Proskauer

New Year: New Regulatory Developments Affecting Managers of Hedge Funds, Private Equity Funds and Other Private Funds

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Regulators were busy at the end of 2015, especially in the United States, perhaps being motivated to push forward new rule proposals in anticipation of a change in administration after the presidential elections later this year. Among the developments that we are monitoring that could affect managers of private funds are:

Implementation of Common Reporting Standard (CRS)

Over 50 countries, including key offshore jurisdictions like the Cayman Islands, Bermuda and the British Virgin Islands, have agreed to implement the Common Reporting Standard (CRS) put forth by the Organization for Economic Cooperation and Development (OECD) in an effort to coordinate and standardize tax information sharing and related disclosure requirements in various countries. CRS is similar to the U.S. Foreign Account Tax Compliance Act (FATCA) and equivalent rules relating to automatic tax information exchange adopted by the United Kingdom (UK FATCA). As a practical matter, this means that funds organized in a jurisdiction that has implemented the CRS are required, generally beginning January 1, 2016, to use new self-certification forms in order to collect the information necessary to comply with the CRS. However, it is important to note that the United States is not a CRS jurisdiction at this time, which means that US funds do not need to collect this information in addition to the information they are already collecting in connection with FATCA.

Investment advisers to private funds established outside the United States should contact their administrator or legal counsel in order to obtain the new CRS forms. In the case of a Cayman Islands fund, the new CRS forms should be obtained from all new investors beginning January 1, 2016 (although Cayman rules provide for a grace period of 90 days for any new investors that subscribed as of January 1, 2016); and the information required to comply with CRS is required to be collected from all pre-existing individual investors with aggregate investments of greater than $1,000,000 by December 31, 2016, and from all other pre-existing investors by December 31, 2017.

No More Annual Privacy Notices if no Material Change

On December 4, 2015, President Obama signed the "Fixing America's Surface Transportation Act" or "FAST Act". Hidden among provisions authorizing funding for roads and bridges were provisions intended to simplify rules applicable to financial institutions. One of those provisions, Title LXXV—Eliminate Privacy Notice Confusion, amends the existing law that requires financial institutions (including registered investment advisers) to distribute annual privacy notices to their natural person customers. Under the new law, 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. It is expected that the Securities Exchange Commission (SEC) will adopt a conforming amendment to their privacy rules under Regulation S-P.

SEC Accredited Investor Proposal

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, the SEC issued a staff report on the accredited investor definition on December 18, 2015. The report includes several recommendations on the approaches that the SEC should consider in revising the accredited investor definition. These approaches include, among others, (1) implementing a test based on a person's investments rather than such person's assets, (2) indexing all financial thresholds for inflation on a going-forward basis, (3) 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. The SEC has invited public comment on the accredited investor definition generally as well as on the specific recommendations in the report.

CFTC Abandons Proposal Requiring CTAs to Record All Conversations

An amendment to Commodity Futures Trading Commission (CFTC) Rule 1.35(a) was published in the federal register on December 24, 2015, that, among other things, eliminated the requirement that commodity trading advisors (CTAs) that are members of a CFTC-approved designated contract market (DCM) or swap execution facility (SEF) record and maintain a record of all oral communications. The requirement that CTAs record oral conversations had been adopted in 2012 as part of a prior version of Rule 1.35(a), although implementation of the requirement had been deferred pursuant to no-action relief granted by the CFTC.

Proposed CFTC Regulation AT (Automated Trading)

On November 24, 2015, the CFTC voted to propose rules, collectively referred to as Regulation AT, related to automated (also known as algorithmic) trading. 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 it uses an algorithm to trade futures, and if 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.

Proposed 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. The proposed definition of AT Person also includes a new category of previously unregistered person 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 (as defined below). "Direct Electronic Access" is defined under the proposed regulation as "an arrangement where a person electronically transmits an order to a DCM, without the order first being routed through a separate person who is a member of a derivatives clearing organization to which the DCM submits transactions for clearing." This could potentially 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 DCM, must become registered.

The proposed regulation will impose a number of requirements on any AT Person registered with the CFTC in any capacity, including (1) the implementation of pre-trade risk controls and order cancellation systems, (2) the development, testing and ongoing monitoring of algorithmic trading systems (ATS), including the maintenance of a source code repository, and (3) the maintenance of certain books and records and the submission of an annual report 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. AT Persons would also have to implement standards regarding the development and ongoing monitoring and compliance of any ATS, as well as 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 (1) maintaining a "production trading environment" that is independent of the actual trading environment for use while developing, modifying and testing source code, (2) testing all source code and systems used for Algorithmic Trading before actual use, (3) regular and ongoing testing of ATS to ensure that ATS function properly in a variety of market situations, (4) 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 (5) 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. Of greatest concern to many private fund managers leery of regulators' ability to protect such valuable proprietary information, AT Persons will be required to maintain the source code repository for five years, and the source code will be subject to inspection upon request by the CFTC or the Department of Justice in accordance with CFTC Rule 1.31.

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