can be significant. Some states may require payment of a fine, or even demand that an issuer offer rescission to each investor in a state, or the administrator may issue a consent order.

Although Section 18 of the Securities Act states that covered securities, such as securities offered pursuant to Rule 506 of Regulation D, are not subject to state regulation, an increasing number of states have nevertheless used their authority under broker-dealer and investment adviser regulation and anti-fraud statutes to review and comment on Form Ds filed in connection with Rule 506 offerings. Questions regarding whether a related party listed under item 3 of the Form D is required to be registered as an investment adviser in the state are not unusual. Some states have also requested to see copies of the offering materials to be provided.

Form 13F

An investment adviser is required to file a Form 13F with the SEC if it exercises investment discretion over \$100 million or more in Section 13(f) securities as of the last trading day of any month in any calendar year. In general, Section 13(f) securities include U.S. listed equity securities, certain equity options and warrants, shares of closed-end investment companies and certain convertible debt securities. The SEC publishes an [official list](#) of Section 13(f) securities at the end of every quarter.

An investment adviser must file a Form 13F for the last quarter of the calendar year during which the reporting threshold is met. In addition, it must file a Form 13F for the first three quarters in the subsequent calendar year, even if its holding level has dropped below \$100 million. In each case, Form 13F will be due within 45 days of quarter-end.

For investment advisers that exceeded the reporting threshold for the first time in 2016, the first Form 13F filing deadline in 2017 will be **February 14, 2017** (for the quarter ending December 31, 2016).

Schedules 13D and 13G

A person that has direct or indirect beneficial ownership of more than 5% of a class of outstanding voting equity securities of a U.S. public company is required to file Schedule 13D, or Schedule 13G, if eligible, with the SEC. "Beneficial ownership" is defined to include the direct or indirect power to (i) vote the securities; or (ii) exercise investment authority over the securities, including the right to acquire the securities within 60 days (such as through the exercise of an option or a convertible security). Under this definition, "beneficial owners" may include a private fund, its investment adviser and certain controlling persons and/or parent companies of the investment adviser.

Schedule 13D. Schedule 13D must be filed within 10 days after crossing the 5% threshold and must be amended promptly following (i) a material increase or decrease in the filer's holding; or (ii) a material change in the Schedule 13D. An increase or decrease is deemed "material" if it equals at least 1% of the

outstanding securities and may, depending on the facts and circumstances, be deemed “material” even if it is less than 1%.

Schedule 13G. A beneficial owner otherwise required to file Schedule 13D may file Schedule 13G if it acquired the securities in the ordinary course of its business and not with the purpose or effect of changing or influencing the control of the issuer.

- If the beneficial owner falls within any of the specified categories of “Qualified Institutional Investors” (QII), which includes SEC-registered investment advisers, it must file Schedule 13G within 45 days after the end of a calendar year if its holding crossed the 5% threshold during the year and is at least 5% as of year-end (by **February 14, 2017** for 2016). Schedule 13G must be amended within 10 days of a month-end if the holding exceeds 10% of the class of equity securities as of such month-end and if it thereafter increases or decreases by more than 5% of the class of equity securities.
- A beneficial owner that does not qualify as a QII may still use Schedule 13G as a “passive investor,” so long as its holding is below 20% of the class of securities. A passive investor must file Schedule 13G within 10 days of crossing the 5% threshold. Schedule 13G must be amended promptly once the holding exceeds 10% of the class of equity securities and if it thereafter increases or decreases by more than 5% of the class of equity securities.

Schedule 13G is also available to a beneficial owner that crossed the 5% threshold as of calendar year-end but is exempt from filing a Schedule 13D due to exemptions under Section 13(d) of the Exchange Act or otherwise. This may include, for example, a beneficial owner that met the 5% threshold at the time the issuer went public and continues to meet the 5% threshold at the end of the relevant calendar year-end. Each such exempt filer is required to file a Schedule 13G within 45 days after the end of a calendar year (by **February 14, 2017** for 2016).

QII, passive investor and exempt investor filers must amend Schedule 13G within 45 days of each calendar year-end to report any changes in the information previously reported, provided that no amendment will be required if the only change relates to the filer’s percentage holding and is solely due to a change in the underlying aggregate number of outstanding shares in the class. The filing deadline for 2016 amendments will be **February 14, 2017**.

Forms 3, 4 and 5

Form 3. A person, including an investment adviser and/or an employee or representative acting on its behalf, is required to file Form 3 with the SEC within 10 days of (i) acquiring beneficial ownership of more than 10% of a class of equity securities of a U.S. public company (including, among other things, puts, calls, options, warrants, convertible securities or other rights or obligations to buy or sell securities exercisable within 60 days); and/or (ii) becoming an officer or director of a U.S. public company.

“Beneficial ownership” is defined in the same way as in the [Schedule 13D and 13G](#) context. With respect to an issuer undergoing an IPO, the initial Form 3 filing is due on the effective date of the registration.

Form 4. If a director, officer or 10% beneficial owner effects a transaction which changes the beneficial ownership of securities previously reported on Form 3, such director, officer or beneficial owner must file a Form 4 with the SEC within 2 business days of the transaction.

Form 5. Form 5 must be filed with the SEC within 45 days following the issuer’s fiscal year to report any exempt or other insider transactions not previously reported on Form 4 (by **February 14, 2017** if the issuer has a fiscal year-end of December 31).

Form 13H

Large traders of Regulation NMS securities (generally defined to be exchange listed securities, including options) are required to file Form 13H with the SEC. A “large trader” is any person that exercises investment discretion over transactions in Regulation NMS securities that equal or exceed (i) two million shares or \$20 million during any day; or (ii) 20 million shares or \$200 million during any month. Large traders must file Form 13H with the SEC when the thresholds above are met. The initial Form 13H filing must be made “promptly” after reaching the threshold (generally within 10 days). Thereafter, an annual 13H filing must be submitted within 45 days of the end of the calendar year (by **February 14, 2017** for 2016). Amendments to Form 13H must be filed promptly following the end of a calendar quarter if any information on the Form 13H becomes inaccurate. For example, the addition or removal of brokers would need to be reported at the end of a calendar quarter.

CFTC Annual Reaffirmations and Periodic Reports

CPO and CTA Exemption Reaffirmations. Each CPO exempt from CPO registration under CFTC Rule 4.5, 4.13(a)(1), 4.13(a)(2), 4.13(a)(3) or 4.13(a)(5) and each CTA exempt from CTA registration under CFTC Rule 4.14(a)(8) must submit an annual affirmation of its exemption via the NFA’s Electronic Exemption System within 60 days of calendar year-end (by **March 1, 2017** for 2016).

Annual Reports and Account Statement Requirements. Each registered CPO, including a CPO relying on CFTC Rule 4.7, must file financial statements of each commodity pool it operates with the NFA within 90 days after each such commodity pool’s fiscal year-end (by **March 31, 2017**, if the fiscal year ends on December 31).

In addition, each registered CPO must distribute monthly account statements to participants of the commodity pool within 30 days of month-end for commodity pools with a net asset value greater than \$500,000. For commodity pools with a net asset value of \$500,000 or less, or operated under CFTC Rule 4.7, the CPO is instead required to distribute quarterly account statements to pool participants within 30 days of the quarter-end.

CFTC Form CPO-PQR and NFA Form PQR. Each registered CPO is required to report certain information to the CFTC on CFTC Form CPO-PQR, the CFTC equivalent of Form PF. CFTC Form CPO-PQR contains three sections: Schedule A, Schedule B and Schedule C. The frequency that a CPO must file CFTC Form CPO-PQR and the sections that it must complete will depend on the CPO’s amount of assets under management (**AUM**) and its SEC reporting obligations (if a dual registrant).

Each registered CPO that is an NFA member is also required to file NFA Form PQR quarterly with the NFA. NFA Form PQR consists of certain questions from Schedule A and Schedule B of CFTC Form CPO-PQR.

As discussed [above](#), the NFA has imposed a \$200 late fee for each business day the NFA Form PQR is filed after the due date. The late fee is effective for all NFA Forms PQR required under NFA Compliance Rule 2-46, beginning with reports dated September 30, 2016 and later.

Both CFTC Form CPO-PQR and NFA Form PQR are filed on the NFA’s [EasyFile](#) system. As NFA Form PQR is incorporated into CFTC Form CPO-PQR, there are no separate filings for the CFTC and the NFA. A CPO will satisfy its NFA Form PQR reporting obligations to the extent it is already responding to the same items on its CFTC Form CPO-PQR for that reporting period.

In addition, CPOs that are registered as investment advisers with the SEC may satisfy certain of their CFTC Form CPO-PQR filing obligations by filing Form PF with the SEC.

Filing Requirements				
CPO Size	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Large CPO (CPO with AUM of at least \$1.5 billion)	CFTC Form CPO-PQR Schedules A, B and C (within 60 days of quarter-end)	CFTC Form CPO-PQR Schedules A, B and C (within 60 days of quarter-end)	CFTC Form CPO-PQR Schedules A, B and C (within 60 days of quarter-end)	CFTC Form CPO-PQR Schedules A, B and C (within 60 days of quarter-end)
Mid-Sized CPO (CPO with AUM of at least \$150 million but less than \$1.5 billion)	NFA Form PQR (within 60 days of quarter-end)	NFA Form PQR (within 60 days of quarter-end)	NFA Form PQR (within 60 days of quarter-end)	CFTC Form CPO-PQR Schedules A and B (within 90 days of year-end)
Small CPO (CPO with AUM of less than \$150 million)	NFA Form PQR (within 60 days of quarter-end)	NFA Form PQR (within 60 days of quarter-end)	NFA Form PQR (within 60 days of quarter-end)	CFTC Form CPO-PQR Schedule A and NFA Form PQR (within 90 days of year-end)
Dual-Registered CPO (CPO that is an SEC-registered investment adviser and files Form PF with the SEC)	NFA Form PQR (within 60 days of quarter-end)	NFA Form PQR (within 60 days of quarter-end)	NFA Form PQR (within 60 days of quarter-end)	CFTC Form CPO-PQR Schedule A and NFA Form PQR (within 60 or 90 days of quarter-end, depending on AUM)

The upcoming filing deadlines for the period ending on December 31, 2016 will be **March 1, 2017** for Large CPOs and **March 31, 2017** for Mid-Sized and Small CPOs.

CFTC Form CTA-PR and NFA Form PR. All registered CTAs, regardless of size and dual registration, must file CFTC Form CTA-PR annually within 45 days of the end of the fiscal year. CFTC Form CTA-PR covers certain identifying information about the CTA as well as performance information. In addition, each CTA that is an NFA member must file NFA Form CTA-PR within 45 days of each quarter-end. As the same form is used for CFTC Form CTA-PR and NFA Form PR, a CTA will satisfy its NFA Form PR obligation for the quarter ending on December 31 by filing its annual CFTC Form CTA-PR. Both CFTC Form CTA-PR and NFA Form PR are filed on the NFA's [EasyFile](#) system.

The deadline for the period ending December 31, 2016 will be **February 14, 2017**. As discussed [above](#), the NFA has imposed a \$200 late fee for each business day the NFA Form PR is filed after the due date.

The late fee is effective for all NFA Forms PR required under NFA Compliance Rule 2-46, beginning with reports dated September 30, 2016 and later.

The CFTC has published a series of [FAQs](#) on CFTC Form CPO-PQR and CTA-PR.

TIC Form B

A U.S. investment manager (on behalf of itself and any U.S. or non-U.S. funds that it manages) and U.S. resident funds managed by a non-U.S. resident investment manager are required to report cross-border claims, liabilities and short-term securities holdings on TIC B Forms with the Federal Reserve Bank of New York, in each case if the reporting person is owed "reportable claims" or owes "reportable liabilities" in excess of certain monetary thresholds, as discussed below.

The TIC B Forms require reporting of current obligations (including loans, regardless of their maturity) and short-term securities:

- That are owed by a U.S. resident entity to a non-U.S. resident, or by a non-U.S. resident entity to a U.S. resident;
- That are not held by a U.S. custodian or sub-custodian; and
- That are in excess of the relevant reporting thresholds (determined on an aggregated basis for the top-tier U.S. entity in an affiliated group, and separately for all of the funds that they manage).

TIC B Forms consist of a series of monthly and quarterly forms. Monthly TIC B filings (Forms BC, BL-1, and BL-2) are due no later than 15 days following the end of a month, and the quarterly TIC B filings (Forms BQ-1, BQ-2 (Part 1), BQ-2 (Part 2) and BQ-3) are due no later than 20 days following the end of a quarter. Any financial institutions with "reportable claims" or "reportable liabilities" (as described below) exceeding the monetary thresholds and required to file for a reporting period are also required to file for all subsequent reporting periods in that year (regardless of whether the thresholds are exceeded in the subsequent periods). The reporting threshold for each TIC B Form (except Form BQ-3) is \$50 million total (\$25 million in any one foreign country). The reporting threshold for Form BQ-3 is \$4 billion total (no country limit). A reporter is only required to file the applicable TIC B Forms for which its reportable claims and/or liabilities exceed the relevant threshold.

"Reportable claims" generally include all claims not held by a U.S. resident custodian or sub-custodian, including deposit balances due from banks, negotiable certificates of deposit of any maturity, brokerage balances, customer overdrawn accounts, loans and loan participations, resale agreements and similar financing agreements, short-term (original maturity of one year or less) negotiable and non-negotiable securities, money-market instruments, reinsurance recoverables and accrued interest receivables.

"Reportable liabilities" generally include all liabilities not held by a U.S. resident custodian or sub-custodian, including non-negotiable deposits of any maturity, brokerage balances, overdrawn deposit accounts, loans of any maturity, short-term (original maturity of one year or less) non-negotiable securities, repurchase agreements and similar financing agreements, insurance technical reserves and accrued interest payables.

"Reportable claims" and "reportable liabilities" do not include long-term securities (including equities and any long-term notes, bonds and debentures), derivatives, credit commitments, contingent liabilities, and securities borrowing or lending agreements in which one security is borrowed or lent in return for

another. For purposes of the TIC B Forms, a feeder fund's investment into a master fund is considered a non-reportable long-term security and is not a reportable claim.

Representatives of the government agencies responsible for the TIC B Forms have indicated that any claims or liabilities held by a U.S. resident custodian or sub-custodian (such as a bank) or otherwise reportable by another U.S. financial institution (such as an administrative agent) should not be reported by investment managers or funds or used to calculate whether the threshold limits have been exceeded.

A U.S. resident investment manager reporting on behalf of itself and the entities in its organization should generally file Forms BC, BL-1, BQ-2 (Part 1) and/or BQ-3, as applicable. A U.S. resident investment manager should generally file consolidated reports on behalf of the funds it manages, including reportable claims and liabilities of non-U.S. resident funds, on Forms BL-2, BQ-1, BQ-2 (Part 2). Non-U.S. investment managers do not have a reporting obligation, but any U.S. resident fund they manage may be required to make a TIC B filing.

TIC Form S

A U.S. resident entity, including a U.S. investment adviser, is required to file TIC Form S with the Federal Reserve Bank of New York if its transactions (*e.g.*, purchases, sales, redemptions and new issues) in long-term securities with foreign residents exceed \$350 million in the aggregate during a month. Long-term securities are securities without a stated maturity date (such as equities) or with an original term-to-maturity of over a year.

Reportable transactions include, among other things, purchases and sales of newly-issued securities, purchases and sales of existing securities from other investors, and transactions resulting from sinking fund redemptions, called or maturing securities. Long-term securities received or delivered to settle derivative contracts are also reportable as purchases or sales by foreign residents. For U.S. investment advisers, reportable transactions include, among other things:

- Purchases and sales they make for the accounts of their U.S. resident funds and other clients that are conducted directly with a foreign resident or placed through a foreign-resident broker, dealer or underwriter;
- Purchases and sales made for the accounts of their foreign-resident funds and other clients that are placed through U.S. resident brokers, dealers or underwriters, if the identity of the underlying account holder had not been fully disclosed to such brokers, dealers or underwriters;
- Redemptions from the accounts of their U.S. resident funds and other clients that are presented to a foreign-resident intermediary (*e.g.*, foreign-paying agent, foreign-resident broker, foreign-resident dealer or foreign-resident issuer) without the use of a U.S. resident custodian; and
- Purchases and sales of interests in a foreign master fund by a U.S. resident feeder fund or in a U.S. resident master fund by a foreign feeder fund.

U.S. investment advisers meeting the reporting threshold in any given month must file TIC Form S no later than 15 days following month-end, and must continue to file TIC Form S monthly for the remainder of the calendar year, regardless of the level of transactions in the subsequent months.

TIC Form SLT

U.S. resident custodians (including U.S. resident banks), U.S. resident issuers (including U.S. private funds) and U.S. resident end-investors (including U.S. investment advisers, whether or not registered) are

required to file TIC Form SLT with the Federal Reserve Bank of New York to report their cross-border ownership of reportable long-term securities, if the fair market value of their reportable holdings and issuances equals at least \$1 billion as of the last business day of any month.

Most equity securities and debt securities with a maturity of greater than one year are considered reportable long-term securities for purposes of Form SLT. Certain types of securities are excluded, such as, among other things, short-term securities (original maturity of one year or less), bankers' acceptances and trade acceptances, derivative contracts (including forward contracts to deliver securities), loans and loan participation certificates, letters of credit, bank deposits and annuities.

U.S. investment advisers with aggregate holdings of reportable long-term securities with a fair market value of at least \$1 billion by the investment adviser and its clients are likely to be subject to Form SLT reporting. An investment adviser that is subject to the reporting requirement will file one consolidated report for all U.S. resident parts of its organization and all U.S. resident entities that it advises. Funds organized under the laws of any U.S. state are included in the "U.S. resident" portion of a reporting investment adviser's organization, which will subject securities issued by non-U.S. master funds that are held by U.S. feeder funds and holdings of U.S. master fund securities by non-U.S. feeder funds to reporting.

For U.S. resident holdings of non-U.S. securities, the reporting party would be required to disclose:

- The residence of the non-U.S. issuer; and
- The fair market value and type of non-U.S. security.

For non-U.S. resident holdings of U.S. securities, the reporting party would be required to disclose:

- The non-U.S. holder's residence;
- The fair market value and type of U.S. security; and
- Whether the non-U.S. holder is a "foreign official institution" (including national governments, international and regional organizations and sovereign wealth funds).

Form SLT must be filed monthly by the 23rd day following the end of each month (by **January 23, 2017** for December 2016). If the \$1 billion threshold is crossed as of the end of any month, the reporting person must file Form SLT for all remaining months in that calendar year regardless of the subsequent amount of its reportable holdings.

BE-13

BE-13 collects data on new foreign direct investment in the U.S. from U.S. persons that meet the reporting requirements, even if such U.S. person has not been contacted by the BEA.

A U.S. entity is required to make a BE-13A filing if a non-U.S. person acquires direct or indirect ownership or control of 10% or more of the voting securities of such U.S. entity. A U.S. entity that crosses the 10% reporting threshold must file a Form BE-13A if the cost of acquiring or establishing such interest exceeds \$3 million.

Subject to the recently enacted amendments discussed [above](#), a different BE-13 form is required depending on the type of event that has occurred (*e.g.*, formation, acquisition, merger or expansion). If the 10% reporting threshold is crossed but the cost of the transaction does not exceed \$3 million, a U.S.

entity must file a BE-13 Claim for Exemption. The BE-13 forms are due no later than 45 calendar days after an acquisition is completed, a new U.S. business enterprise is established or the expansion is begun.

Annual U.S. Tax Elections and Filings

This section briefly summarizes certain U.S. tax filings and elections (and related deadlines) relevant to private funds, their investors and related persons. For key FATCA action items and deadlines, please see the “Continued FATCA Implementation and International Tax Information Exchange” section [above](#).

Section 83(b) Elections. For 2015 and earlier, if an individual filed a Section 83(b) election with the IRS during a given year, that individual was required to attach a copy of the filed election to his or her U.S. federal income tax return for such year. However, under regulations finalized earlier this year ([TD 9779](#)), this requirement no longer applies.

Form 8832 Filings. If an entity filed an IRS Form 8832 (an entity classification election) with respect to 2016, that entity must attach a copy of the Form 8832 with its U.S. federal income tax return. If that entity is not required to file a U.S. return, all direct or indirect owners of that entity generally must attach a copy with their U.S. federal income tax returns, if they are otherwise required to file U.S. returns. The deadline will be the due date (including any applicable extensions) of the filer’s 2016 U.S. federal income tax return.

“Qualified Electing Fund” (QEF) Election. If a private fund has invested in a non-U.S. portfolio company that is (or may be) a “passive foreign investment company” (PFIC), the first U.S. person in the PFIC’s ownership chain (*e.g.*, the fund itself, if a U.S. fund, or each U.S. investor, if a non-U.S. fund) may wish to file a QEF election with respect to that PFIC. The QEF election must be filed with that U.S. person’s U.S. federal income tax return for the first year in which the fund invested in the PFIC. The deadline for PFICs acquired in 2016 will be the due date (including any applicable extensions) of that U.S. person’s 2016 U.S. federal income tax return.

“Electing Investment Partnership” (EIP) Election. Private funds that satisfy certain requirements may opt out of otherwise mandatory tax basis adjustments (including those that may result from transfers of interests in a fund) by filing an EIP election. The EIP election must be filed with the private fund’s U.S. federal income tax return for the first year in which the election is intended to apply. For funds wishing to be treated as EIPs with respect to 2016 (and subsequent years), the deadline will be the due date (including any applicable extensions) of the private fund’s 2016 U.S. federal income tax return.

Certain U.S. Tax Filings with respect to Non-U.S. Entities. U.S. private funds and their U.S. investors may be required to make certain filings with respect to non-U.S. entities owned by the private fund. These filings may include, without limitation:

- IRS Form 5471 (with respect to certain non-U.S. corporations, including “controlled foreign corporations,” owned by the private fund);
- IRS Form 926 (with respect to certain contributions of property to a non-U.S. corporation);
- IRS Form 8621 (with respect to certain non-U.S. corporations that are PFICs; however, such reporting is generally not required of U.S. tax-exempt investors pursuant to regulations issued on December 30, 2013);
- IRS Form 8865 (with respect to certain non-U.S. partnerships);
- IRS Form 8858 (with respect to certain non-U.S. disregarded entities); and

- IRS Form 8938 (with respect to certain non-U.S. financial assets).

Generally, the deadline will be the due date (including any applicable extensions) of the U.S. person's 2016 U.S. federal income tax return.

Report of Foreign Bank and Financial Accounts (FBAR). With very limited exceptions, a U.S. person who has a financial interest in, or signatory authority over, one or more non-U.S. financial accounts must report those accounts annually to the Treasury Department, unless the aggregate value of all such accounts did not exceed \$10,000 at any time during the year. Under current law, hedge funds and private equity funds generally are not considered "financial accounts." Nevertheless, such private funds and their investment advisers may be required to file FBARs if they have non-U.S. bank or other financial accounts.

Under [proposed regulations](#) released in March 2016 (the **FBAR Proposed Regulations**), officers, employees, and agents of U.S. entities who previously had an FBAR filing obligation as a result of having signatory or other authority over, but no financial interest in, a non-U.S. financial account, are relieved of their own requirement to file an FBAR with respect to that account, provided that U.S. entity or any U.S. entity "within the same corporate or business structure" is required to report the non-U.S. financial account on an FBAR. While this will relieve certain individuals of their FBAR filing responsibility, it is important to note that such individuals are only relieved of that responsibility if the requirement highlighted in the prior sentence is satisfied. This is a change from past FinCEN guidance, which said that certain individuals with signatory authority over, but no financial interest in, a more limited range of non-U.S. financial accounts were not obligated to file an FBAR, regardless of whether another U.S. filer would be filing an FBAR with respect to such non-U.S. financial accounts. Thus, while the scope of individuals relieved of filing an FBAR under the FBAR Proposed Regulations generally is broader than those relieved of such obligation under current guidelines, the fact that this exception will only apply if another U.S. filer is filing an FBAR with respect to the relevant non-U.S. account narrows the exception such that employees of registered investment advisers with signatory or other authority over, but no financial interest in, a non-U.S. account could have to file an FBAR if the FBAR Proposed Regulations are finalized in their current form.

In addition, employers are required to maintain information identifying all officers, employees or agents with signature or other authority over, but no financial interest in, foreign financial accounts. Such records must be maintained for five years and made available to FinCEN or law enforcement on request. The FBAR Proposed Regulations would also remove a special rule allowing simplified reporting for persons with financial interest in, or signature or other authority over, 25 or more accounts.

Under the FBAR Proposed Regulations, FBARs for calendar years 2016 and onward must be filed by the April 15 following the close of the calendar year, using the E-Filing System maintained by FinCEN. Filers must first register on the FinCEN site, so it is advisable to register well in advance of the April 15 filing deadline. The FBAR Proposed Regulations also provide taxpayers the ability to request and be granted an extension for filing until October 15 of the following calendar year. While these proposed regulations generally are not effective until final, the new due date of April 15 has been enacted for 2016 onwards pursuant to a short-term highway funding measure that included certain procedural tax matters (P.L. 114-41).

Please see our [March 10, 2016](#) client alert for more information.

Other Annual Requirements and Considerations

Audited Financial Statements Delivery

Rule 206(4)-2 of the Advisers Act (**Custody Rule**) requires registered investment advisers with custody of client assets to implement certain safeguards designed to protect client assets against the risk of loss, misuse or misappropriation. Among other things, it requires assets of an investment adviser's clients to be held by a qualified custodian and to be subject to surprise annual examinations by an independent public accountant that is registered with and subject to inspection by the Public Company Accounting Oversight Board (**PCAOB**). With respect to private fund clients, however, an investment adviser, rather than complying with the surprise audit requirement, may comply with the Custody Rule by relying on the Audit Provision under part (b)(4) of the Custody Rule. To rely on the Audit Provision, the investment adviser must have an independent public accountant that is registered with and subject to inspection by the PCAOB conduct an annual audit of each private fund client and deliver audited financial statements to all of its private fund investors. The audited financial statements must be delivered:

- Within 120 days of the private fund's fiscal year-end (by **April 30, 2017**, if the fiscal year ends on December 31); or
- Within 180 days of the private fund's fiscal year-end, if the private fund is a fund-of-funds (by **June 29, 2017**, if the fiscal year ends on December 31).

The accountant conducting the annual audit must be registered with and subject to inspection by the PCAOB. Currently, only auditors to public companies are subject to regular inspection by the PCAOB. However, on October 4, 2016, the staff of the SEC's Investment Adviser Regulation Office in the Division of Investment Management issued a [no-action letter](#) which affirmed continuing relief that the SEC would not recommend enforcement action against an investment adviser engaging an auditor that is not subject to inspection by the PCAOB to audit the financial statements of a pooled investment vehicle in connection with the annual audit provision, on the condition that such auditor was (i) registered with the PCAOB, and (ii) engaged to audit the financial statements of a broker or a dealer as of the commencement of the professional engagement period and as of each calendar-year end. This relief was extended by the SEC through the earlier of (i) the date the SEC would approve a PCAOB-adopted permanent program for the inspection of broker and dealer auditors, or (ii) December 31, 2019.

Privacy Policy Delivery

On December 4, 2015, President Obama signed the Fixing America's Surface Transportation Act (**FAST Act**). Hidden among provisions authorizing funding for roads and bridges were provisions intended to simplify rules applicable to financial institutions. One such provision under the Fast Act, Title LXXV—Eliminate Privacy Notice Confusion, amends the existing law that requires financial institutions (including investment advisers) to distribute annual privacy notices to their natural person customers.

Under the new law, financial institutions will no longer be required to deliver annual privacy notices to clients (including fund investors) who are natural persons, if (i) the financial institution's privacy policy has not changed and (ii) the financial institution does not share nonpublic personal information with non-affiliated third parties (except as permitted under certain exceptions, *e.g.*, to service providers who perform services on behalf of the financial institution). Annual privacy notices will only be required if a financial institution's privacy policies and practices have changed since the last distribution of a privacy notice.

If there has been any change to the privacy policy that would permit nonpublic client information to be disclosed to non-affiliated third parties, and the new disclosure is not covered in the existing notice, the financial institution must deliver an updated notice to clients and provide them a reasonable opportunity to opt out of the new disclosure.

Please see our [January 25, 2016](#) client alert for more information.

Schedule K-1 Delivery

Under IRS rules, partnerships are required to deliver certain information on Schedule K-1 to their partners on or before the day on which the return for the relevant taxable year is required to be filed. As required by IRS rules issued in 2012, a partnership must obtain a partner's affirmative consent for the partnership to validly deliver Schedule K-1 to the partner electronically (*e.g.*, via email or by posting the Schedule K-1 on a web portal). For the consent to be valid, it must be obtained from a partner in the same electronic manner in which the partnership will deliver the Schedule K-1 to the partner. The applicable IRS rules also prescribe certain other requirements for electronic delivery of Schedule K-1s, including certain disclosures, which must be provided to partners regarding electronic delivery of Schedule K-1s. In addition to these IRS rules, states or other jurisdictions may impose security requirements for maintenance and transmission of sensitive personal information (such as individual social security numbers), which a partnership may need to comply with when delivering Schedule K-1s to its partners.

New Issues Investor Reaffirmations

If a private fund intends to invest in "new issues," the investment adviser will often obtain annual reaffirmations from the private fund's investors relating to each such investor's eligibility to participate in profits and losses from new issues. Reaffirmation may be obtained by sending out notices asking each investor to notify the investment adviser if the investor's new issues status has changed or by including a representation in the investor's subscription agreement whereby the investor agrees to notify the investment adviser of any subsequent change in its new issues status.

ERISA/VCOE Annual Certifications and Compliance

Many private funds that accept investments from investors subject to ERISA are operated in such a manner so that the assets of such private funds do not constitute the "plan assets" of ERISA investors for purposes of ERISA. Typically, such a fund will either be operated as a "venture capital operating company" (**VCOE**) or so that "benefit plan investor" equity participation is not "significant" (*i.e.*, under the ERISA 25% limit), and the sponsor of such a private fund often will contractually agree with its ERISA investors to deliver an annual certification as to the private fund's continued compliance with the VCOE requirements and/or the 25% benefit plan investor limit. Private funds that accept investments from ERISA investors should conduct the VCOE or 25% benefit plan investor limit analysis as applicable, whether or not they are required to annually certify compliance with respect thereto, and should be prepared to deliver any required or requested certifications in a timely manner.

Private funds that are designed to hold "plan assets" and that are actually holding "plan assets" of ERISA investors may need to provide the ERISA investors with certain information relating to any changes to the fees or expenses paid by the fund.

California Finance Lenders Law Requirements

The California Finance Lenders Law (**CFLL**) generally requires lenders (including private funds) “engaged in the business of a finance lender” in California to obtain a license, although there is an exemption for a person making no more than five loans per year, so long as the loans are incidental to the business of the person relying on the exemption (*e.g.*, bridge loans to a portfolio company) and the person is not engaged in the business of making loans. The licensing process is cumbersome and time consuming, but willful violation of the law can result in civil and criminal penalties. A license holder is subject to certain inspection and reporting obligations. Please let us know if you have any questions about the potential applicability of the CFLL to your operations.

Lobbyist Registration

Under a California law that became effective January 1, 2011, “placement agents” hired or engaged to solicit California state plans (*e.g.*, CalSTRS, CalPERS and the University of California pension system) are required to register as lobbyists. Under existing law, lobbyists are restricted in their ability to provide gifts and make campaign contributions and are prohibited from accepting fees contingent upon the success of their lobbying efforts. Under the 2011 law, certain employees of a fund sponsor may be subject to the lobbyist registration requirements and the gift and campaign contribution limits, and sponsors that retain placement agents may have filing and record keeping obligations as “lobbyist employers.” If you are contemplating retention of a placement agent or any solicitation of CalSTRS, CalPERS or the University of California pension system, please contact a member of your Proskauer team for more information.

In addition, under New York City’s Lobbying Law and based on regulatory guidance issued in 2010-2012, placement agents and/or employees of investment fund managers may be required to register with New York City in connection with the offering of fund interests to any of the New York City pension funds (including New York City Employees’ Retirement System, the New York City Police Pension Fund, the New York Fire Department Pension Fund, the New York City Teachers’ Retirement System, and the New York City Board of Education Retirement System). Although the Lobbying Law had been in effect for 20 years, it had not previously been interpreted to apply to the marketing activities of investment funds and their agents.

As a reminder, other state and local plans have their own regulations and policies on the use of placement agents (including disclosure or placement agent bans in some circumstances), and lobbyist registration may be relevant for marketing to other state or local plans.

Liability Insurance

Investment advisers should consider purchasing management liability insurance depending on their level of exposure and the extent to which their business and operations warrant such coverage. Given the heightened regulatory scrutiny of the private funds industry, investment advisers may benefit from protection against officer and director liability, fiduciary liability, error and omission liability and employment practice liability.

2017 Federal Filings and Other Document Delivery Calendar

<u>Filing / Delivery</u>	<u>Who must file</u>	<u>Deadline</u>
<u>November 2016</u>		
Form 13F	Investment advisers that exercise investment discretion over \$100 million or more in Section 13(f) securities	November 14 (for the quarter ending September 30, 2016)
NFA Form PR	Registered CTAs	November 14 (for the quarter ending September 30, 2016)
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of \$50 million (or \$25 million with respect to an individual country)	November 15 (for October 2016)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding \$350 million as of any month	November 15 (for October 2016)
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding \$1 billion as of the last day of any calendar month	November 23 (for October 2016)
Form PF	Large Hedge Fund Advisers	November 29 (for the quarter ending September 30, 2016)
CFTC Form CPO-PQR	Large CPOs	November 29 (for the quarter ending September 30, 2016)
NFA Form CPO-PQR	All registered CPOs, except Large CPOs	November 29 (for the quarter ending September 30, 2016)
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below \$500,000)	November 30 (for October 2016)

<u>Filing / Delivery</u>	<u>Who must file</u>	<u>Deadline</u>
<u>December 2016</u>		
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of \$50 million (or \$25 million with respect to an individual country)	December 15 (for November 2016)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding \$350 million as of any month	December 15 (for November 2016)
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding \$1 billion as of the last day of any calendar month	December 23 (for November 2016)
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below \$500,000)	December 30 (for November 2016)
<u>January 2017</u>		
Form PF	Large Liquidity Fund Advisers	January 17 (for the quarter ending December 31, 2016)
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of \$50 million (or \$25 million with respect to an individual country)	January 17 (for December 2016)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding \$350 million as of any month	January 17 (for December 2016)
TIC Form BQ-1, BQ-2 and BQ-3	U.S. residents with reportable cross-border claims or liabilities in excess of \$50 million (or \$25 million with respect to an individual country) (Form BQ-1 and BQ-2 Part 1), in excess of \$50 million (no country limit) (Form BQ-2 Part 2), or in excess of \$4 billion (no country limit) (Form BQ-3)	January 20 (for the quarter ending December 31, 2016)

<u>Filing / Delivery</u>	<u>Who must file</u>	<u>Deadline</u>
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding \$1 billion as of the last day of any calendar month	January 23 (for December 2016)
Delivery of Quarterly Account Statements to Pool Participants	Registered CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below \$500,000	January 30 (for the quarter ending December 31, 2016)
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below \$500,000)	January 30 (for December 2016)
<u>February 2017</u>		
Form 13F	Investment advisers that exercise investment discretion over \$100 million or more in Section 13(f) securities	February 14 (for the quarter ending December 31, 2016)
Schedule 13G Annual Amendment	Beneficial owners of at least 5% of a class of outstanding equity securities of a U.S. public company eligible to file Schedule 13G (<i>i.e.</i> , Qualified Institutional Investors and/or passive investors)	February 14 (for 2016)
Form 13H Annual Amendment	Large traders of Regulation NMS securities	February 14 (for 2016)
Form 5	Insiders required to report any exempt or other insider transactions not previously reported on Form 4	February 14 (if the issuer has a December 31 fiscal year-end)
CFTC Form CTA-PR	Registered CTAs	February 14 (for the quarter ending December 31, 2016)
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of \$50 million (or \$25 million with respect to an individual country)	February 15 (for January 2017)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding \$350 million as of any month	February 15 (for January 2017)

<u>Filing / Delivery</u>	<u>Who must file</u>	<u>Deadline</u>
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding \$1 billion as of the last day of any calendar month	February 23 (for January 2017)
<u>March 2017</u>		
Form PF	Large Hedge Fund Advisers	March 1 (for the quarter ending December 31, 2016)
CFTC Form CPO-PQR	Large CPOs	March 1 (for the quarter ending December 31, 2016)
CFTC Registration Exemption Reaffirmations	CPOs exempt from CPO registration under CFTC Rule 4.5, 4.13(a)(1), 4.13(a)(2), 4.13(a)(3) or 4.13(a)(5) and CTAs exempt from CTA registration under CFTC Rule 4.14(a)(8)	March 1 (for 2016)
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below \$500,000)	March 2 (for January 2017)
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of \$50 million (or \$25 million with respect to an individual country)	March 15 (for February 2017)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding \$350 million as of any month	March 15 (for February 2017)
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding \$1 billion as of the last day of any calendar month	March 23 (for February 2017)
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below \$500,000)	March 30 (for February 2017)

<u>Filing / Delivery</u>	<u>Who must file</u>	<u>Deadline</u>
Form ADV Part 1 Annual Update	Registered investment advisers and exempt reporting advisers	March 31 (for an investment adviser with a December 31 fiscal year-end)
Form ADV Part 2A Annual Update	Registered investment advisers	March 31 (for an investment adviser with a December 31 fiscal year-end)
CFTC Form CPO-PQR	All registered CPOs, except Large CPOs	March 31 (for 2016)
NFA Form CPO-PQR	Small CPOs	March 31 (for the quarter ending December 31, 2016)
NFA Commodity Pool Annual Financial Statements Filing	Registered CPOs	March 31 (for a pool with a December 31 fiscal year-end)
FATCA Information Report	Participating FFIs (except for FFIs in Model 1 IGA jurisdictions)	March 31
<u>April 2017</u>		
FBAR	Hedge funds and private equity funds, and their investment advisers, if they have non-U.S. bank or other financial accounts	April 15 (with a six-month extension available upon request)
Form PF	Large Liquidity Fund Advisers	April 17 (for the quarter ending March 31, 2017)
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of \$50 million (or \$25 million with respect to an individual country)	April 17 (for March 2017)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding \$350 million as of any month	April 17 (for March 2017)

<u>Filing / Delivery</u>	<u>Who must file</u>	<u>Deadline</u>
TIC Form BQ-1, BQ-2 and BQ-3	U.S. residents with reportable cross-border claims or liabilities in excess of \$50 million (or \$25 million with respect to an individual country) (Form BQ-1 and BQ-2 Part 1), in excess of \$50 million (no country limit) (Form BQ-2 Part 2), or in excess of \$4 billion (no country limit) (Form BQ-3)	April 20 (for the quarter ending March 31, 2017)
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding \$1 billion as of the last day of any calendar month	April 24 (for March 2017)
Delivery of Updated Form ADV Part 2A to Clients	Registered investment advisers	April 30 (for an investment adviser with a December 31 fiscal year-end)
Delivery of Annual Audited Financial Statements to Clients	Registered investment advisers (except with respect to fund-of-funds)	April 30 (for private fund with a December 31 fiscal year-end)
Delivery of Quarterly Account Statements to Pool Participants	Registered CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below \$500,000	April 30 (for the quarter ending March 31, 2017)
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below \$500,000)	April 30 (for March 2017)
<u>May 2017</u>		
Form PF	Registered investment advisers with at least \$150 million in RAUM attributable to private funds, including Large Private Equity Fund Advisers	May 1 (for an investment adviser with a December 31 fiscal year-end)
Form 13F	Investment advisers that exercise investment discretion over \$100 million or more in Section 13(f) securities	May 15 (for the quarter ending March 31, 2017)
NFA Form PR	All registered CTAs	May 15 (for the quarter ending March 31, 2017)

<u>Filing / Delivery</u>	<u>Who must file</u>	<u>Deadline</u>
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of \$50 million (or \$25 million with respect to an individual country)	May 15 (for April 2017)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding \$350 million as of any month	May 15 (for April 2017)
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding \$1 billion as of the last day of any calendar month	May 23 (for April 2017)
Form PF	Large Hedge Fund Advisers	May 30 (for the quarter ending March 31, 2017)
CFTC Form CPO-PQR	Large CPOs	May 30 (for the quarter ending March 31, 2017)
NFA Form CPO-PQR	All registered CPOs, except Large CPOs	May 30 (for the quarter ending March 31, 2017)
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below \$500,000)	May 30 (for April 2017)
<u>June 2017</u>		
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of \$50 million (or \$25 million with respect to an individual country)	June 15 (for May 2017)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding \$350 million as of any month	June 15 (for May 2017)
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding \$1 billion as of the last day of any calendar month	June 23 (for May 2017)

<u>Filing / Delivery</u>	<u>Who must file</u>	<u>Deadline</u>
Delivery of Annual Audited Financial Statements to Clients	Registered investment advisers (with respect to fund-of-funds)	June 29 (for a fund-of-funds with a December 31 fiscal year-end)
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below \$500,000)	June 30 (for May 2017)
<u>July 2017</u>		
Form PF	Large Liquidity Fund Advisers	July 17 (for the quarter ending June 30, 2017)
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of \$50 million (or \$25 million with respect to an individual country)	July 17 (for June 2017)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding \$350 million as of any month	July 17 (for June 2017)
TIC Form BQ-1, BQ-2 and BQ-3	U.S. residents with reportable cross-border claims or liabilities in excess of \$50 million (or \$25 million with respect to an individual country) (Form BQ-1 and BQ-2 Part 1), in excess of \$50 million (no country limit) (Form BQ-2 Part 2), or in excess of \$4 billion (no country limit) (Form BQ-3)	July 20 (for the quarter ending June 30, 2017)
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding \$1 billion as of the last day of any calendar month	July 24 (for June 2017)
Delivery of Quarterly Account Statements to Pool Participants	Registered CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below \$500,000	July 30 (for the quarter ending June 30, 2017)

<u>Filing / Delivery</u>	<u>Who must file</u>	<u>Deadline</u>
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below \$500,000)	July 30 (for June 2017)
<u>August 2017</u>		
Form 13F	Investment advisers that exercise investment discretion over \$100 million or more in Section 13(f) securities	August 14 (for the quarter ending June 30, 2017)
NFA Form PR	All registered CTAs	August 14 (for the quarter ending June 30, 2017)
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of \$50 million (or \$25 million with respect to an individual country)	August 15 (for July 2017)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding \$350 million as of any month	August 15 (for July 2017)
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding \$1 billion as of the last day of any calendar month	August 23 (for July 2017)
Form PF	Large Hedge Fund Advisers	August 29 (for the quarter ending June 30, 2017)
CFTC Form CPO-PQR	Large CPOs	August 29 (for the quarter ending June 30, 2017)
NFA Form CPO-PQR	All registered CPOs, except Large CPOs	August 29 (for the quarter ending June 30, 2017)
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below \$500,000)	August 30 (for July 2017)

<u>Filing / Delivery</u>	<u>Who must file</u>	<u>Deadline</u>
<u>September 2017</u>		
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of \$50 million (or \$25 million with respect to an individual country)	September 15 (for August 2017)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding \$350 million as of any month	September 15 (for August 2017)
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding \$1 billion as of the last day of any calendar month	September 25 (for August 2017)
FATCA Information Report	Participating FFIs in Model 1 IGA jurisdictions	September 30
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below \$500,000)	September 30 (for August 2017)
<u>October 2017</u>		
Form PF	Large Liquidity Fund Advisers	October 16 (for the quarter ending September 30, 2017)
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of \$50 million (or \$25 million with respect to an individual country)	October 16 (for September 2017)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding \$350 million as of any month	October 16 (for September 2017)

<u>Filing / Delivery</u>	<u>Who must file</u>	<u>Deadline</u>
TIC Form BQ-1, BQ-2 and BQ-3	U.S. residents with reportable cross-border claims or liabilities in excess of \$50 million (or \$25 million with respect to an individual country) (Form BQ-1 and BQ-2 Part 1), in excess of \$50 million (no country limit) (Form BQ-2 Part 2), or in excess of \$4 billion (no country limit) (Form BQ-3)	October 20 (for the quarter ending September 30, 2017)
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding \$1 billion as of the last day of any calendar month	October 23 (for September 2017)
Delivery of Quarterly Account Statements to Pool Participants	Registered CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below \$500,000	October 30 (for the quarter ending September 30, 2017)
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below \$500,000)	October 30 (for September 2017)
<u>November 2017</u>		
Form 13F	Investment advisers that exercise investment discretion over \$100 million or more in Section 13(f) securities	November 14 (for the quarter ending September 30, 2017)
NFA Form PR	All registered CTAs	November 14 (for the quarter ending September 30, 2017)
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of \$50 million (or \$25 million with respect to an individual country)	November 15 (for October 2017)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding \$350 million as of any month	November 15 (for October 2017)

<u>Filing / Delivery</u>	<u>Who must file</u>	<u>Deadline</u>
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding \$1 billion as of the last day of any calendar month	November 24 (for October 2017)
Form PF	Large Hedge Fund Advisers	November 29 (for the quarter ending September 30, 2017)
CFTC Form CPO-PQR	Large CPOs	November 29 (for the quarter ending September 30, 2017)
NFA Form CPO-PQR	All registered CPOs, except Large CPOs	November 29 (for the quarter ending September 30, 2017)
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below \$500,000)	November 30 (for October 2017)
<u>Other Floating Deadlines</u>		
Form D	Private funds conducting an offering under Regulation D	<p>Initial Filing: Within 15 days of the initial sale of securities</p> <p>Annual Amendment: Anniversary date of the previous Form D filing</p> <p>Interim Amendment: As soon as practicable after certain changes in information</p> <p>Note: Additional state blue sky filing requirements may apply</p>
Schedule 13D	Beneficial owners of at least 5% of a class of outstanding equity securities of a U.S. public company	<p>Initial Filing: Within 10 days of crossing the 5% threshold</p> <p>Amendment: Promptly after any material change in beneficial ownership percentage</p>

<u>Filing / Delivery</u>	<u>Who must file</u>	<u>Deadline</u>
Schedule 13G	Beneficial owners of at least 5% of a class of outstanding equity securities of a U.S. public company eligible to file Schedule 13G (<i>i.e.</i> , Qualified Institutional Investors and/or passive investors)	Initial Filing: Generally, within 45 days of year-end (if a QII or exempt investor) or within 10 days of crossing the 5% threshold (if a passive investor) Annual Amendment: Within 45 days of year-end (see above) Interim Amendment: Within 10 days of month-end (if a QII) or promptly (if a passive investor) if holding exceeds 10% or if it thereafter increase or decrease by over 5%
Form 13H	Large traders of Regulation NMS securities	Initial Filing: Promptly (usually 10 days) after reaching reporting threshold Annual Amendment: Within 45 days of year-end (see above) Interim Amendment: Promptly after quarter-end if there is any change in information
Form 3	Beneficial owners of more than 10% of a class of equity securities of a U.S. public company, or officers or directors of a U.S. public company	Within 10 days of becoming a 10% beneficial owner, officer or director
Form 4	Beneficial owners of more than 10% of a class of equity securities of a U.S. public company or officers or directors of a U.S. public company that effect a transaction changing the beneficial ownership of securities previously reported on Form 3	Within 2 business days of the transaction

<u>Filing / Delivery</u>	<u>Who must file</u>	<u>Deadline</u>
Hart-Scott-Rodino Filings	Persons contemplating a business transaction which is not “solely for the purpose of investment” and relates to either: (i) the acquisition of voting securities valued in excess of \$78.2 million (adjusted annually); or (ii) the acquisition of a majority of interests in certain unincorporated entities (such as certain partnerships or LLCs). The passive investor exemption is available only for holdings not exceeding 10% of an issuer’s voting stock	Prior to completion of the proposed business transaction Note: Filers are generally subject to 30-day waiting period after submitting their HSR notice filing
Form BE-13A or BE-13 Claim for Exemption	U.S. entities in which a non-U.S. person acquires direct or indirect ownership or control of 10% or more of the voting securities If the cost of the transaction exceeds \$3 million, then the U.S. entity should file Form BE-13A If the cost of the transaction does not exceed \$3 million, then the U.S. entity should file a BE-13 Claim for Exemption	Within 45 days after a reportable transaction
New Issues Affirmations	Private funds that invest in new issues	Annually
Delivery of Privacy Policy Notice to Clients	Financial institutions who have changed their privacy policies and practices since the last distribution of a privacy notice (see above)	Annually
Delivery of ERISA/VCOC Annual Certification to ERISA Investors	Private funds operating as a VCOC or pursuant to the 25% cap	Annually
Delivery of Schedule K-1	Private funds that are partnerships	Due date (including any applicable extension) of the partnership’s U.S. federal income tax return

<u>Filing / Delivery</u>	<u>Who must file</u>	<u>Deadline</u>
Form 8832 Filing	Entities that filed an IRS Form 8832 with respect to 2016	Due date (including any applicable extension) of that entity's 2016 U.S. federal income tax return
QEF Election	In the case of a private fund that has invested in a non-U.S. portfolio company that is (or may be) a PFIC, the first U.S. person in the PFIC's ownership chain (<i>e.g.</i> , the fund itself if a U.S. fund, or each U.S. investor if a non-U.S. fund)	Due date (including any applicable extensions) of that U.S. person's 2016 U.S. federal income tax return
EIP Election	Eligible private funds wishing to opt out of mandatory tax basis adjustments	Due date (including any applicable extensions) of that private fund's 2016 U.S. federal income tax return
CbCR	U.S. MNEs with an annual accounting period that begins on or after June 30, 2016. (Note that for 2017, this will extend to all U.S. MNEs)	Due date (including any applicable extension) of that entity's 2016 U.S. federal income tax return
Certain U.S. Tax Filings with respect to Non-U.S. Entities	Private funds and their U.S. investors may be required to make certain filings with respect to non-U.S. entities owned by the private fund, including, without limitation: <ul style="list-style-type: none"> • IRS Form 5471 • IRS Form 926 • IRS Form 8621 • IRS Form 8865 • IRS Form 8858 • IRS Form 8938 	Generally, due date (including any applicable extensions) of the U.S. person's 2016 U.S. federal income tax return

Contacts

For additional information on matters discussed in this Annual Review, please contact any of the Proskauer attorneys listed below:

HEDGE FUNDS

Robert G. Leonard

212.969.3355

rleonard@proskauer.com

Michael F. Mavrides

212.969.3670

mmavrides@proskauer.com

Christopher M. Wells

212.969.3600

cwells@proskauer.com

Peter McGowan (London)

+44.20.7280.2066

pmcgowan@proskauer.com

PRIVATE INVESTMENT FUNDS

Monica Arora

212.969.3003

marora@proskauer.com

Howard J. Beber

617.526.9754

hbeber@proskauer.com

Stephanie W. Berdik

617.526.9441

sberdik@proskauer.com

Bruno Bertrand-Delfau (London)

+44.20.7280.2126

bbertrand-delfau@proskauer.com

Lynn Chan (Hong Kong)

+852.3410.8018

lchan@proskauer.com

Sarah K. Cherry

617.526.9769

scherry@proskauer.com

Niamh A. Curry

212.969.3474

ncurry@proskauer.com

Anthony M. Drenzek

617.526.9655

adrenzek@proskauer.com

Daniel P. Finkelman

617.526.9755

dfinkelman@proskauer.com

Camille Higonnet

617.526.9738

chigonnet@proskauer.com

Sean J. Hill

617.526.9805

shill@proskauer.com

David T. Jones

617.526.9751

djones@proskauer.com

Ying Li (Hong Kong)

+852.3410.8088

yli@proskauer.com

Bruce L. Lieb

212.969.3320

blieb@proskauer.com

Matthew McBride

617.526.9670

mmcbride@proskauer.com

Stephen T. Mears

617.526.9775

smears@proskauer.com

Malcolm B. Nicholls III

617.526.9787

mnicholls@proskauer.com

Charles (Chip) Parsons

212.969.3254

cparsons@proskauer.com

Marc A. Persily

212.969.3403

mpersily@proskauer.com

Robin A. Painter

617.526.9790

rpainter@proskauer.com

Yong Ren (Beijing)

+86.10.8572.1899

yren@proskauer.com

Kate Simpson (London)

+44.20.7280.2068

ksimpson@proskauer.com

Michael R. Suppappola

617.526.9821

msuppappola@proskauer.com

David W. Tegeler
617.526.9795
dtegeler@proskauer.com

John Verwey (London)
+44.20.7280.2033
jverwey@proskauer.com

Nigel van Zyl (London)
+44.20.7280.2070
nvanzyl@proskauer.com

TAX

Richard M. Corn
212.969.3553
rcorn@proskauer.com

Michael Fernhoff
310.284.5671
mfernhoff@proskauer.com

Robert Gaut (London)
+44.20.7280.2064
rgaut@proskauer.com

Martin T. Hamilton
212.969.3964
mhamilton@proskauer.com

Marguerite R. Lombardo
617.526.9472
mlombardo@proskauer.com

Scott S. Jones
617.526.9772
sjones@proskauer.com

Anne Kim
310.284.4575
akim@proskauer.com

Mary B. Kuusisto
+44.20.7280.2159
mkuusisto@proskauer.com

Arnold P. May
617.526.9757
amay@proskauer.com

David S. Miller
212.969.3006
dmiller@proskauer.com

Amanda H. Nussbaum
212.969.3642
anussbaum@proskauer.com

Jamiel E. Poindexter
617.526.9773
jpoindexter@proskauer.com

Catherine Sear (London)
+44.20.7280.2061
csear@proskauer.com

PRIVATE EQUITY AND HEDGE FUND LITIGATION

David Chu (Hong Kong)
+852.3410.8028
dchu@proskauer.com

Peter Duffy Doyle
212.969.3688
pdoyle@proskauer.com

Timothy W. Mungovan
617.526.9412
tmungovan@proskauer.com

Kevin J. Perra
212.969.3454
kperra@proskauer.com

SEC ENFORCEMENT

Robert J. Cleary
212.969.3340
rjcleary@proskauer.com

Ralph C. Ferrara
202.416.5820
rferrara@proskauer.com

Sigal P. Mandelker
212.969.3360
smandelker@proskauer.com

Joshua M. Newville
212.969.3336
jerichman@proskauer.com

Jonathan E. Richman
212.969.3448
jerichman@proskauer.com

BROKER-DEALER

Benjamin J. Catalano
212.969.3980
bcatalano@proskauer.com

Edward A. Kwalwasser
212.969.3515
ekwalwasser@proskauer.com

Kathy H. Rocklen
212.969.3755
krocklen@proskauer.com

CFTC/DERIVATIVES/SECURITIES LENDING/ REPOS

Peter McGowan (London)

+44.20.7280.2066

pmcgowan@proskauer.com

Christopher M. Wells

212.969.3600

cwells@proskauer.com

MARKETS AND TRADING/REGULATION

Edward A. Kwalwasser

212.969.3515

ekwalwasser@proskauer.com

Frank Zarb

202.416.5870

fzarb@proskauer.com

ERISA

Ira G. Bogner

212.969.3947

ibogner@proskauer.com

Adam W. Scoll

617.526.9486

ascoll@proskauer.com

EXECUTIVE COMPENSATION

Michael J. Album

212.969.3650

malbum@proskauer.com

Daniel Ornstein (London)

+44.20.7280.2067

dornstein@proskauer.com

Michael S. Sirkin

212.969.3840

msirkin@proskauer.com

EMPLOYMENT

Allan S. Bloom

212.969.3880

abloom@proskauer.com

WHISTLEBLOWER

Connie N. Bertram

202.416.6810

cbertram@proskauer.com

Lloyd B. Chinn

212.969.3341

lchinn@proskauer.com

TRUSTS AND ESTATES

Henry J. Leibowitz

212.969.3602

hleibowitz@proskauer.com

David Pratt

561.995.4777

dpratt@proskauer.com

Jay D. Waxenberg

212.969.3606

jwaxenberg@proskauer.com

BANKRUPTCY AND RESTRUCTURING

Martin J. Bienenstock

212.969.4530

mbienenstock@proskauer.com

Jeff J. Marwil

312.962.3540

jmarwil@proskauer.com

FCPA/OFAC/ANTI-MONEY LAUNDERING

Mark J. Biros

202.416.5804

mbiros@proskauer.com

Chantel L. Febus

212.969.3429

cfebus@proskauer.com

CYBERSECURITY/ INTELLECTUAL PROPERTY AND TECHNOLOGY

Daryn A. Grossman

212.969.3665

dgrossman@proskauer.com

Kristen J. Mathews

212.969.3265

kmathews@proskauer.com

Jeffrey D. Neuburger

212.969.3075

jneuburger@proskauer.com

MULTI-TRANCHE FINANCE

Gary J. Creem
617.526.9637
gcreem@proskauer.com

Steven M. Ellis
617.526.9660
sellis@proskauer.com

CAPITAL MARKETS

Julie M. Allen
212.969.3155
jallen@proskauer.com

Peter Castellon (London)
+44.20.7280.2091
pcastellon@proskauer.com

Jeremy Leifer (Hong Kong)
+852.3410.8048
jleifer@proskauer.com

Frank Lopez
212.969.3492
flopez@proskauer.com

Fabio A. Yamada (Sao Paulo)
+55.11.3045.1250
fyamada@proskauer.com

MERGERS & ACQUISITIONS

Jonathan Benloulou
310.284.5698
jbenloulou@proskauer.com

Steven Davis (London)
+44.20.7280.2049
sdavis@proskauer.com

James P. Gerkis
212.969.3135
jgerkis@proskauer.com

Jeremy Leifer (Hong Kong)
+852.3410.8048
jleifer@proskauer.com

Ronald R. Papa
212.969.3325
rpapa@proskauer.com

Steven M. Peck
617.526.9890
speck@proskauer.com

Peter G. Samuels
212.969.3335
psamuels@proskauer.com

Monica J. Shilling
310.284.4544
mshilling@proskauer.com

Michael A. Woronoff
310.284.4550
mworonoff@proskauer.com

NON-COMPETE/TRADE SECRET DISPUTES

Steven M. Kayman
212.969.3430
skayman@proskauer.com

Beijing

Suite 5102, 51/F
Beijing Yintai Centre Tower C
2 Jianguomenwai Avenue
Chaoyang District
Beijing 100022, China
t: +86.10.8572.1800
f: +86.10.8572.1850

Boca Raton

2255 Glades Road
Suite 421 Atrium
Boca Raton, FL 33431-7360, USA
t: +1.561.241.7400
f: +1.561.241.7145

Boston

One International Place
Boston, MA 02110-2600, USA
t: +1.617.526.9600
f: +1.617.526.9899

Chicago

Three First National Plaza
70 West Madison, Suite 3800
Chicago, IL 60602-4342, USA
t: +1.312.962.3550
f: +1.312.962.3551

Hong Kong

Suites 1701-1705, 17/F
Two Exchange Square
8 Connaught Place
Central, Hong Kong
t: +852.3410.8000
f: +852.3410.8001

London

110 Bishopsgate
London EC2N 4AY, United Kingdom
t: +44.20.7280.2000
f: +44.20.7280.2001

Los Angeles

2049 Century Park East, 32nd Floor
Los Angeles, CA 90067-3206, USA
t: +1.310.557.2900
f: +1.310.557.2193

New Orleans

Poydras Center
650 Poydras Street
Suite 1800
New Orleans, LA 70130-6146, USA
t: +1.504.310.4088
f: +1.504.310.2022

New York

Eleven Times Square
New York, NY 10036-8299, USA
t: +1.212.969.3000
f: +1.212.969.2900

Newark

One Newark Center
Newark, NJ 07102-5211, USA
t: +1.973.274.3200
f: +1.973.274.3299

Paris

374 rue Saint-Honoré
75001 Paris, France
t: +33.1.53.05.60.00
f: +33.1.53.05.60.05

São Paulo

Rua Funchal, 418
26º andar
04551-060 São Paulo, SP, Brasil
t: +55.11.3045.1250
f: +55.11.3049.1259

Washington, D.C.

1001 Pennsylvania Avenue, NW
Suite 600 South
Washington, DC 20004-2533, USA
t: +1.202.416.6800
f: +1.202.416.6899