2018 Proskauer Annual Review and Outlook for Hedge Funds, Private Equity Funds and Other Private Funds

2018 Proskauer Annual Review and 2019 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 2019.

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, Anthony M. Drenzek, and Daniel G. Nelson with contributions from Mark W. Batten, Howard J. Beber, Martin J. Bienenstock, Allan S. Bloom, Ira G. Bogner, Benjamin J. Catalano, Lloyd B. Chinn, John E. Failla, Chantel L. Febus, Robert E. Gaut, Vincent Indelicato, David T. Jones, Edward A. Kwalwasser, Henry J. Leibowitz, Jeremy Leifer, Jeffrey W. Levitan, Ying Li, Kristen J. Mathews, Stephen T. Mears, Timothy W. Mungovan, Jeffrey D. Neuburger, Joshua M. Newville, Amanda H. Nussbaum, Robert E. Plaze, Jonathan E. Richman, Kathy H. Rocklen, Catherine Sear, Michael R. Suppappola, John Verwey, Samuel J. Waldon, Jay D. Waxenberg, Fabio A. Yamada, Frank Zarb, Sarah Anischik, Elise M. Bloom, Edward J. Canter, William D. Dalsen, Joshua A. Esses, Emma Gao, Azevedo F. Alves. Guilherme, Michael R. Hackett, Michael S. Hayes, Brian A. Hooven, Lijuan Hou, Mani Kakkar, Nathan R. Lander, Matthew J. Leibowitz, Steve Ma, Sergio E. Marin, Jonathan P. Mollod, Annabel Pollioni, Tiffany Quach, Louis E. Rambo, Samantha L. Regenbogen, Adam W. Scoll, Jeanette Stecker, Elliot R. Stevens, Carol Sullivan, Margaret F. Swetman, Divya Taneja, Amar D. Unadkat, Rebecca L. Wallis and Susan L. Wiener.

TABLE OF CONTENTS

2018 Developments and Outlook for 2019

SEC Examinations

The Securities and Exchange Commission's (SEC) Office of Compliance Inspections and Examinations (OCIE) reported that in its most recent fiscal year it examined approximately 15% of all registered investment advisers, up from 8% just five years ago. OCIE indicated that the selection of advisers to be examined was frequently based on OCIE's risk-based analysis (rather than routine cycles), derived from internal data analytics systems, including OCIE's National Examination Analytics Tool (NEAT).

Although there were some indications last year that the focus of exams might shift away from private equity fund managers and back to hedge fund managers, we continue to see a significantly greater percentage of private equity fund managers being examined.

The most typical exam format for private fund advisers, especially in examinations by OCIE's New York and Boston offices, continues to be a "one week on site format," typically conducted after the adviser receives two weeks' advance notice and a lengthy (often two to three hours) introductory conference call in which a number of different SEC staff members may participate. Follow-up written questions may continue to be received by the adviser for weeks or months after completion of the onsite portion of the exam, although the examiners typically try to conclude exams within six months as required by internal OCIE guidelines.

We also continue to see a number of "remote" examinations that begin exclusively offsite with a conference call and document request, and where the examiners indicate that they will determine in the course of the exam whether or not there will be an onsite portion of the exam.

Fees and expenses, allocation of investment opportunities and conflicts of interest continue to be a focus of many examinations.

On November 8, 2018, OCIE issued a risk alert announcing a new examination initiative focused on mutual funds and exchange-traded funds and the protection of retail investors. One of the key issues highlighted in the alert as a focus of the initiative is advisers managing both registered funds and private funds using the same or a similar strategy on a side-by-side basis. The alert indicated that the targeted examinations would focus on, among other things, trade and expense allocation practices, conflicts of interest, and disclosures to the boards of directors of registered funds about any risks associated with side-by-side management.

On April 12, 2018, OCIE issued a risk alert listing the most common compliance issues identified in examinations concerning fees and expenses, including:

- incorrect valuations of client assets (in particular, using a different method for valuing assets than is required in the client's advisory agreement);
- failure to prorate fees for periods during which the adviser provided advice for only a portion of the period;
- use of an incorrect fee rate;
- inaccurate or inconsistent disclosure in Form ADV; and
- improper allocations of expenses (including, in particular, distribution and marketing fees, regulatory and filing fees, and travel expenses).

On July 11, 2018, OCIE issued a risk alert identifying key compliance issues identified in examinations related to best execution. The OCIE Alert reiterates that an adviser responsible for selecting broker-dealers to execute clients' orders has a fiduciary duty to seek to obtain "best execution" for the transactions, taking into consideration the relevant circumstances for the particular trade. In general, the overall price to the client—including the commission, mark-up or mark-down—should be as favorable as possible under prevailing market conditions. However, the OCIE Alert emphasizes that ultimately the measure of performance is qualitative not quantitative. In determining whether an adviser has received best execution, the adviser should consider the full range and quality of brokerage services, including the execution price, commission rate, financial responsibility and responsiveness of the broker-dealer, as well as the value of any research provided by the broker.

The OCIE Alert also identified eight of the most common deficiencies associated with best execution obligations cited in deficiency letters by OCIE staff in over 1,500 examinations, including failure to:

- perform best execution reviews;
- consider materially relevant factors during best execution reviews;
- evaluate existing arrangements in comparison to other broker-dealers;
- fully disclose best execution practices (and the potential impact of adviser's practices on different types of client accounts);
- disclose soft dollar arrangements;
- properly administer mixed use allocations;
- have adequate policies and procedures relating to best execution; and
- follow best execution policies and procedures.

OCIE expects advisers to "periodically and systematically" evaluate the quality of executions provided by the broker-dealers they use to execute clients' orders. The staff found that some advisers either failed to review broker-dealer execution performance or did not document their reviews. Others did not adequately consider relevant factors, described above, in choosing a broker-dealer or evaluating its performance.

In 2000, the SEC created a special reporting regime to enable investors and other market participants to better evaluate the performance of execution venues. Rule 605 (previously Rule 11Ac1-5) of Regulation NMS requires all stock exchanges, exchange specialists, over-the-counter market makers, alternative trading systems and other "market centers" to publish monthly statistics measuring the quality of executions in national market systems (NMS) stocks traded at these venues. The reports must be posted free of charge in electronic form on the market center's website.

Rule 606 (previously Rule 11Ac1-6) of Regulation NMS requires every broker-dealer to publish quarterly reports identifying the top ten venues to which it directs customer orders in NMS securities for execution (as well as any venue to which it directs five percent or more of its orders). The report must describe material aspects of the broker-dealer's relationship with each venue, including any payment for order flow, profit sharing or other arrangements. Advisers are entitled to learn the specific venues to which their orders were routed in the last six months. The rule is intended to operate in combination with Rule 605 to allow advisers (and other investors) to evaluate the performance of the market centers used by the broker-dealers that execute their orders.

Advisers can use these reports to evaluate which broker-dealers to use to execute client trades in NMS securities. In addition, prime brokers, clearing firms, custodians and other financial services providers offer diagnostic services, analytics and reports based on market data, including Rule 605 and Rule 606 information, to assist in evaluating execution quality.

Many registered broker-dealers with similar obligations under the Exchange Act and self-regulatory organization rules have established best execution committees and other processes to administer compliance with continuing best execution responsibilities.

On October 31, 2018, OCIE issued a risk alert identifying common compliance issues under the solicitation rule, Rule 206(4)-3, including:

- deficiencies in solicitor disclosure documents, specifically advisers whose third-party solicitors did not provide solicitor disclosure documents to prospective clients or provided solicitor disclosure documents that did not contain all the required information;
- failure to receive client acknowledgements of receipt of the adviser brochure and the solicitor disclosure document in a timely and/or fully completed manner;
- payment of fees to a solicitor without a solicitation agreement in place or pursuant to an agreement that did not contain all required provisions; and
- failure to make a bona fide effort to ascertain whether third-party solicitors were complying with solicitation agreements.

Additional issues identified by OCIE in its annual statement of national examination priorities included cybersecurity and cryptocurrencies, Initial Coin Offerings (ICO) and other digital assets. See "*Cryptocurrencies, Tokens and Other Digital Assets*" below. In fact, OCIE appears to be focusing examinations on advisers who report holding investments in digital assets, and also appears to be using exam requests to conduct an informal survey of private fund involvement in digital assets, in some cases requesting information from exempt reporting advisers.

We continue to see detailed questions relating to service providers, focused on potential conflicts or affiliations between the service provider and the fund adviser, as well as on transactions between a fund, its adviser or any of its affiliated individuals. Other matters we have seen raised repeatedly in exams include:

- any form of conflict of interest (such as parallel trading of client and proprietary accounts, investment allocations among client accounts, cross trades, side letters and other relationships with counterparties);
- use of social media by advisers and their employees;
- personal trading by employees;
- pay-to-play practices; and
- valuation practices.

Performance presentations and calculations also continue to draw attention. For example, in the private equity space, there has been a focus on presentations of internal rates of return (IRR) and the effect of subscription credit lines on those returns. Examiners are focused on whether there is adequate disclosure of subscription credit lines and how IRRs are calculated in light of those facilities. At times, the examiners have asked advisers to recalculate performance figures using alternate measurement dates for capital contributions.

Finally, we have seen increased involvement of technical specialists, often drawn from other groups within the SEC staff, to assist OCIE in exams, especially in connection with the evaluation of advisers that employ quantitative trading strategies or algorithms. This initiative also includes focused document and information requests concerning the development and monitoring of such strategies.

SEC Enforcement

We have just reached the end of the first full year of Enforcement under the leadership of SEC Chairman Jay Clayton and Co-Directors of Enforcement Stephanie Avakian and Steven Peiken. On November 2, 2018, the Division released its Annual Report for Fiscal Year 2018, and there are a few key takeaways. First, the SEC's Enforcement program remains robust. In 2018, the SEC brought 821 Enforcement Actions, the second highest total ever. The SEC did this notwithstanding a hiring freeze in place since 2016 that has resulted in far fewer Enforcement attorneys. Second, the SEC stated that it continues to focus on five key areas for Enforcement: (i) protecting main street investors; (ii) ensuring individual accountability; (iii) keeping pace with technological change; (iv) imposing remedies that further Enforcement goals; and (v) allocating (limited) resources effectively. Notably, private funds, and the Enforcement issues they typically face, do not fall squarely into any of those five areas of focus. Third, the SEC brought over 100 Enforcement actions involving advisers and investment companies, a 32% increase from 2017. Actions against advisers and investment companies made up the second largest category of actions brought by the SEC in 2018.

What does this mean for advisers (and their private funds)? It might be tempting for advisers to take comfort from the fact that the SEC's Enforcement focus might seem to be elsewhere. In fact, advisers to private funds are hardly mentioned in the Annual Report, and the SEC did not bring any headline-grabbing actions against advisers to private funds last year. However, the numbers tell a different story. They tell a story of an active and aggressive SEC that continues to bring a substantial number of cases against investment advisers. As a result, advisers to private funds should not expect significant changes from SEC Enforcement. Instead, as discussed below, they should expect the SEC to continue to bring significant numbers of cases against advisers to private funds involving, in particular, conflicts of interest; fees and expenses; valuations; advertising; and insider trading.

Fee and Expense Disclosures

One of the key types of cases the SEC brings against advisers concern fee and expense practices and, more importantly, disclosures about them to investors. A number of cases from the past year are illustrative:

- *In re Platinum Equity Advisors* from late 2017, concerns an alleged failure to disclose how broken deal expenses would be reimbursed for the portions of investments allocated to co-investors. The relevant LPAs provided that certain affiliated co-investors would co-invest on the same terms and conditions as the partnership but provided little other information. While the LPAs provided that each fund would bear its expenses "related to its own operations" and specifically its own broken deal expenses, the LPAs did not disclose that the funds would also reimburse broken deal expenses for co-investors. The funds nevertheless reimbursed approximately $1.8 million in such expenses that would have been allocated to co-investors. The SEC found this conduct to violate the anti-fraud and compliance policies and procedures provisions of the Advisers Act.

- In another matter that demonstrates the SEC's continued focus on disclosure of conflicts of interest, an adviser had a practice of entering into monitoring agreements with portfolio companies in exchange for a monitoring fee, which was disclosed in the LPA. However, the SEC alleged that the LPA did not disclose accelerated collection of future monitoring fees. Because the adviser did not disclose its receipt of those accelerated fees to investors until after the investors had committed capital, the SEC alleged that the adviser had a conflict of interest and, in any event, could not consent to the accelerated collection on behalf of the funds.

Another problematic scenario is where an adviser fails to offset fees as required under the LPA. In *Aisling Capital*, an adviser provided investment advisory services to venture funds. While the fund agreements and private placement memoranda disclosed that the adviser may receive transaction/consulting fees from portfolio companies, they required the adviser to offset a portion of those fees against management fees the funds paid. Aisling allegedly retained the full amount of certain consulting fees without offset. As a result, the funds paid excess management fees of $759,870.

After the SEC contacted Aisling, Aisling voluntarily reimbursed the excess fees plus interest. The SEC nevertheless alleged violations of the antifraud provisions, and in June 2018, Aisling paid a $200,000 penalty—which is notable, given the alleged retention of over $759,000 in excess management fees.

Secondary Transactions

In a September 2018 settlement, the SEC alleged that an adviser's owner and manager withheld material information about a fund's value while simultaneously offering to buy out investors' interest in the fund. In early 2015, the sponsor decided to dissolve a fund through a distribution in kind but offered investors the option to sell their interests to the adviser's owner and managing partner at audited net cash value as of December 2014. After some investors accepted the offer, the adviser allegedly became aware of information showing a material increase in the fund's valuation in Q1 2015. However, the adviser did not disclose that new information when it renewed the April cash offer to the remaining investors at the same price and did not provide Q1 2015 financial statements to the remaining limited partners. The SEC found that this conduct was in violation of the antifraud provisions of the Advisers Act.

Conflicts of Interest

In *SEC. v. Tao et. al.* (December 2017), two individuals acting as financial advisers associated with an adviser formed a private fund and solicited investments from advisory clients (including brokerage clients). Among other things, they allegedly failed to disclose that the fund was investing in companies that the adviser owned or in which he had a personal stake, which was a clear conflict of interest. Aside from the conflict of interest, this case is notable for the SEC's position that soliciting investments from advisory clients violated broker-dealer registration requirements because the fund interests were not offered by the brokerage firm with which Tao and Boyd were associated at the time.

The SEC also charged two investment adviser subsidiaries of Voya Holdings Inc. with conflicting interests in a securities lending scheme. The SEC alleged that Voya would loan certain securities in order to generate additional income for the funds, but would recall those securities before the dividend date so that certain affiliates of the advisers would receive tax benefits. The SEC found that this practice should have been disclosed as it caused the investors to lose potential income from continuing to lend those securities and did not offer those investors any comparable tax benefit. Voya consented to an order finding anti-fraud violations of the Advisers Act and agreed to pay a $500,000 civil penalty along with approximately $3.1 million in disgorgement and prejudgment interest.

In *In re WCAS Management Corp.,* the adviser failed to disclose fees it received for services provided to portfolio companies. The adviser, WCAS, received 25% of the net revenue that a "group purchasing organization"—a company that aggregates spending to obtain volume discounts—received from portfolio company purchasing activity as a "professional services fee." The fee was not disclosed to investors. According to the SEC, WCAS also did not seek prior approval for the conflict of interest from the investor committee established for that purpose.

Valuation

The SEC's ongoing focus on valuation is demonstrated by a settled action against LendingClub Asset Management (LCA) from September 2018 alleging, among other things, that the adviser improperly valued asset-backed securities held by its funds. LCA disclosed that the relevant funds exclusively owned ABS securities backed by consumer credit loans and that it would periodically determine a fair market value for those assets using Level 3 inputs. As is typical for Level 3 assets, they lacked observable market inputs and were valued based on management estimates or pricing models. LCA used a discounted cash flow (DCF) model to predict the future performance of the loans discounted to present value.

The SEC, however, took issue with two categories of management adjustments to the model. First, the SEC alleged that the adviser improperly incorporated a "floor" for monthly returns that was not based on supportable assumptions. Second, the SEC alleged that the adviser made an unjustified change to the discount rate used for its DCF model, which had the result of increasing fund returns. Although LCA later took a series of remedial measures, including outsourcing its monthly valuation to an independent third party, recalculating fund returns and reimbursing investors, the SEC ultimately determined to pursue an enforcement action against the adviser and certain individuals affiliated with it.

ICOs and Digital Assets

The landscape surrounding ICOs and digital assets is rapidly evolving. After over a year of warnings, in September the SEC announced a pair of settlement orders with respect to registration requirements for a fund and broker-dealer operating in the crypto and digital assets space. These were the agency's first ever enforcement actions applying the investment company and broker-dealer registration provisions of the securities laws to businesses involved in digital securities. As we have previously reported on Proskauer's Blockchain and the Law blog, we expect the SEC to continue to expand its oversight of digital tokens as securities.

TokenLot and *CAM* are the SEC's first enforcement actions applying these provisions of the securities laws to digital assets, following the SEC's issuance of the DAO Report on July 25, 2017, its request to lawyers to cease engaging in unregistered coin offerings, and various other enforcement proceedings over the past year. This pair of orders signals that the SEC believes that any grace period with respect to securities law compliance in connection with crypto and other digital assets is over.

With the SEC's assertion of jurisdiction over ICOs as securities, and the Commodity Futures Trading Commission's (CFTC or the Commission) recent release indicating that it will regulate and monitor cryptocurrencies and cryptocurrency futures contracts, registration and compliance issues with respect to digital assets are paramount. If a violation renders a security defective, transactions involving digital assets may also be called into question as either void (automatically unwound) or voidable (unwound at the wronged party's discretion). Advisers with investments in or exposure to ICOs and, more broadly speaking, cryptocurrencies and other digital assets should prepare for increasing regulatory scrutiny and enforcement spillover.

Unicorns

Potential disputes involving unicorns have been a hot topic for the last several years, as we outlined in The Top Ten Regulatory and Litigation Risks for Private Funds in 2018. As we have previously noted, valuation-related regulatory risks increase as the time lengthens between purchase and exit. The SEC's examination and enforcement staff have been focused on valuation of privately-held companies for years.

In April, the Regional Director of the SEC's San Francisco office, Jina Choi, confirmed this in her comments during a San Francisco Federal Bar Association panel, specifically focusing on the SEC's actions against Zenefits, Credit Karma, and Theranos, and reiterated the SEC's continued commitment to monitoring suspected investor fraud in privately-held companies. We expect to see the SEC continue to focus on unicorns in future investigations and proceedings. Private companies should prepare for increased scrutiny of their investor disclosures, particularly those related to and affecting the company's valuation, and SEC actions may spark parallel private actions by investors against those companies and board members. Advisers overseeing investments in unicorns, especially those with board representation, should be aware that they are at risk of being viewed as a "deep pocket."

Hypothetical/Back-tested Performance

In *In re Massachusetts Financial Services Company*, MFS advertised the results of a hypothetical portfolio of stocks using its "blended" methodology, which combined analysis of fundamental "buy" rated stocks with analysis of quantitative "buy" rated stocks, to contend its blended research strategy produced better annual returns. But MFS did not disclose that some of the ratings used in its quantitative research strategy were the result of a retroactive, back-tested application of the MFS blended model. The SEC alleged that the undisclosed blend of real-time fundamental and quantitative data with some back-tested quantitative data, and the positive effect the back-tested data had upon the MFS model's performance, was misleading.

Preferential Liquidation Rights

The SEC has shown a continued interest in preferential liquidation rights. Aria Partners GP, LLC settled with the SEC based on allegations that Aria accommodated withdrawal and redemption requests from select investors on a faster timeline than the publicly disclosed withdrawal rate. Specifically, the SEC alleged that Aria had an informal policy, which was not disclosed to all investors, of accommodating investors' requests to provide partial redemptions on significantly less notice than the 90 days required by the fund's governing documents, and that Aria granted full redemptions to a limited number of investors on 60 days' notice, while similarly situated investors were held to the 90 day notice period. Aria settled to anti-fraud, custody rule, and compliance violations, and agreed to pay a $150,000 civil penalty.

Failure to Supervise Actions

The SEC brought a settled proceeding against the CFO of an adviser for failing to supervise two portfolio managers and properly respond to red flags which should have alerted the adviser to their misconduct. Both portfolio managers were the subjects of separate actions, alleging that they had mismarked assets held by the fund, falsely inflating their value, and engaged in insider trading. In connection with the settlements, the Director of the SEC's New York Regional Office stated that "[a]dvisory firms must create a culture of zero tolerance when it comes to unlawful conduct, and supervisors at those firms must take reasonable measures necessary to detect and prevent securities law-related violations by their personnel."

Principal Trade Rule

Another area where undisclosed conflicts can lead to SEC action is where an adviser acts as both agent and a principal when dealing with funds that it manages. One such adviser, Ophrys, LLC, recently settled with the SEC regarding allegations that it failed to provide adequate disclosure to, and obtain consent from, its clients for agency transactions in which the adviser received compensation in addition to its management fee and for transactions in which it acted in a principal role. In two transactions, Ophrys received compensation for services it provided as a broker for a client who sold securities to other advisory clients. In a third transaction, Ophrys purchased securities from a private fund in which it was the sole remaining investor, and sold the securities to another advisory client. Ophrys failed to disclose its roles, and conflicts of interest, in these transactions and to obtain consent from its private fund clients. Ophrys agreed to pay a $500,000 civil penalty.

Advertising — The Testimonial Rule

Following a July 2018 mini-sweep focused on the testimonial rule, the SEC sued a series of advisers and representatives for violations based on their use of social media and the internet. The SEC alleged that each of these advisers had hired a marketing company to cause various testimonials to be published across popular social media platforms, and that each published testimonial contained information about the advisers or its representatives and the advice and services they rendered to their clients. The SEC's orders found that the advisers and representatives each violated, or caused violations of, the testimonial rule; and the SEC imposed civil fines ranging from $10,000 to $35,000.

Custody Rule

The SEC has continued to police the custody rule, Rule 206(4)-2 under the Advisers Act. The SEC sued Hudson Housing Capital LLC for violating the custody rule by failing to submit to surprise exams or distribute audited financial statements every year since the fund registered with the SEC in 2012. The investigation also revealed compliance rule violations which resulted in HHC settling for violations of Section 206(4) of the Advisers Act and Rules 206(4)-2 and 206(4)-7 thereunder, and to paying a civil penalty of $65,000 in September 2018.

Pay-to-Play

Pay-to-play actions are another item still on the SEC's radar:

- Sofinnova Ventures Inc. paid a $120,000 penalty in July 2018 to settle pay-to-play charges based on allegations that it continued to provide investment advisory services to a public pension plan in Illinois for eight months after one of its covered associates made a campaign contribution to a candidate for an elected office in Illinois that had influence over selecting investment advisers for Illinois public pension plans.
- Another adviser also settled pay-to-play charges the same month, agreeing to pay a penalty based on similar allegations that it provided advice to a pension fund after certain of its covered associates made campaign contributions to candidates for elected office, where those candidates were campaigning for offices that had influence over selecting investment advisers for applicable public pension plans.

Analytical Tools — Cherry-Picking Schemes

The SEC used analytical tools to identify several cherry-picking schemes in 2018:

- The principal of Valor Capital Asset Management LLC agreed to fraud charges under both the Exchange Act and the Advisers Act, as well as to be barred from the securities industry, without a right to reapply, and to pay a $160,000 penalty and more than $550,000 in disgorgement and prejudgment interest based on cherry-picking allegations. The SEC's order alleged a typical day-trading cherry-picking scheme: that the individual traded securities in Valor's omnibus account, waited to allocate the trades to client accounts until after the securities' performance changed over the course of the day, and then "cherry-picked" the trades, disproportionately allocating profitable trades to his personal accounts and unprofitable trades to his clients' accounts. The SEC noted that there was less than a one-in-a-trillion chance that such allocations were coincidental.

- An investment adviser representative BKS Advisors LLC settled fraud charges based on a similar cherry-picking scheme in August for a similar penalty.

The SEC also filed a cherry-picking complaint against World Tree Financial, LLC and its majority-owner in September 2018. The order charged that the owner delayed allocating the securities to specific client accounts until he had observed the securities' performance over the course of the day, after which he allocated profitable trades to his own accounts at the expense of other investors. The matter is still pending, with the Commission pursuing fraud charges and seeking disgorgement, prejudgment interest, and civil penalties.

SEC Policy and Rulemaking

Proposed SEC Fiduciary Rule

On April 18, 2018, the SEC voted to propose a package of rulemakings and interpretations designed to enhance the quality and transparency of investors' relationships with advisers and broker-dealers while preserving access to a variety of types of advice relationships and investment products.

Under proposed Regulation Best Interest, a broker-dealer would be required to act in the best interest of a retail customer when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer. The Commission stated that Regulation Best Interest is designed to make it clear that a broker-dealer may not put its financial interests ahead of the interests of a retail customer in making recommendations.

In addition to the proposed enhancements to the standard of conduct for broker-dealers in Regulation Best Interest, the Commission proposed an interpretation to reaffirm and, in some cases, clarify the Commission's views of the fiduciary duty that advisers owe to their clients.

The Commission also proposed to help address what it perceived as investor confusion about the nature of relationships with investment professionals through a new short-form disclosure document – a customer or client relationship summary that would have to be provided to all retail clients of advisers and brokers dealers. Form CRS would provide retail investors with simple, easy-to-understand information about the nature of their relationship with their investment professional, and would supplement other more detailed disclosures. For advisers, additional information can be found in Form ADV. For broker-dealers, disclosures of the material facts relating to the scope and terms of the relationship would be required under Regulation Best Interest. The public comment period for the proposal closed on August 7, 2018.

New Custody Rule FAQs

On June 5, 2018, the staff of the SEC's Division of Investment Management released additional guidance on the custody rule on the Commission's webpage Staff Responses to Questions About the Custody Rule. These new questions and answers address situations where certain custodial agreements, unbeknownst to the adviser, might give an adviser the ability to instruct a custodian to disburse, or transfer, funds or securities and thus cause the adviser to inadvertently be deemed to have custody of client funds or securities.

The response to new Question II.11 provides that where an adviser does not have a copy of a client's custodial agreement, and does not know, or have reason to know, whether the agreement would give the adviser the ability to instruct the custodian to disburse, or transfer, funds or securities, the adviser need not comply with the custody rule with respect to that client's account if such inadvertent custody would be the sole basis for custody. The staff stated that it would not recommend enforcement action to the Commission under the Advisers Act against any such adviser if that adviser neither complied with the requirements of the custody rule nor indicated it has custody in its Form ADV filing. The staff noted, however, that this relief would not be available where the adviser recommended, requested, or required a client to use a particular custodian.

New Question II.12 addresses a situation where an adviser may have (i) client accounts subject to the custody rule due to check-writing authority, (ii) client accounts subject to the custody rule, but exempt from its compliance requirements, due to the only indicia of custody being the ability to deduct advisory fees, and (iii) client accounts where the adviser (a) neither has custody due to check-writing ability nor the deduction of advisory fees, and (b) does not know (or have reason to know) whether any of the clients' custodial agreements would otherwise give the firm inadvertent custody. The response to new Question II.12 provides that the staff would not recommend enforcement action for not complying with the custody rule, or the custody-related ADV reporting requirements, for client accounts described in (iii) above. The staff noted, however, that this relief would be limited to situations where the adviser does not have copies of its clients' custodial agreements and it did not recommend, request, or require the client to use a particular custodian.

Investment Company Act Amendments

On May 24, 2018, President Trump signed the Economic Growth, Regulatory Relief and Consumer Protection Act, which amended the Investment Company Act of 1940 to exempt from the definition of an "investment company," a qualifying venture capital fund that has no more than 250 investors and less than $10 million in aggregate capital contributions and uncalled committed capital.

Under current law, a venture capital fund is considered to be an investment company if it has more than 100 investors and all of its investors are not Qualified Purchasers. The expanded exemption refers to the definition of a venture capital fund in Advisers Act Rule 203(l)–1.

Whistleblower Rules

The number of whistleblower tips and the size of awards continued to grow in 2018, which saw the largest SEC and CFTC whistleblower awards to date. However, the scrutiny of separation agreements decreased this year, as the SEC announced no new enforcement actions in 2018 concerning efforts to impede potential whistleblowers from reporting information to the SEC. This decrease in SEC scrutiny should not lead to complacency among advisers when it comes to whistleblowing as the consequences of a disgruntled existing or former employee making allegations against an adviser can have dire consequences.

This year also saw a U.S. Supreme Court ruling (see discussion below) which limited the definition of a "whistleblower" under Dodd-Frank to those who report information to the SEC. Internal reporting is no longer sufficient to invoke the anti-retaliation provisions of the statute. In the next year, we expect a decision from the SEC on its relatively recent proposed amendments to the whistleblower program rules (see discussion below), which could be announced at any time.

First Overseas Whistleblower Awards

In September 2018, the SEC issued its first whistleblower award to an individual residing in a foreign country. In announcing the nearly $4 million award, Chief of the SEC's Office of the Whistleblower, Jane Norberg noted that "[w]histleblowers, whether they are located in the U.S. or abroad, provide a valuable service to investors and help us stop wrongdoing."

Meanwhile, in July 2018, the U.S. Commodities Futures Trading Commission (CFTC) issued its first whistleblower award to a foreign national. In the order awarding over $70,000, the CFTC revealed that the whistleblower was unaware of the whistleblower program when he originally contacted the CFTC about an ongoing litigation matter. After providing information and assistance to the CFTC and while the litigation was still pending, the person submitted a Form TCR to perfect his whistleblower status.

Largest Whistleblower Awards to Date

In March 2018, the SEC announced its largest whistleblower award to date wherein two whistleblowers shared equally a $49 million bounty award while a third received more than $33 million. The previous high award was a 2014 award of $30 million. The SEC treated the individuals sharing the $49 million as a single whistleblower on the basis that they jointly submitted their Forms TCR and WB-APP. In its order, the SEC noted that, despite the fact that these two individuals unreasonably delayed their reporting to the Commission, the SEC reduced their joint award less than it might otherwise have on the basis that the two individuals promptly reported additional new information they later learned to the SEC. In this same order, the SEC denied an award to three others whom the Commission determined had not provided original information that led to successful enforcement of the covered action.

In July 2018, the CFTC announced its largest ever whistleblower award of approximately $30 million. To date, the CFTC's whistleblower program has only issued five awards, with a previous high award in 2016 at over $10 million. In announcing the award, CFTC Chairman J. Christopher Giancarlo stated his hope that "an award of this magnitude will incentivize whistleblowers to come forward with valuable information and provide notice to market participants that individuals are reporting quality information about violations of the Commodity Exchange Act."

Proposed Changes to Whistleblower Rules

Just three months after rendering its largest whistleblower awards to date, the SEC voted on June 28, 2018 to propose amendments to its whistleblower program rules. The public comment period on the proposed amendments closed on September 18, 2018, and it is unclear when the SEC will take further action. Of particular interest in the proposed changes are the following:

- Additional flexibility in determining awards in cases involving (i) more than $100 million in collected monetary sanctions and (ii) awards to a single whistleblower of less than $2 million. Currently, the SEC must pay a whistleblower between 10% and 30% of the monetary sanctions recovered. Under the proposed rule, the SEC could adjust an award downward, subject to the 10% floor, to an "amount that is reasonably necessary" in a case involving more than $100 million in sanctions if the Commission considers the proposed amount excessive. In all such cases, however, the award could not be reduced below $30 million. In cases of an award of less than $2 million, the proposed rule would allow the SEC to adjust the award percentage upward, subject to the 30% statutory maximum, to an amount of up to $2 million.

- Amendment to the rules' definition of "whistleblower." This proposed amendment is in response to the U.S. Supreme Court's recent ruling in *Digital Realty Trust, Inc. v. Somers*, discussed below, which clarified a split in the federal appeals courts on who qualifies as a "whistleblower" under the Exchange Act. The proposed rule would create a uniform definition of "whistleblower" to apply to all aspects of the Exchange Act, including the whistleblower award program, heightened confidentiality requirements, and anti-retaliation provisions. It would require reporting in writing to the SEC in order to invoke the protection of the anti-retaliation provisions, and would continue to permit submission of information via a Form TCR or the SEC's online tips portal in order to be eligible for an award or obtain heightened confidentiality protection.
- Addition of a discretionary bounty award for whistleblowers whose tips lead to actions that do not currently meet the SEC's requirements, either because the action is under the SEC's $1 million threshold, the tip is based on publicly-available information, or where the monetary sanctions collected are minimal.

Please see our June 28, 2018 post on Proskauer's Whistleblower Defense Blog for more information.

Supreme Court Ruling on Definition of "Whistleblower"

Last year's Annual Review noted an anticipated ruling from the U.S. Supreme Court on the question of whether employees who only complain internally are covered by the Dodd-Frank anti-retaliation protections. On February 21, 2018, the Court unanimously ruled in *Digital Realty Trust, Inc. v. Somers*, No. 16-1276, 583 U.S. (2018), that an individual is not covered by the anti-retaliation provision of the Dodd-Frank Act, unless they have provided information regarding a violation to the SEC. Internal reporting is insufficient.

The Court's decision resolved a split between the Second and Ninth Circuits and the Fifth Circuit on whether a person who reports internally falls within the definition of a "whistleblower" under the statute.

The United States District Court for the District of New Jersey has already applied this narrower definition of "whistleblower" to hold that testifying before FINRA, which is overseen by the SEC, is not the same as reporting information to the SEC. *See Price v. UBS Financial Services, Inc.*, No. 2:17-cv-01882. In *Price*, the plaintiff was a former UBS Private Wealth Advisor who testified before FINRA about allegedly unlawful conduct of UBS management. After being terminated, he filed anti-retaliation claims pursuant to Dodd-Frank and the Florida Whistleblower Act. UBS obtained a dismissal of the plaintiff's claims after the court agreed that testifying before FINRA did not meet the statutory requirement to report securities laws violations to the SEC.

Relying upon *Digital Realty*, the United States District Court for the Northern District of New York has concluded that a person who reports potential securities laws violations to the SEC after being terminated is not entitled to make a claim for retaliation under Dodd-Frank. *See Johnson v. AmeriGas Propane, L.P.*, No. 1:17-cv-252.

Please see our February 23, 2018 post on Proskauer's Whistleblower Defense Blog for more information.

CFTC

CFTC Proposes to Codify Prior Relief For CPOs and CTAs

On October 9, 2018, the CFTC proposed new rules in connection with the CFTC's Project KISS Initiative directed at simplifying Commodity Pool Operator (CPO) and Commodity Trading Advisor (CTA) regulations. The proposed rules would codify several forms of no-action letter relief previously granted related to Part 4 of the CFTC regulations with respect to certain family offices and non-U.S. funds. The proposed rules would also provide relief for advisers of Business Development Companies (BDCs), as well as take a step toward harmonizing rules with the Securities and Exchange Commission (SEC) by aligning Part 4 of the regulations with the JOBS Act of 2012.

Exemption for Non-U.S. Funds

The proposed rules would amend § 4.13 of the CFTC's regulations by adding a new CPO registration exemption for commodity pools outside the United States, based on CFTC Advisory No. 18-96. Currently, Advisory No. 18-96 exempts CPOs of non-U.S. funds from many of the regulatory obligations that normally would apply. Since this is a location-based exemption, in order to qualify, the pool must: (a) be organized and operated outside of the United States; (b) not hold meetings or conduct administrative activities within the Unites States; (c) not have shareholders or participants that are or will be U.S. persons; (d) not receive, hold or invest any direct or indirect capital from sources within the Unites States; and (e) not be marketed in a way that would solicit participation by U.S. persons.

Family Office Exemption

The proposed rules would codify the CPO and CTA Family Office No-Action Letters (CFTC No-Action Letters No. 12-37 and No. 14-143, respectively) which provide relief from registration to CPOs and CTAs of family offices. The proposed CPO registration exemption in new § 4.13(a)(8) and CTA registration exemption in § 4.14(a)(11) would be contingent on the family office meeting the requirements of the SEC family office exclusion in 17 CFR § 275.202(a)(11)G-1, including restricting its investing activities to family clients (as defined in such section) and not soliciting persons other than family clients.

Jobs Act Relief

The JOBS Act Relief Letter (CFTC No-Action Letter No. 14-116) provides relief from certain provisions of § 4.7(b) and § 4.13(a)(3), which restrict marketing and solicitation to the public. The no-action letter intended to harmonize the CFTC Rules with SEC Regulation D and SEC Rule 144A, which permit general solicitation and advertising subject to specific conditions. These SEC rules were amended pursuant to the Jumpstart Our Business Startups Act of 2012 (the JOBS Act). The proposed rules would remove the restrictive language in the relevant provisions of § 4.7(b) and § 4.13(a)(3) to permit marketing in compliance with the provisions of either Regulation D or Rule 144A.

Advisers of Business Development Companies

The BDC No-Action Letter (CFTC No-Action Letter No. 12-40) extended to advisers of BDCs the same exemption as applies to CPOs of investment companies registered under the Investment Company Act of 1940 from the requirement to register as a CPO. Under the proposed rule, § 4.5 would be amended to include advisers of BDCs in the list of entities excluded from the CPO definition and include BDCs as a "qualifying entity" for which a CPO exclusion may be claimed.

Enforcement Activity

Another notable development in 2018 was the continued aggressive use by the CFTC of its expanded anti-fraud enforcement authority to pursue a number of cases involving spoofing and other forms of market manipulation and fraud by commodities market participants. See also the discussion below under "Insider Trading – CFTC Task Force."

Cryptocurrencies, Tokens and Other Digital Assets

The regulatory environment for crytpocurrencies, tokens and other digital assets has become clearer in 2018. The CFTC has clearly asserted its authority to regulate cryptocurrencies (also often referred to as digital or virtual currencies), such as Bitcoin and Ethereum, and the SEC has clearly indicated its intention to regulate tokens (often referred to as initial coin offerings or ICOs) as securities.

Virtual Currencies Regulated by CFTC as a "Commodity"

In two separate rulings in 2018, courts have upheld the CFTC's position that "virtual currencies" are commodities subject to CFTC jurisdiction under the Commodity Exchange Act (CEA). Given that the CFTC has stated its intention to actively police the cryptocurrencies markets, these decisions are important in reinforcing the CFTC's legal authority and jurisdiction over cryptocurrency offerings. The CEA generally grants CFTC exclusive jurisdiction over futures contracts and the exchanges where they are traded. "Commodity" is a defined term in the CEA, and it includes a host of specifically enumerated agricultural products as well as "all other goods and articles…and all services rights and interests…in which contracts for future delivery are presently or in the future dealt in." In one decision, a Massachusetts district court declined to dismiss a complaint filed by the CFTC against an entity over an alleged fraudulent virtual currency offering, ruling that cryptocurrencies fall under the definition of "commodity" under the CEA. Similarly, a New York district court affirmed the CFTC's jurisdiction over virtual currencies,

On August 23, 2018, a New York federal court entered a final judgment ordering Patrick K. McDonnell and CabbageTech, Corp. d/b/a Coin Drop Markets to pay over $1.1 million in civil monetary penalties and restitution in an action alleging fraud in connection with virtual currencies, including Bitcoin and Litecoin. https://www.cftc.gov/PressRoom/PressReleases/7774-18

The CFTC has taken action against unregistered Bitcoin futures exchanges, issued warnings about digital currency markets, and issued proposed guidance on what is a derivative market and what is a spot market in the digital currency context (which is important, given the uncertainty as to when "delivery" of cryptocurrencies occurs after a purchase or transfer, since forward or futures transactions in commodities can only take place on regulated commodities exchanges).

The National Futures Association (NFA) issued an Interpretive Notice that became effective on October 31, 2018, requiring NFA member CPOs and CTAs to include certain mandatory disclosures regarding the risks of investing in cryptocurrencies in disclosure documents for any commodity pool (including an exempt pool operated under CFTC Rule 4.13(a)(3)) or managed account program that trades cryptocurrencies.

https://www.nfa.futures.org/news/PDF/CFTC/InterpretiveNoticeRegardingMembersVirtualCurrencyDisclosures.pdf

The NFA also amended the annual questionnaire that is required to be completed by all NFA members to require registered CTAs and CPOs to report whether or not they hold any cryptocurrencies. The NFA in Notice 1-17-28 indicated that any NFA member CPO or CTA must immediately amend its questionnaire to report any transactions in cryptocurrencies.

Tokens/ICOs

While the CFTC has taken the lead in regulating cryptocurrencies, the SEC has taken the lead in regulating digital “tokens” or ICOs. In July 2017, the SEC issued an investigative report concluding that tokens (specifically DAO tokens) were securities. The SEC applied the “Howey test” (from a 1946 Supreme Court case of the same name) and concluded that tokens were securities because they included the basic elements of a security, which are (1) an investment of money (2) in a common enterprise (3) with an expectation of profit (4) derived primarily from the efforts of others. This conclusion was recently formally endorsed by a federal court in Brooklyn (*United States v Zaslavskiy*, E.D.N.Y, No. 1:170-cr-00647, order 9/11/18).

In June 2018, William Hinman, the Director of the SEC’s Division of Corporate Finance, stated that the SEC does not consider either Bitcoin or Ethereum to be a security, effectively because they have evolved as cryptocurrencies to the point that they no longer satisfy all of the elements of the Howey test (*i.e.*, they no longer represent an investment in a common enterprise whose value is primarily dependent upon the efforts of others).

The SEC included cryptocurrencies and ICOs among OCIE’s 2018 examination priorities, emphasizing the need to ensure that advisers have adequate controls and safeguards to protect against theft or misappropriation, and provide adequate disclosure about the risks associated with investments in digital assets, including investment risks, liquidity risks, price volatility and potential fraud.

On September 11, 2018, the SEC issued a cease and desist order and imposed a $200,000 penalty on Crypto Asset Management, LP for operating an unregistered investment company investing in digital assets.

Most recently, on October 11, 2018, the SEC announced that it had obtained an emergency court order against Blockvest LLC and its founder, Reginald Buddy Ringgold, III halting a planned ICO, freezing the defendants’ assets and other emergency relief in U.S. District Court for the Southern District of California. The SEC’s complaint alleged that (i) Blockvest falsely claimed that its ICO and its affiliates received regulatory approval from various agencies, including the SEC; (ii) Blockvest and Ringgold were using the SEC seal without permission, a violation of federal law, and falsely claiming their crypto fund was “licensed and regulated,”; (iii) Ringgold promoted the ICO with a fake agency called the “Blockchain Exchange Commission,” using a graphic similar to the SEC’s seal and the same address as SEC headquarters and misrepresented Blockvest’s connections to a well-known accounting firm; and (iv) they continued their fraudulent conduct even after the NFA sent a cease-and-desist letter to stop them from using the NFA’s seal and from making false claims about their status with that organization.

The SEC plans to release a “plain English instrument” intended to help clarify when and how digital assets may be categorized as securities. In comments made during the DC Fintech Week conference in November 2018, William Hinman, Director of the SEC’s Division of Corporation Finance, stated that the guidance will not only define if a token is a security or not, it will also give step by step guide on how to proceed thereafter, including guidance on how to register initial coin offerings as securities offerings or how to get a registration exemption for them. While the SEC has not officially set a release date, Hinman has informally indicated that the guide may come out by the end of the year or early next year.

Custody

A key consequence of treating tokens as securities is that any tokens held in the account of a client of an adviser registered with the SEC, where the adviser is deemed to have “custody” over the funds and securities in the account, must be held by an “eligible custodian” (essentially a registered broker-dealer or bank), in accordance with the SEC's custody rule, Rule 206(4)-2. Although there have been numerous reports of new and existing broker-dealers and banks developing custody services for digital assets, the market for such services is still very much evolving, and it is not entirely clear how a custodian effectively should hold "custody" of digital assets that are represented and controlled by a digital "key," or password. Although holdings of Bitcoin and Ethereum are not subject to the SEC's custody rule, advisers should give very serious consideration as to the issues and risks associated with how and by whom keys representing digital assets should be held in order to protect against theft or loss.

Digital assets also raise very interesting valuation issues, as many cryptocurrencies and other digital assets may be traded on multiple markets, often at significantly different prices, and some prominent digital exchanges and markets have in the past suspended trading, failed, become very illiquid, or experienced other issues.

For more information about blockchain and digital assets including cryptocurrencies and ICOs, and the regulation thereof, please visit our blog at blockchainandthelaw.com.

Big Data, Web Scraping and Other Issues in Data Science

Applicability of the Computer Fraud and Abuse Act to Data Scraping

As noted in last year's Annual Review, the legality of automated data collection - also referred to as web scraping, data scraping and spidering, among other names - remains very much unsettled. One of the most important issues is whether the Federal Computer Fraud and Abuse Act (CFAA) can be used as a means for challenging unwanted scraping. 2018 saw decisions in a number of cases addressing this question, while the Ninth Circuit's ongoing review of the *hiQ* decision with regard to the applicability of the CFAA to scraping of publicly-available website data is shaping up to be a landmark decision that will affect the openness of website data for both established platforms and new entrants in the marketplace.

Computer Fraud and Abuse Act

The CFAA was enacted in 1984 to enhance the government's ability to prosecute computer crimes and target hackers. The CFAA, 18 U.S.C. §1030, prohibits a number of different computer crimes, the majority of which involve accessing computers without authorization or in excess of authorization, and then taking specified forbidden actions, ranging from obtaining information to damaging a computer or computer data. The statute also provides for a civil right of action for violations, and such a claim is regularly pled by website owners against unwanted data scrapers.

2018 Computer Fraud and Abuse Act / Data Scraping Decisions

In July, an Illinois district court dismissed, with leave to amend, claims relating to a competitor's alleged scraping of sales listings from a company's website for use on its own site. (*Alan Ross Machinery Corp. v. Machinio Corp*., No. 17-3569 (N.D. Ill. July 9, 2018)).

The court dismissed a CFAA claim that the defendant accessed the plaintiff's servers "without authorization," finding that the plaintiff failed to plead with specificity any damage or loss related to the scraping and did not allege that the unlawful access resulted in monetary damages of $5,000 or more as required to maintain a civil action under the CFAA. In the court's view, the "mere copying of electronic information from a computer system is not enough to satisfy the CFAA's damage requirement."

The court dismissed the CFAA claim because the complaint failed to allege the requisite damage or loss, as plaintiff merely asserted it "had been harmed" due to the defendant's scraping and that Machinio "used valuable information" it had scraped from plaintiff's site. The court did not examine whether defendant had allegedly scraped plaintiff's site "without authorization" (*e.g.,* Did plaintiff's demand constitute a revocation of access? Did any prior discussions between the parties give defendant adequate notice that scraping was not permitted under the website terms?). Therefore, in evaluating the significance of this decision, it is important to realize that, at least with respect to the CFAA claim, the court's short opinion did not delve into many of the "authorization" issues that are typically pertinent to such a claim. In fact, as acknowledged by the court in dismissing the complaint without prejudice, the outcome had more to do with inadequate pleading, which may or may not be fortified with the filing of an amended complaint.

In June, a Texas district court denied a bid from a web service for a temporary restraining order (TRO) to enjoin a competitor that allegedly scraped a large amount of proprietary data from its closed site via several user accounts. (*BidPrime, LLC v. SmartProcure, Inc.*, No. 18-478 (W.D. Tex. June 18, 2018)). While tempting to draw a general legal conclusion about the permissibility of scraping from this decision, the decision was in fact based on the judgment of the court that scraping was unlikely to continue during the pendency of the litigation.

Nonetheless, the dispute highlights the host of legal issues that can arise when an entity accesses a website or database to scrape data for competitive or other reasons using user credentials or fake accounts or proxies to mask its true identity. For example, the plaintiff BidPrime, LCC ("BidPrime") sought injunctive relief based upon claims under the CFAA and state law counterpart, state trade secret law, and breach of contract, among others. Whether such claims are viable are of course dependent on the specific facts and circumstances of the dispute, the restrictions contained in the website terms of use, what countermeasures and demands the website owner made to the web scraper to prevent unwanted access, and the state of the current interpretation of applicable law. This decision did not analyze these factors beyond concluding that ongoing scraping was unlikely.

On the CFAA claim for unauthorized access - a typical claim in a web scraping dispute - the court ruled that BidPrime did not show irreparable harm, as the facts suggested that it was not likely that SmartProcure would access BidPrime's website during the litigation. For example, the court noted that SmartProcure offered plaintiff assurances that such access would no longer occur, SmartProcure stated it had imaged laptops that were allegedly used for the scraping and that plaintiff's security countermeasures have been shown effective at detecting or blocking several of SmartProcure's attempts to access the site. As it is still early in the litigation, it remains to be seen how the court will view the merits of the claims after the facts are more fully developed.

The BidPrime case highlights the different considerations that come into play when scraping a private website where data is only accessible to registered or paid accounts. Indeed, the issue of the scraping of data from private websites or apps for competitive reasons is an emerging issue, evidenced by another scraping-related suit filed in June concerning the alleged use of fake accounts to gain access. (*See Lemonade, Inc. v. One Versicherung AG*, No. 18-5368 (S.D.N.Y. Complaint filed June 14, 2018) (insurer lodged CFAA and contract claims against a competitor for allegedly created fake accounts to access the insurer's app to extract data on pricing and claim procedures)).

One additional case of interest is *Sandvig v. Sessions*, No. 16-1368 (D.D.C. Mar. 30, 2018), in which a group of professors and a media organization, which are conducting research into whether the use of algorithms by various housing and employment websites to automate decisions produces discriminatory effects, brought a constitutional challenge alleging that the potential threat of criminal prosecution under the CFAA for accessing a website "without authorization" (based upon the researchers' data scraping done in violation of the site's terms of use) violates their First Amendment rights.

In a preliminary decision in April, the district court held that the plaintiffs have standing and allowed their as-applied constitutional challenge to the CFAA to go forward with regard to the activity of creating fictitious accounts on web services for research purposes. The decision contains vivid language on the nature of the public internet as well as how the plaintiffs' automated collection and use of publicly available web data would not violate the CFAA's "access" provision even if a website's terms of service prohibits such automated access (at least with respect to the facts of this case, which involves academic or journalistic research as opposed to commercial or competitive activities).

In finding that the plaintiffs have standing (*e.g.*, showing a credible threat of prosecution), the court made some noteworthy findings regarding whether the plaintiffs' scraping actions are protected activity. The court found that the First Amendment generally protects the gathering and creation of information, and, as such, "scraping plausibly falls within the ambit of the First Amendment." Going further, the court added, "scraping is merely a technological advantage that makes information collection easier." The court also found that, for standing purposes, plaintiffs have a First Amendment interest in sock puppeting, or harmless misrepresenting their identities in order to audit test websites.

Ultimately, the court noted that much of the plaintiffs' proposed activities fall outside the CFAA's reach and that the CFAA "prohibits far less than the parties claim (or fear) it does." Thus, out of all the plaintiff's proposed activities, the court held that only the researchers' plans to create fictitious user accounts on employment sites would violate the CFAA because such activities do not occur on portions of websites that anyone can view, but on pages that are limited to "those who meet the owners' chosen authentication requirements and targeted to the particular preferences of the user." At this stage, the court allowed the plaintiffs' as-applied constitutional challenge to go forward based on such potential sock puppeting activities, because, absent any evidence that the speech would be used to gain a material advantage, such false speech retains First Amendment protection and "rendering it criminal does not appear to advance the government's proffered interests."

What are the implications of the *Sandvig* ruling for data scraping and the availability of a civil CFAA cause of action based upon violations of a website terms of use? The *Sandvig* case primarily presents constitutional questions, but the opinion offers some relevant language with respect to how to interpret terms of use violations under the CFAA. Given that the plaintiffs' academic scraping activities differ greatly from the typical commercial data scraping scenario, the opinion's importance is limited (but helpful) – the decision contains some language that narrowly interprets the scope of the CFAA in the criminal context for terms of service violations for research activities, but the decision certainly falls short of giving the all-clear signal to data scraping of public websites when considering the potential for civil liability. Indeed, the opinion does not really address the important issue before the Ninth Circuit in the *hiQ* appeal.

hiQ Labs, Inc. v. LinkedIn, Corp. As noted above, the Ninth Circuit is currently considering LinkedIn's appeal of the lower court's decision to grant a preliminary injunction compelling LinkedIn to disable any technical measures it had employed to block the defendant's data scraping activities. In its appeal, LinkedIn argued that the District Court erred when it issued the injunction stating that LinkedIn was unlikely to prevail on the CFAA claim and that its decision to block hiQ might be anticompetitive.

The ultimate question is whether a public website can invoke the CFAA to block unwanted scraping activities after having expressly revoked access to its site to the unwanted user. Regardless of the Ninth Circuit's decision, it is likely to be a landmark decision that will affect the openness of website data for both established platforms and new entrants in the marketplace.

Insider Trading

The last twelve months have seen an important ruling from the Second Circuit in *United States v. Martoma* on the nature of the "personal benefit" needed to create liability for insider trading. The Second Circuit's decision could lay to rest the upheaval from that court's 2014 decision in *United States v. Newman* and return the law to its pre-*Newman* state. The year also saw a highly publicized insider-trading trial that resulted in acquittals under the traditionally used provision of the Exchange Act, but convictions for the same conduct under a 2002 criminal-fraud statute. Also of note were a consent order against an asset manager and an indictment of a Congressman for alleged tipping of material, nonpublic information that led to trading by the tippees. And the CFTC has created an insider-trading task force with several offices throughout the country.

The Demise of the "Close Personal Relationship" Requirement for Tippee Liability?

Our annual updates over the past several years addressed the apparently short-lived revolution in insider-trading law wrought by the Second Circuit's 2014 decision in *United States v. Newman*. The Supreme Court's 2016 decision in *Salman v. United States* and the Second Circuit's June 2018 ruling in *United States v. Martoma* collectively appear to have driven a stake through the heart of *Newman*, and insider-trading law now seems to have ended up more or less where it was in 2014, before *Newman*.

The debate has centered on the nature of the "personal benefit" that a tipper of material, nonpublic information must obtain in order to create tipper and tippee liability for trading based on that information. Insider-trading liability arises under the Exchange Act only if securities are bought or sold on the basis of material, nonpublic information used or obtained in breach of a fiduciary duty or a duty of trust or confidence owed to the shareholders of the issuer or to the source of the information. That breach of duty depends on whether the tipper received a personal benefit in exchange for providing the information.

Background of the "Personal Benefit" Requirement

Our prior reviews of insider-trading law explored the ongoing debate about the nature of that "personal benefit," which first arose in the Supreme Court's 1983 decision in *Dirks v. SEC*, 463 U.S. 646 (1983), and was fleshed out in subsequent rulings in the *Newman*, *Salman*, and *Martoma* cases.

- *Dirks.* The *Dirks* case established the framework for tippee liability. The Supreme Court held that a tippee's liability derives from the liability of his or her tipper - and that a tipper breaches a fiduciary duty by disclosing confidential information only if he or she benefits directly or indirectly from the disclosure. The Court gave examples of such a personal benefit, including "a pecuniary gain," "a reputational benefit that will translate into future earnings," "a relationship between the [tipper] and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient," or "a gift of confidential information to a trading relative or friend" where "[t]he tip and trade resemble trading by the [tipper] himself followed by a gift of the profits to the recipient."
- *Newman.* In 2014, the Second Circuit announced a more rigorous construction of *Dirks*'s personal-benefit requirement. The court ruled in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), that, to the extent "a personal benefit may be inferred from a personal relationship between the tipper and tippee," rather than from a direct *quid pro quo*, "such an inference 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*" (emphasis added).

- *Salman.* Two years later, the Supreme Court decided *Salman v. United States*, 137 S. Ct. 420 (2016), which involved a family relationship. The tipper had allegedly provided confidential business information to his brother, and the brother had then tipped Salman (the trader), whose sister had become engaged to and later married the original tipper. The Court reemphasized *Dirks*'s holding that "a tipper breaches a fiduciary duty by making a gift of confidential information to 'a trading relative'" and added: "when a tipper gives inside information to 'a trading relative or friend,' the jury can infer that the tipper meant to provide the equivalent of a cash gift." The Court rejected Salman's reliance on *Newman* for the proposition that the tipper must receive an objective, consequential personal benefit representing an actual or potential pecuniary gain. Rather, the Court held that, "[t]o the extent the Second Circuit held that the tipper must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift to family or friends, . . . this requirement is inconsistent with *Dirks*."

These three decisions underlay the long-running battle in the *Martoma* litigation.

The Martoma Case

The *Martoma* case arose out of the government's investigation of a prominent hedge fund advisers. Mathew Martoma, a portfolio manager at the adviser, had had dealings with two doctors who had been involved in the clinical trial of a drug for Alzheimer's disease. The doctors had entered into paid consulting arrangements with the adviser under contracts through expert-networking agencies.

The government alleged that at least one of the doctors had shared confidential safety data about the drug with Martoma, leading Martoma and the adviser to build and maintain positions in the securities of the two companies that owned rights to the drug. The government also alleged that the doctor had given Martoma advance information of the drug trial's failure – and that the adviser had then sold off its positions in the two drug companies' stock before the news became public. Martoma was convicted of insider trading and conspiracy to commit securities fraud.

Martoma appealed, claiming that the government had not proven that the doctor had received a legally sufficient personal benefit in exchange for providing the confidential information. Martoma's argument focused on the interplay among *Dirks*, *Newman*, and *Salman.*

Martoma argued on appeal that, even though the *Salman* decision had rejected *Newman*'s requirement of a pecuniary or pecuniary-like benefit, it had not undermined *Newman*'s other requirement that the tipper-tippee relationship be a "meaningfully close personal relationship." The nature of that relationship had not been at issue in *Salman*, which had involved brothers. Martoma insisted that he and the doctor had not shared a close personal relationship, so *Salman*'s gift-giving analogy was inapposite, and a personal benefit more direct and consequential than mere friendship was required. He also claimed that, even though the doctor had been paid under the consulting arrangement with the fund, the doctor had not been paid for disclosing the drug-efficacy data.

The Second Circuit – in a 2-to-1 decision – affirmed the conviction. *United States v. Martoma*, 869 F.3d 58 (2d Cir. 2017).

Second Circuit's First Decision

The court first ruled that the evidence was sufficient to sustain Martoma's conviction on a simple pecuniary-benefit theory: the doctor had been paid for his consultations with Martoma. Even if the doctor had not billed Martoma for the specific meetings at which he had conveyed the nonpublic information about the drug trial's failure, "the tipper's gain need not be *immediately* pecuniary." "In the context of their ongoing relationship of *quid pro quo*, . . . where [the doctor] regularly disclosed confidential information in exchange for fees, a rational trier of fact could have found the essential elements of the crime [of insider trading] beyond a reasonable doubt under a pecuniary *quid pro quo* theory."

The majority devoted more of its opinion to discussing the nonpecuniary, gift-giving aspect of insider-trading liability because Martoma had challenged the jury instructions, which had described the personal-benefit theory in terms of both financial and non-financial benefits. The majority concluded that "the logic of *Salman* abrogated *Newman*'s 'meaningfully close personal relationship' requirement" for a non-financial or non-*quid pro quo* personal benefit.

The court held that "an insider or tipper personally benefits from a disclosure of inside information whenever [*i*] the information was disclosed 'with the expectation that [the recipient] would trade on it' . . . and [*ii*] the disclosure 'resemble[s] trading by the insider followed by a gift of the profits to the recipient,' . . . whether or not there was a 'meaningfully close personal relationship' between the tipper and the tippee." In the majority's view, "nothing in [*Salman*'s] logic supports a distinction between gifts to people with whom a tipper shares a 'meaningfully close personal relationship' . . . and gifts to those with whom a tipper does not share such a relationship."

The dissent (by Judge Pooler) criticized the majority for rejecting *Newman* without convening the full court for *en banc* review. But Judge Pooler also disagreed with what she viewed as a ruling that "an insider receives a personal benefit when the insider gives inside information as a 'gift' to *any* person. In holding that someone who gives a gift *always* receives a personal benefit from doing so, the majority strips the long-standing personal benefit rule of its limiting power."

Martoma petitioned for panel or *en banc* rehearing. In June 2018, the panel withdrew its original decision and issued a new one, again affirming Martoma's conviction but at least facially modifying the initial decision's rejection of *Newman*. *United States v. Martoma*, 894 F.3d 64 (2d Cir. 2018).

Second Circuit's Amended Decision on Rehearing

The majority's amended decision retreated from abrogating *Newman*'s "meaningfully close personal relationship" element. Instead of holding that *Salman* undermined *Newman*'s "meaningfully close personal relationship standard," the panel declared that, "because there are many ways to establish a personal benefit, we conclude that we need not decide whether *Newman*'s gloss on the gift theory is inconsistent with *Salman*." The requisite relationship can be established by proving "either [*i*] that the tipper and tippee shared a relationship suggesting a *quid pro quo* or [*ii*] that the tipper gifted confidential information with the intention to benefit the tippee."

The majority focused on what it called "the key sentence of *Dirks*," which it admitted is "ambiguous": the Supreme Court's statement that "there may be a relationship between the [tipper] and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient." The majority concluded that "the comma separating the 'intention to benefit' and 'relationship . . . suggesting a *quid pro quo*' phrases can be read to sever any connection between them," so they stand as alternative elements. Thus, according to the majority, this sentence "effectively reads, 'there may be a relationship between the [tipper] and the recipient that suggests a *quid pro quo* from the latter, or there may be an intention to benefit the particular recipient.'"

Under this disjunctive reading, the government may "prove a personal benefit with objective evidence of the tipper's intent, without requiring in every case some additional evidence of the tipper-tippee relationship." The majority provided an example: "the statement 'you can make a lot of money by trading on this,' following the disclosure of material non-public information, suggests an intention to benefit the tippee in breach of the [tipper's] fiduciary duty." Under the dissent's interpretation, however, "this plain evidence that the tipper intended to benefit the tippee would be insufficient to show a breach of the tipper's fiduciary duty . . . due to the lack of [additional proof of] a personal relationship" between the tipper and the tippee. The majority viewed its reading as more consistent with *Dirks*: "The tipper's intention to benefit the tippee proves a breach of fiduciary duty because it demonstrates that the tipper improperly used inside information for personal ends and thus lacked a legitimate corporate purpose [for disclosing it]. That is precisely what, under *Dirks*, the personal benefit element is designed to test."

Based on this new reading of *Newman*, the majority held that the jury instructions at Martoma's trial had been erroneous. The instructions had "allowed the jury to find a personal benefit based solely on the conclusion that [the doctor] had tipped Martoma in order to 'develop[] or maintain[] a friendship,'" but had not told the jury that "it could find a personal benefit based on a 'gift of confidential information to a trading relative or friend' only if it also found that [the doctor] and Martoma shared a relationship suggesting a *quid pro quo* or that [the doctor] intended to benefit Martoma with the inside information."

However, the majority concluded that the inaccurate instructions had not affected Martoma's "substantial rights" because (*i*) "the government produced compelling evidence that [the doctor], the tipper, 'entered into a relationship of *quid pro quo'* with Martoma" in light of the very substantial consulting fees he had received, and (*ii*) "even if a jury were inclined to accept Martoma's argument that there was no *quid pro quo*-like relationship because [the doctor] did not bill Martoma for the two key sessions [at which the doctor had disclosed the drug trial's results], a rational jury could nonetheless find that [the doctor] personally benefited by disclosing inside information with the 'intention to benefit' Martoma."

The majority observed: "We think a jury can often infer that a corporate insider receives a personal benefit (*i.e.*, breaches his fiduciary duty) from deliberately disclosing valuable, confidential information without a corporate purpose and with the expectation that the tippee will trade on it" – in other words, pretty much the standard in the now-vacated original panel decision.

Judge Pooler again dissented, opining that "the majority's attempt to undercut the meaningfully close personal relationship requirement is in derogation of circuit precedent and unnecessary to arrive at their disposition. Only by abrogating *Newman* could my colleagues announce a new rule that a jury can infer a personal benefit based on a freestanding 'intention to benefit' and that this 'intention to benefit' is at the core of the meaningfully close personal relationship standard."

Martoma petitioned for rehearing *en banc*, but the Second Circuit denied the petition on August 27, 2018. Martoma will presumably ask the Supreme Court to review the case.

Where Are We Now?

The *Martoma* majority's approach appears to dispense with the personal-relationship element in *Dirks*'s and *Salman*'s discussions of "trading relatives or friends." The tipper's intent to benefit the tippee can now suffice, regardless of the parties' relationship.

But although a meaningfully close personal relationship no longer seems to be essential, another aspect of *Newman* – which the *Martoma* majority called "the central question in *Newman*" – remains intact: the requirement that a tippee must have *known* (or at least have been reckless in not knowing) that the tipper breached his or her duty by providing inside information in exchange for a personal benefit, whatever that benefit might be. Particularly in cases involving remote tippees, this requirement could be decisive – as it was in *Newman*. Remote tippees at the end of a multi-person chain might have little, if any, idea of what happened at the initial tipper's level and might not know whether the tipper breached any duty in exchange for a personal benefit. This prong of *Newman* remains the law in the Second Circuit and is likely to be the first line of defense for remote tippees.

The *Martoma* ruling also focuses only on tippers who disclose inside information with the expectation that the tippees will trade on it. The majority stressed that its decision does not "mean that a tipper who accidentally or unknowingly reveals inside information can be found guilty. Such a tipper would be protected by the requirement that the tipper know (or is reckless in not knowing) that the information is material and non-public . . . or by the requirement that the tipper expect the tippee to trade." *Martoma* thus would not appear to apply to disclosures for whistleblowing purposes (as in *Dirks*) or to inadvertent disclosures; nor would it appear to apply to disclosures made for legitimate corporate purposes.

From a compliance point of view, *Martoma*'s cutting back on *Newman* probably makes little practical difference. The nature of the personal benefit that a tipper did or did not receive relates to a *defense* to charges of insider trading. But we generally advise our clients – and our compliance colleagues generally instruct their traders and portfolio managers – not to gamble on defenses. The goal is to avoid being charged with a securities-law violation, not to defeat the charge once it has been filed. None of the back-and-forth in the *Newman*, *Salman*, and *Martoma* cases involved the nature of material, nonpublic information. We still believe that our clients would be best served by avoiding any transactions involving material, nonpublic information, rather than by speculating about whether a tipper did or did not receive a legally sufficient personal benefit for disclosing such information.

Securities-Fraud Liability Even Without Personal Benefits and Fiduciary Breaches

The elements of insider-trading liability in *Dirks*, *Newman*, *Salman*, and *Martoma* arose from traditional securities-fraud law (§ 10(b) of the Exchange Act and SEC Rule 10b-5), and most criminal or civil insider-trading proceedings filed to date have relied on that legal framework. But a criminal fraud statute enacted as part of the Sarbanes-Oxley Act of 2002 – 18 U.S.C. § 1348 – has been receiving more attention lately, and that statute does not require consideration of either fiduciary breaches or personal benefits. As one recent prosecution has shown, a defendant can be acquitted of securities fraud for insider trading under the Exchange Act, but can still be convicted under § 1348.

Section 1348 imposes criminal liability on anyone who "knowingly executes, or attempts to execute, a scheme or artifice" either (1) "to defraud any person in connection with" any commodity or any security of a registered issuer or (2) "to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of" any such commodity or security. The language is derived from the federal mail-fraud and wire-fraud statutes. Because § 1348 is a criminal statute, it cannot provide the basis for an SEC enforcement action. Only the Department of Justice can use it.

In *United States v. Blaszczak*, four individuals were prosecuted in connection with alleged schemes to obtain information from the Centers for Medicare and Medicaid Services (CMS) about reimbursement rates for certain medical treatments. A CMS employee had allegedly given nonpublic information to a friend (Blaszczak), a consultant and former CMS employee; the consultant then passed the news to persons at a hedge fund adviser, who traded on the information. The CMS employee allegedly had received benefits from the tippee-consultant in the form of free meals, tickets to sporting events, and an offer to join the consultant's firm.

The government charged all defendants with securities fraud under the Exchange Act and with violations of § 1348. The court's jury instructions on the Exchange Act charge addressed all the familiar elements – including whether the tipper (the CMS employee) had owed and breached any duty of trust or confidence, whether he had received a personal benefit for doing so, and whether the defendants had known of the tipper's breach of duty and receipt of a benefit – and the defendants asked the court to include those same elements in its charge under § 1348. The court denied the request and required the jury to find only that the defendants had knowingly and willfully engaged in "an illegal scheme or artifice" by providing confidential CMS information "to another person for the purpose of buying or selling securities on the basis of that information." Nothing about the tipper's duty, his personal benefit, or the tippees' knowledge of either of those things. In May 2018, the jury acquitted the defendants on the securities-fraud charges, but convicted them of § 1348 violations (except the CMS employee, who was convicted of wire fraud and conversion of government property).

The *Blaszczak* indictment had been returned in May 2017, when *Newman* was still the law in the Second Circuit. Section 1348 thus must have seemed to be a particularly attractive way for prosecutors to avoid *Newman*'s more stringent requirements. Now that *Martoma* has eroded *Newman*'s strictures, the government might see less of a need to resort to § 1348. But inasmuch as § 1348 might provide an easier path to conviction than § 10(b) demands, it could become a more popular weapon in the prosecution's arsenal.

The *Blaszczak* case was not the first use of § 1348 to prosecute insider trading. For example, in 2014, a federal court in Georgia declined to dismiss a § 1348 indictment even though the charge did not require proof of § 10(b)'s elements concerning the tipper's personal benefit and the tippee's knowledge of that benefit. *United States v. Slawson*, 2014 WL 5804191 (N.D. Ga. Nov. 7, 2014) (Report and Recommendation), *adopted*, 2014 WL 6990307 (N.D. Ga. Dec. 10, 2014). But *Blaszczak* – coming in the middle of the Second Circuit's highly publicized *angst* about the elements of a § 10(b) violation – could draw more attention to § 1348, especially in light of the jury's verdict acquitting the defendants of § 10(b) insider trading but convicting them for the same underlying conduct under § 1348.

The government also used § 1348 as well as § 10(b) in its prosecution of an Equifax employee who allegedly sold stock after learning about Equifax's data breach, but before the breach was disclosed. A Magistrate Judge recently recommended that the District Judge deny the defendant's motion to dismiss the indictment. The court also determined that the §§ 10(b) and 1348 were not multiplicitous because the violations have different elements. *U.S. v. Ying*, No. 1:18-cr-0074-AT-RGV (N.D. Ga. Sept. 17, 2018).

The existence of this alternative prosecutorial route using § 1348 underscores the importance of making compliance judgments based on avoiding prosecution, rather than on framing defenses. If trading decisions do not involve material, nonpublic information, the relatively lower prosecutorial burdens under § 1348 should not be cause for concern.

Focusing on whether material, nonpublic information is at issue – rather than on whether a breach of duty occurred or a legally sufficient personal benefit existed – also avoids potential liability under the European Union's Market Abuse Regulation (the "MAR"), which is more stringent than traditional U.S. insider-trading law. As we noted in our previous annual reviews, the MAR applies to all securities admitted for trading on an EU market (even if they are cross-listed in the United States, and even if the trading at issue occurs only on a U.S. market), and it prohibits use of material, nonpublic information that the user knows or should have known is nonpublic.

The *Visium* Settlement

Leaks from government officials also led to proceedings involving Visium Asset Management, an adviser to hedge funds. A Visium portfolio manager allegedly received material, nonpublic information from a consultant – a former official of the Food and Drug Administration's Office of Generic Drugs (OGD) –

about the impending approval of a generic drug. The consultant, in turn, had received the advance information from an OGD employee and friend. In addition, another Visium portfolio manager allegedly received material, nonpublic information from a political consultant and former CMS employee (Blaszczak) about an impending CMS announcement concerning Medicare reimbursement rates for home healthcare services. The consultant allegedly had obtained this information from his sources within CMS.

Visium entered into a cease-and-desist settlement with the SEC, which alleged that Visium had failed to enforce policies and procedures designed to prevent misuse of material, nonpublic information. *In the Matter of Visium Asset Management, L.P.*, Admin. Proceeding No. 3-18473 (May 8, 2018). Visium had policies prohibiting insider trading, and those policies instructed employees to alert the Chief Compliance Officer of any possibility that employees had received material, nonpublic information. The policies also addressed the use of outside consultants (such as Blaszczak), requiring employees to ensure that all agreements with consultants contain "an insider trading prohibition disclosure" and remind consultants "that Visium should not be a recipient of actual or potential material, nonpublic information." The cease-and-desist order concluded, however, that Visium had not taken adequate steps to enforce its policies and to monitor its employees' communications with consultants.

The settlement again puts the spotlight on the need for advisers to have and enforce adequate policies and procedures – and to monitor employees' compliance with them. Consulting arrangements have given rise to many insider-trading scenarios (as we also saw in the *Martoma* and *Blaszczak* cases) and are likely to receive continued scrutiny from the SEC and prosecutors.

Bar for Chief Compliance Officer

Although it was not an insider-trading matter, an SEC settlement with Southwind reinforces the need for advisers to fulfill their responsibilities or risk being barred by the SEC from serving in any supervisory or compliance capacity. *In the Matter of Southwind Assocs. of NJ Inc.*, Admin. Proceeding No. 3-18323 (Dec. 22, 2017).

Southwind involved numerous alleged violations of the Advisers Act by an adviser, its president and owner, and its CCO: alleged failures to hold surprise examinations of client funds and securities, to ensure timely distribution of audited financial statements, to have audits conducted by qualified independent public accountants, to make and keep certain electronic publications, to adopt and implement appropriate written policies and procedures, and to conduct annual reviews of those policies and procedures. The respondents and the SEC entered into a cease-and-desist settlement, which included an order barring the CCO from acting "in a supervisory or compliance capacity with any broker, dealer, investment adviser, municipal securities dealer, municipal adviser, transfer agent, or nationally recognized statistical rating organization."

Southwind serves as a reminder that bar orders remain real risks for CCOs and others in situations of repeated and serious noncompliance.

Congressman Collins's Travails

Perhaps the most notorious insider-trading proceeding at the moment is the indictment of Congressman Chris Collins, from upstate New York. *United States v. Collins*, No. 18 Cr. 567 (S.D.N.Y.).

Collins was a director and large shareholder of an Australian pharmaceutical company called Innate Immunotherapeutics Limited, which had a standard Securities Trading Policy prohibiting directors, officers, employees, and others from using or disclosing inside information. While attending a

Congressional picnic at the White House one evening in June 2017, Collins received an email from Innate's CEO informing Innate's directors that the company's only significant product had failed a drug trial. The CEO concluded that "no doubt we will want to consider this extremely bad news . . . ."

Within the next several minutes, Collins allegedly made six "missed" calls to his son and finally connected on a seventh try. The indictment charges that, during the seventh call, Collins told his son about the drug-trial failure. The son then allegedly tipped his then-fiancée (they apparently are no longer engaged), her father and mother, and a friend.

Collins did not sell any of his own shares of Innate – allegedly because his shares were held in Australia and were subject to an Australian trading halt. But the tippees, who held U.S.-based shares of Innate that were not subject to the trading halt, started selling their shares the next morning and over the following days, before Innate announced the news of the drug trial. After that announcement, Innate's stock price fell 92%. The government obtained an indictment of Collins, his son, and the father of the son's then-fiancée for securities fraud under the Exchange Act and for wire fraud – but not for an alleged violation of § 1348.

The STOCK Act – the 2012 statute that prohibits insider trading or tipping by government officials – is not implicated here, because Collins did not obtain nonpublic information about the drug trial in his capacity as a Congressman. He obtained it solely as an Innate director. (The rules of the House of Representatives allow sitting Representatives to serve on public-company boards, although the Senate's rules do not permit such service.) Stay tuned.

CFTC Task Force

The CFTC appears to be ramping up surveillance of insider trading. The CFTC announced on September 28, 2018 that it has created an Insider Trading and Information Protection Task Force with offices at the CFTC's Washington headquarters and in CFTC regional offices in Illinois, Missouri, and New York. On that same day, the CFTC also filed an enforcement action against a commodities trader who allegedly had used his firm's clients' trading information to help a friend make money.

The CFTC's actions could signal more aggressive insider-trading enforcement by that agency. But the CFTC is not certainly new to this area, having initiated several investigations and enforcement actions in the past, including a high-profile investigation of a leak of Federal Reserve minutes.

Legislation on Insider Trading? Nothing Yet.

Our prior annual updates speculated on the prospects for legislation to define insider trading. We noted last year that, after the Equifax hack and the allegations of executive stock sales, SEC Chairman Clayton said that he would work with Congress to strengthen insider-trading rules. But nothing has happened yet.

On October 9, 2018, however, SEC Commissioner Robert J. Jackson, Jr. and former United States Attorney for the Southern District of New York Preet Bharara announced that they were forming the Bharara Task Force on Insider Trading to make "concrete proposals" to update the insider-trading laws. The Task Force will consist of eight former regulators and prosecutors, judges, academics, and defense lawyers. We will see whether anything comes of this new effort.

Activist Investing

When Passive Investors Drift Into Active Status

Advisers to private funds that are not "activist" may nonetheless from time to time want to engage with other investors about a portfolio company's performance, or engage directly with a portfolio company on matters that go beyond ordinary operations. However, such interactions with other investors and with management can in some cases cause an adviser to be viewed as seeking to influence the management of the company, or to have formed a "group" with another party, and inadvertently subject the adviser and fund to heightened "activist" regulatory requirements, which may include, among other things, the adviser and fund having to:

- file a long-form Schedule 13D instead of a short-form Schedule 13G;
- comply with reporting requirements under Section 16 (as well as becoming subject to potential short-swing liability);
- address potentially complex insider trading issues; and
- comply with Hart-Scott-Rodino filing requirements.

The boundaries determining when an adviser and fund will become subject to these requirements are not always clear. Discussions with a portfolio company can easily land in a gray area as to whether or not the adviser has a control intent, and discussions with other parties can result in the formation of a "group" for Section 13(d) purposes.

Please see Chapter 1 of our Practical Guide to the Regulation of Hedge Fund Trading Activities, "When Passive Investors Drift into Activist Status" for a further discussion of these issues.

Private Equity Fund Litigation

Innovative market disruptors, a maturing credit cycle, and a philosophical change in how the industry views and utilizes litigation are likely to lead to increased litigation risk for advisers (and their funds) in 2019. Here are several areas that should be on the top of every adviser's list as we look toward 2019.

The Unicorn Ripple Effect

While the number of IPOs has increased, rich valuations for private companies may constrain opportunities for liquidity and future funding rounds. Ultimately, an uneven IPO outlook for unicorns could lead to disputes. Overly optimistic valuations can lead to inflated expectations, especially among employee shareholders expecting a payout and investors expecting gains. A company with rich valuations may have greater difficulty creating liquidity for shareholders. As more unicorns linger and fall into distress, some may fail, leading to litigation. And as the Theranos case has taught us, the failure of a unicorn is likely to attract not only regulatory scrutiny, but also potential private litigation claims.

Litigation Funding Alters the Landscape

Historically, limited partners have shied away from initiating litigation – in part because their primary objective is to maximize the value of their investment and litigation is viewed as having high costs with an uncertain return. In addition, advisers have an asymmetric advantage in that they often can draw on the fund to cover legal expenses, whereas limited partners must cover their own expenses. Enter litigation funders, who are raising funds and capital at an unprecedented pace and whose business strategy is to invest in claims by covering the expenses of litigation in exchange for a share in the recovery. Litigation funding has the potential to fuel a new wave of LP-driven litigation that, up until recently, had been viewed as a risk that was hard to quantify and seemed unlikely to materialize.

Private Credit Defaults and Workouts

The market for private credit lending (sometimes called alternative finance or private capital) continues to boom, with some experts estimating that it will exceed $1 trillion by 2020. The influx of capital into the private credit industry is altering the landscape for deal types and deal terms. Rising competition, intense deal activity, and the reach for yield have led to more complicated capital structures. This complexity coupled with higher interest rates are signs of a maturing credit cycle – which in turn signals an increased risk of defaults. End of cycle defaults often lead to contentious workouts. Given that disputes tend to follow market trends, the continued growth of the private credit market today could lead to disputes tomorrow.

Portfolio Company Litigation

There are seemingly countless ways that ownership and sale of a portfolio company can expose advisers and their funds to litigation. There is a growing trend by plaintiffs' lawyers to name advisers, funds and their board-designees as defendants in traditional portfolio company litigation. Advisers (their principals) and their funds also are common targets when a portfolio company fails post-sale and a creditors' committee comes knocking to pursue recoveries. And there has also been a steady uptick in something that was once viewed as taboo in the industry – advisers and their funds suing other advisers and their funds related to sales of portfolio companies. Each of these trends is likely to continue in 2019 and beyond.

FCPA

FCPA Enforcement Activity

The Foreign Corrupt Practices Act (FCPA) remains a top enforcement priority. The FCPA generally prohibits making payments to foreign government officials for the purpose of obtaining or retaining business. There have been twelve FCPA-related enforcement actions that have been brought by the SEC and DOJ against companies so far in 2018. The enforcement actions have involved a wide range of different industries, including the medical device, oil and gas, mining, manufacturing, banking, and financial services sectors. This level of enforcement activity is roughly in line with the enforcement activity in 2017, although it is well-short of the record-high twenty-seven enforcement actions brought against companies in 2016.

Still, it is clear that the FCPA remains a top enforcement priority of the DOJ and the SEC. Deputy Assistant Attorney General Matthew S. Miner said as much in his July 25, 2018 remarks at the American Conference Institute 9th Global Forum on Anti-Corruption Compliance in High Risk Markets, stating that "fighting corruption and ensuring a level playing field for law-abiding companies remains a significant priority." This is also clear from the enforcement actions that the government has brought, which have involved record penalties and disgorgement orders. For example, in September 2018, the DOJ and SEC assessed $1.78 billion in penalties and disgorgement against the Brazilian state-owned energy company Petróleo Brasileiro S.A. (Petrobras) — making it the largest FCPA enforcement action of all time.

This year, we also saw a continued focus on enforcement activity in the banking and financial services sectors. In 2016 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. So far in 2018 the government has brought enforcement actions against an investment bank, an asset manager, and a commercial data company that services the financial industry. With more sure to come, this is an important time for advisers to private 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.

Major Ruling on FCPA Jurisdiction

On August 24, 2018, the U.S. Court of Appeals for the Second Circuit issued a major ruling on the extraterritorial application of the FCPA. The question presented in *United States v. Hoskins,* No. 16-1010 (2d. Cir. 2018) was whether conspiracy or aiding and abetting charges can be used to extend the reach of the FCPA to a nonresident foreign national even if he is not an agent of a domestic concern and does not commit acts while physically present in the territory of the United States. The Second Circuit held that they could not. This may limit the government's ability to charge foreign nationals in connection with extraterritorial acts.

The FCPA's anti-bribery provisions apply broadly to three categories of persons and entities: (1) "issuers" and their officers, directors, employees, agents, and shareholders; (2) "domestic concerns" and their officers, directors, employees, agents, and shareholders; and (3) certain persons and entities, other than issuers and domestic concerns, acting while in the territory of the United States.

- *Jurisdiction over Issuers.* An "issuer" is any company (U.S. or foreign) that has entered the U.S. public markets and is listed on a U.S. stock exchange, or is otherwise required to file reports with the SEC (*e.g.*, SEC Forms 10-K and 10-Q). This includes foreign companies whose American Depository Receipts are traded on a U.S. stock exchange.
- *Jurisdiction over Domestic Concerns.* Under the FCPA, "domestic concern" is broadly defined to include "any individual who is a citizen, national, or resident of the United States," or any business association "organized under the laws of the United States or its states, territories, possessions, or commonwealths or that has its principal place of business in the United States."
- *Territorial Jurisdiction.* In addition to issuers and domestic concerns, the FCPA also applies to foreign nationals or entities who engage in any act in furtherance of a foreign bribery scheme "within the territory of the United States."

For years, the government has taken the view that, beyond the three categories of persons or entities described above, the FCPA could also reach foreign nationals who act outside the territory of the United States through the conspiracy and complicity statutes. In 2012, the SEC and DOJ issued the FCPA Resource Guide, which stated that "[a] foreign company or individual may be held liable for aiding and abetting an FCPA violation or for conspiring to violate the FCPA, even if the foreign company or individual did not take any act in furtherance of the corrupt payment while in the territory of the United States" (emphasis added). Because most FCPA enforcement actions end with a settlement, this position largely went unchallenged.

That changed earlier this year. In *Hoskins*, the court addressed whether the DOJ could use conspiracy and complicity statutes to charge the defendant — a former executive at a global company headquartered in France — with offenses not punishable under the FCPA itself because of the statute's jurisdictional limitations. The court held that the DOJ could not, writing that "[t]he FCPA does not impose liability on a foreign national who is not an agent, employee, officer, director or shareholder of an American issuer or domestic concern — unless that person commits a crime within the territory of the United States."

On its face, this would appear to be a major setback for the government. However, the practical effect of the *Hoskins* ruling may be rather limited. First, foreign individuals still may have FCPA exposure under an agency theory. Although the court in *Hoskins* ruled that the government could not side-step the FCPA's jurisdictional limitations by using the conspiracy and complicity statutes, it allowed the government to proceed against the defendant under a different theory — that is, the government was allowed to move forward under the theory that the defendant was an agent of the global company's U.S. subsidiary, a domestic concern under the FCPA. This will no doubt be a focus of any jurisdictional analysis under the FCPA going forward.

Second, the payment of bribes to foreign officials often involves violations of criminal statutes other than the FCPA — for example, violations of the money laundering statutes – which have different jurisdictional requirements. Thus, if prevented from charging an individual with conspiracy to violate the FCPA, the government may use the conspiracy and complicity statutes in connection with other substantive charges like wire fraud and money laundering. *See*, *e.g.*, *United States v. Joseph*, No. 09-CR-2101 (S.D. Fla.) (director of state-owned company pleaded guilty to money laundering conspiracy charge after being accused of accepting bribes).

Because of this, advisers should remain vigilant regarding the risk posed by foreign bribery. The best way to do this is by having an effective compliance and ethics program – something advisers and other financial institutions can take proactive steps to put in place and improve upon.

Committee on Foreign Investment in the United States

The potential for national security review of foreign investment in the U.S. has been around for thirty years since the 1988 enactment of the Exon-Florio Amendment to the Defense Production Act, which created the Committee on Foreign Investment in the U.S. (CFIUS or the Committee). The CFIUS process is now undergoing a major overhaul and expansion as a result of the recent passage of the Foreign Investment Risk Review Modernization Act, or FIRRMA, with the aim, according to the legislation's sponsors, to "modernize and strengthen" review by CFIUS.

CFIUS has the authority to review "covered transactions", which, prior to FIRRMA's enactment, applied to any control transaction by or with a foreign person of a U.S. business. Control is a key threshold concept under existing CFIUS regulations and FIRRMA for identifying transactions that are within the scope of review. FIRRMA codifies the existing CFIUS regulations' definition of control as "the power, direct or indirect, whether exercised or not exercised, to determine, direct, or decide important matters affecting an entity, subject to regulations prescribed by the Committee." This means even a small minority investment can potentially bring a transaction within the scope of CFIUS review if the investor obtains rights, for instance, relating to the selection of new business lines or ventures; significant contracts; policies or procedures regarding treatment of nonpublic technical, financial, or other proprietary information; appointment or dismissal of officers or senior managers; or other significant or important rights. The term U.S. business means any entity engaged in interstate commerce in the United States, but only to the extent of its activities in interstate commerce.

However, prior to FIRRMA, filings by parties to CFIUS covered transactions were voluntary. While there were no penalties or sanctions for failure to file under the traditional CFIUS program, buyers that failed to voluntarily file left themselves open to the risk that the Committee would investigate the transaction on its own, pre or post-closing. Such investigations could result in the Committee seeking remedies, up to and including divestiture, for transactions deemed to present substantial national security issues.

FIRRMA Overview

FIRRMA expands and strengthens the CFIUS review process in a number of important ways, including:

- New categories of covered transactions (including certain real estate and bankruptcy transactions, transactions involving sensitive personal data of U.S. citizens, and changes in a foreign investor's governance rights).

- Expanded coverage of non-passive “critical technology” and “critical infrastructure” investments. The scope of potential investments was expanded beyond traditional national security and critical infrastructure investments to include other “critical technologies” such as nanotechnology, biotechnology, and emerging and foundational technologies.
- Requirement for mandatory filings for certain transactions in industries impacting critical technologies (discussed below).

FIRRMA introduces new filing fees and extended review periods beyond what is currently provided for under existing law. In addition, FIRRMA authorized CFIUS to create pilot programs to implement certain parts of FIRRMA that did not go into immediate effect.

Pilot Program and Mandatory Filings

While most FIRRMA provisions will not go into effect until implementing regulations are established in the 2019-2020 timeframe, a CFIUS Pilot Program began on November 10, 2018 (the November Pilot Program), triggering mandatory filing requirements for certain transactions, subject to a potential penalty for failure to file of up to the total value of the transaction. The requirement extends to <u>all</u> foreign investor transactions (without regard to dollar value, percentage interest acquired, or whether control is obtained) in a U.S. business – but only in certain specifically enumerated sensitive U.S. industries -- that produces, designs, tests, manufactures, fabricates or develops a critical technology that is (a) utilized in connection with the U.S. business’ activity in any such industry, or (b) designed by the U.S. business specifically for use in one or more such of industries (a November Pilot Program U.S. Business).

Critical technologies includes items such as defense articles, missile technology, weapons and nuclear components, but also include certain emerging and foundational technologies controlled under the Export Control Reform Act (to be defined by regulation, but generally expected to encompass industries such as artificial intelligence, cybersecurity, virtual reality, etc.). The November Pilot Program mandatory filing requirement is limited to transactions where the foreign investor (or indirect foreign investor) would gain control of any November Pilot Program U.S. Business, including through joint venture, or would:

(i) gain access to “material nonpublic technical information” in the possession of the November Pilot Program U.S. Business regarding critical technologies (information necessary to design, fabricate, develop, test, produce, or manufacture critical technologies, including processes, techniques, or methods, but excluding financial performance information);

(ii) obtain membership or observer rights on the board of the November Pilot Program U.S. Business or the right to nominate someone to the board; or

(iii) have involvement, other than through voting of shares, in substantive decision-making of the November Pilot Program U.S. Business regarding the use, development, acquisition, or release (disclosure) of critical technology.

Parties to transactions intended to close on or after the November 10, 2018 effective date of the November Pilot Program’s mandatory filing requirement need to consider the impact on closing timing as the Program provides for a 45-day review period during which the transaction may not be consummated (effectively prohibiting a simultaneous sign and close).

The November Pilot Program mandatory filing requirement does not apply to certain other categories of businesses that were identified under FIRRMA as warranting enhanced scrutiny, including certain real estate and bankruptcy transactions, and transactions involving sensitive personal data of U.S. citizens or critical infrastructure. Also, the November Pilot Program applies only to investments, and does not extend to other commercial arrangements that a foreign person may have with a November Pilot Program U.S. Business, such as provision of services, sale of goods, etc. However, additional Pilot Programs may be implemented in the future.

FIRRMA directs the final implementing rules to specify criteria to limit CFIUS' application to investments for certain categories of foreign persons based on "how a foreign person is connected to a foreign country or foreign government, and whether the connection may affect the national security of the United States." Following the November Pilot Program, these final regulations may limit the scope of covered transactions involving investment funds and investors from countries that do not pose a significant national security risk to the U.S. FIRMMA also introduced the "country of special concern" concept, which is a country with a "demonstrated or declared strategic goal of acquiring a type of critical technology or critical infrastructure that would affect United States leadership in areas related to national security." Investors associated with countries of special concern (and investment funds with limited partners associated with countries of special concern, unless the exception for investment funds described below applies) should expect to receive a *higher* level of scrutiny in the review process going forward under FIRRMA.

Considerations for Advisers

Indirect participation by foreign investors in U.S. investments via investments funds has been potentially subject to CFIUS review since its inception, however, the CFIUS updates under FIRRMA increase the likelihood and expand the scope of such reviews. Subject to FIRRMA final regulations, neither indirect participation in a U.S. investment by a "foreign person" via an investment fund as a limited partner (or equivalent), nor representation on a fund advisory board or committee, will be a covered transaction, meaning that such investments would be outside the scope of CFIUS review, provided:

- the fund is managed exclusively by a general partner or managing member that is not a "foreign person" (to be defined by the rules),
- the foreign investor does not have the ability to control the fund's investment decisions, to unilaterally select or remove (or determine the compensation of) its general partner or managing member, or to participate on an advisory board or committee of the fund that has the ability to approve, disapprove or control investment decisions of the fund, or decisions relating to entities in which the fund invests, and
- the foreign investor does not have access to "material nonpublic technical information" regarding the fund's investments and targets.

Importantly, a waiver of a potential conflict of interest, waiver of an investment allocation limitation, or a similar activity, applicable to a transaction pursuant to the terms of an agreement governing an investment fund will not be considered to constitute control of investment decisions of the investment fund or decisions relating to entities in which the investment fund has invested, subject to potential FIRRMA regulations that provide for exceptions in extraordinary circumstances.

Pending FIRRMA's final regulations that define "foreign person", whether an investment fund organized in a non-U.S. jurisdiction is itself a foreign person (including by virtue of its general partner being organized in a non-U.S. jurisdiction and/or one or more of its control persons not being a U.S. national) is a fact-specific analysis.

Other Transactions Subject to Review

Mandatory filings will not be required in the other areas where CFIUS has typically reviewed national security implications of transactions (*e.g.*, banking, telecommunications, and transportation industries). However, under existing law, CFIUS review is not industry specific and transactions in all industries are potentially reviewable nonetheless if they have potential for adverse impact on critical technology or critical infrastructure that would affect United States leadership in areas related to national security. Thus, even if a transaction is not covered by a Pilot Program, it may nevertheless be subject to CFIUS review under both existing law and under the FIRRMA update (*e.g*., a foreign person acquiring (directly or indirectly) a controlling or substantial minority interest in a U.S. business that potentially implicates national security or critical infrastructure). As discussed above, "control" can include the acquisition of minority interests, and even certain lending transactions, further expanding potential CFIUS review.

Anti-Money Laundering

FinCEN Adopts Final Rule on Customer Due Diligence Requirements for Financial Institutions

The Financial Crimes Enforcement Network (FinCEN), a bureau of the U.S. Department of the Treasury, recently implemented its final rule on Customer Due Diligence Requirements for Financial Institutions (the "CDD Rule"). Covered financial institutions (banks, broker-dealers, mutual funds, futures commission merchants, and introducing brokers in commodities) were expected to be in compliance with this Rule by May 11, 2018. In recognition of the fact that risk-based CDD policies are central to a strong Anti-Money Laundering (AML) compliance program, the CDD Rule seeks to assist covered financial institutions in determining when transactions are potentially suspicious.

FinCEN's CDD Rule clarifies, codifies, and bolsters current BSA/AML obligations through the articulation of specific elements of effective customer due diligence. Such elements include: (i) verifying customer identities; (ii) verifying the identities of beneficial account owners; (iii) understanding the nature of customer relationships; and (iv) monitoring risk-based procedures for managing ongoing customer due diligence. Covered financial institutions are expected to implement procedures that enable them to develop customer risk profiles that address concerns about money laundering and terrorist financing risks, as well as to enact policies that provide for updating customer information. Further, the risk-based CDD policies, procedures, and processes that a financial institution pursues should be commensurate with the institution's BSA/AML risk profile.

On April 3, 2018, shortly before the CDD Rule went into effect, FinCEN issued a guidance document, Frequently Asked Questions Regarding Customer Due Diligence Requirements for Financial Institutions, FIN-2018-G00, setting forth information on the CDD Rule in thirty-seven questions and answers. The guidance attempts to respond to a range of situations that might arise with respect to collecting and supplementing customer information. For example, the guidance suggests that financial institutions can adopt internal policies that impose more stringent beneficial ownership requirements than the CDD Rule, which requires financial institutions to collect information on anyone holding 25% or more of the equity interests in a legal entity customer. The guidance also states that financial institutions need not re-verify the identity of a beneficial owner of a legal entity customer if the beneficial owner is an existing customer with information that is confirmed and up-to-date under the Customer Identification Program (CIP).

Even with this guidance, however, it is likely that covered financial institutions will continue to seek additional information from private fund customers as they spend time and resources ensuring compliance with these regulatory requirements and expectations. Additionally, because the CDD Rule is new, continued regulatory scrutiny in this area is anticipated.

As discussed in our 2017 Annual Review, in August 2015, FinCEN proposed a rule that would require registered investment advisers to establish AML programs and report suspicious activity to FinCEN. Although the rule is still under consideration and not binding many advisers may wish to incorporate CDD policies into their AML programs to comport with best practices.

SEC Charges Brokerage Firms and AML Officer with AML Violations

On May 16, 2018, the SEC announced it had settled charges against broker-dealers Chardan Capital Markets LLC and Industrial and Commercial Bank of China Financial Services LLC (ICBCFS) for failing to report the suspicious sales of billions of penny stock shares. Stressing the importance of AML obligations and the role of brokerage firms as "gatekeepers to the securities markets," the SEC declared Chardan's and ICSCFS's failure to file Suspicious Activity Reports (SARs) "unacceptable," particularly given the numerous red flags raised by the sales.

Broker-dealers must file SARs for transactions believed to involve fraud or with no apparent lawful purpose. In this case, Chardan, an introducing broker, liquidated more than 12.5 billion penny stock shares for seven of its customers between October 2013 and June 2014. ICBCFS cleared the transactions. Although the transactions raised red flags, including similar trading patterns and sales in issuers who lacked revenues and products, Chardan failed to file any SARs. Similarly, ICBCFS failed to file any SARs despite prohibiting trading in penny stocks for some of the seven customers.

The SEC ultimately found that Chardan and ICBCFS had violated Section 17(a) of the Exchange Act and an SEC financial recordkeeping and reporting rule and also charged Chardan's Anti-Money Laundering (AML) Officer with aiding, abetting and causing his firm's violations.

In total, the accused parties paid fines to the SEC and FINRA amounting to over $7,000,000. These charges reiterate the SEC's and FINRA's continued focus on broker-dealers and their efforts to comply with AML obligations.

SEC & FINRA Fine Broker-Dealer for Failing to File Suspicious Activity Reports

Earlier this year, the SEC and FINRA accused Aegis Capital Corporation, a New-York-based brokerage firm, of failing to file SARs on transactions that appeared to be related to the market manipulation of low-priced securities. FINRA found that Aegis' supervisory system for trading in delivery versus payment (DVP) accounts was inadequate. Because Aegis failed to monitor or investigate trading in seven DVP customer accounts, the accounts were able to liquidate billions of shares of low-priced securities, which generated millions of dollars in proceeds for the customers. Further, several of the customers were foreign financial institutions that carried out transactions on behalf of underlying customers—none of whom were known to Aegis.

Aegis did not identify these trades as suspicious even though its clearing firm alerted Aegis to AML red flags, and Aegis failed to implement an adequate AML program that would have detected such red flags. Accordingly, on March 28, 2018, the SEC entered an order concluding that Aegis had failed to meet its AML obligations with respect to reporting suspicious activity. The SEC stressed the importance of brokerage firms complying with their SAR reporting obligations.

In a separate order, the SEC concluded that Aegis' former AML Compliance Officer aided and abetted the firm's violations, while Aegis's CEO caused the violations.

This activity in connection with Aegis, as well as in the Chardan and ICBCFS matter mentioned above, suggest that SEC and FINRA enforcement is trending toward a focus on SAR failings. Firms can mitigate the risk of SEC or FINRA action for AML failures by taking care to ensure that their AML programs are robust and emphasize the collection of information about customer identities and reporting of suspicious transactions.

In late 2017 and 2018, the Cayman Islands updated and consolidated a number of its anti-money laundering and countering of terrorist financing laws. This included a clarification that all financial services providers are required to appoint a natural person as an Anti-Money Laundering Compliance Officer, Money Laundering Reporting Officer and Deputy MLRO.

Cybersecurity and Privacy Law

CFTC Orders FCM to Pay $100,000 for Cybersecurity Supervision Failures

In February 2018, the CFTC filed and simultaneously settled charges against a registered futures commission merchant (FCM), AMP Global Clearing LLC (AMP), for its alleged failure to supervise diligently its information technology provider's implementation of critical provisions in its information systems security program (ISSP). The alleged failure to supervise the implementation of those provisions of the ISSP left unprotected for almost ten months a significant amount of AMP's customers' records and information, according to the CFTC, leading to the compromise of data via a network vulnerability related to a storage device (Device).

According to the charges, the IT provider failed to identify the defect and erroneously informed AMP in quarterly network risk assessments that there were no network security abnormalities or concerns, despite reports in the media and cybersecurity-related websites of incidents of unauthorized access to sensitive information stored on devices manufactured by the Device manufacturer. An unauthorized third party that was not affiliated with AMP learned of AMP's network vulnerabilities and copied 97,000 files from the Device, including customers' records and personally identifiable information.

The CFTC found that AMP's failure to supervise its IT provider's implementation of its ISSP and resulting failure to secure its customers' records and information violated Regulation 166.3, 17 C.F.R. § 166.3 (2017). Regulation 166.3 requires FCMs to "diligently supervise the handling by its partners, officers, employees and agents" of all activities relating to its business as an FCM, which is an affirmative duty to supervise employees and agents diligently by establishing and executing an adequate supervisory structure and compliance program. The Regulation is violated by either (1) an FCM's supervisory system being generally inadequate or (2) the FCM failing to perform its supervisory duties diligently. According to the CFTC's order, an FCM can delegate the performance of its ISSP's technical provisions, but it must still diligently supervise its IT provider's handling of all activities relating to the FCM's business as an FCM registrant. The order explained that, as Regulation 160.30 requires an FCM to adopt policies and procedures to protect customer records and information, the FCM's duty under Regulation 166.3 requires that the FCM diligently supervise how those policies and procedures are implemented and how the customer records and information are electronically protected. The settlement required AMP to pay a civil penalty of $100,000 and cease and desist from violating the regulation. AMP was also required to provide written follow-up reports to verify its ongoing efforts to strengthen the security of its network and its compliance with its ISSP's requirements.

SEC Charges Broker-Dealer and Adviser with Violations of the Safeguards Rule and Identity Theft Red Flags Rule

In September 2018, the SEC announced that broker-dealer and adviser Voya Financial Advisors Inc. (VFA) agreed to pay $1,000,000 to settle charges related to alleged failures in its cybersecurity policies and procedures relating to a data breach that compromised the personal information of 5,600 customers.

The SEC charged VFA with violating Rule 30(a) of Regulation S-P (17 C.F.R. § 248.30(a)) (the "Safeguards Rule") and Rule 201 of Regulation S-ID (17 C.F.R. § 248.201) (the "Identity Theft Red Flags Rule"). This charge against VFA is the first SEC enforcement action charging violations of the Identity Theft Red Flags Rule.

In 2016, cyber intruders impersonated VFA contractors by calling VFA's support line and requesting the contractors' passwords be reset. The intruders then used these passwords to gain access to the personal identifiable information (PII) of at least 5,600 VFA customers and subsequently created new online customer profiles and obtained unauthorized access to account documents for three customers. According to the SEC's order, VFA's failure to terminate the intruders' access was a result of weaknesses in VFA's cybersecurity procedures, some of which VFA knew of from prior similar fraudulent activity. The order also notes that VFA failed to apply its procedures to the systems used by independent contractors.

The SEC found that VFA willfully violated the Safeguards Rule, which requires broker-dealers and investment advisers to adopt written policies and procedures that are reasonably designed to safeguard customer records and information. During the relevant period, while VFA employees generally used IT equipment and IT systems provided by its parent company Voya, VFA contractors generally used their own IT equipment and operated over their own networks. VFA contractors accessed customer information through a proprietary web portal (VPro). The contractors could log in with a username and password to gain access to certain web applications that contained sensitive information relating to VFA customers. VFA outsourced most of its cybersecurity functions and some of its information technology functions to Voya, which was responsible for responding to contractors' requests for assistance with respect to the web applications.

Over a dozen Voya policies and procedures relating to cybersecurity were supposed to govern the conduct of VFA, including:

- manual account lock-outs for a user suspected of being involved in a security incident from web applications containing critical data, including customer PII;
- a session timeout after fifteen minutes of user inactivity in web applications containing customer PII;
- a prohibition of concurrent web sessions by a single user in web applications containing customer PII;
- multi-factor authentication ("MFA") for access to applications containing customer PII;
- annual and ad-hoc review of cybersecurity policies; and
- cybersecurity awareness training and updates for VFA employees and contractors.

The SEC found that these policies were not reasonably designed to apply to the systems that independent contractors used. Specifically, the SEC found that the following VFA policies and procedures were not reasonably designed to safeguard customer records and information: (1) resetting contractors' passwords; (2) terminating web sessions in its proprietary gateway system for VFA contractors; (3) identifying higher-risk representatives and customer accounts for additional security measures; and (4) creation and alteration of customer profiles.

The SEC also found that VFA willfully violated the Identity Theft Red Flags Rule, which requires registered broker-dealers and investment advisers that offer or maintain covered accounts to develop and implement a written Identity Theft Prevention Program that is designed to detect, prevent, and mitigate identity theft in connection with the opening of a covered account or any existing covered account. Although VFA adopted a written Identity Theft Prevention Program in 2009, the SEC found that VFA violated the Identity Theft Red Flags Rule because it had not reviewed or updated the program in response to changes to risks to its customers and did not provide adequate training to its employees. Additionally, the program did not include reasonable policies and procedures to respond to identity theft red flags, including those detected by VFA during the 2016 breach.

As part of the settlement, VFA agreed to retain, and cooperate fully with, a compliance consultant to review all of its policies and procedures for compliance with Regulation S-P and Regulation S-ID. The settlement also requires VFA to pay a civil penalty of $1,000,000 and cease and desist from violating Regulation S-P and Regulation S-ID.

GDPR Update

The General Data Protection Regulation (the GDPR) came into force across each EU Member State on May 25, 2018. Many of the requirements under the GDPR are similar to those set out in earlier EU legislation on data protection. However, there are certain key differences arising from the GDPR that all those within its scope are required to comply with.

What Does the GDPR Do?

The GDPR implemented more stringent operational requirements for processors and controllers of personal data, including, for example, expanded disclosures about how personal information is to be used, limitations on retention of personal data, increased requirements to delete or hand over an individual's information upon request, mandatory data breach notification requirements, requirements to maintain records of data processing activities and transfers of personal data, and higher standards for data controllers to demonstrate that they have obtained valid consent for certain data processing activities.

- "Processors" are those organizations or persons who process the personal data at the behest of the controller and in accordance with their instructions. They do not decide what happens to the personal data. Processing is defined broadly and encompasses most kinds of actions carried out with respect to the data (including obtaining, recording or holding the data, or carrying out any operation or set of operations on the data, or deleting, transferring or disclosing the data).
- "Controllers" are those organizations or persons who control personal data – they determine the purposes for which the personal data is processed and decide what is done with it.

The personal data that advisers should consider include both employee and investor/client/customer data. Personal data is data relating to a living individual (whether or not they are an EU citizen) (referred to as a "data subject" in the GDPR) who can be identified from that data (or from that data and other information in the business's possession). Personal data can include an individual's business email address and contact details. Personal data may be found in employment agreements, limited liability company or limited partnership agreements, carried interest documentation, elections under section 431 of Income Tax (Earnings and Pensions) Act 2003 (so-called s.431 elections), know your customer (KYC) and related anti-money laundering information, subscription agreements and, potentially, side letters.

Depending on the particular fund structure employed, a private fund's general partner, adviser and/or administrator (as applicable) would likely be considered a controller of personal data of investors. It is also likely that the general partner or adviser (as appropriate) would, in the ordinary course of business, engage third-party processors of personal data such as fund administrators, payroll firms, stock distribution agents, accountants, lawyers or companies engaged to dispose of confidential information.

Who Does the GDPR Apply To?

Broadly, the GDPR applies to controllers and processors based in the EU as well as controllers and processors not based in the EU where the activities that the controllers or processors carry out are either (i) offering goods or services in the EU, and/or (ii) monitoring data subjects' EU activities (*e.g.*, the tracking of individuals online to create profiles, including where this is used to make decisions to analyse/predict personal preferences, behaviours, attitudes, etc.). This change from the previous data protection legislation significantly increases the extra-territorial reach of prior European data privacy legislation. If a controller or processor does not have a base in the EU but the GDPR applies to them then they may need to appoint a representative in the EU.

Why Does the GDPR Matter?

The GDPR significantly increases penalties for non-compliance, with fines for non-compliance of up to the greater of EUR 20 million or 4% of worldwide annual turnover. If a company's privacy or data security measures fail to comply with the GDPR, the company may be subject to actions taken by the relevant EU data supervisory authority, which may lead to enforcement orders, fines or other liabilities; equally, actions brought by individuals against non-compliant firms may lead to claims for damages. The UK's data supervisory authority is already taking a more proactive approach and issuing increased fines, generally in relation to direct marketing and data breaches.

Some of the key changes in the GDPR include:

Breach Notification:

- A data breach consists of "accidental or unlawful destruction, loss, alteration, unauthorised disclosure of, or access to, personal data transmitted, stored or otherwise processed."
- Data controllers are required to notify the applicable data supervisory authority of certain data breaches without undue delay and, where possible, within seventy-two hours of awareness. A reasoned justification must be provided if this deadline is not satisfied.
- Data controllers may also be required to notify data subjects if the breach is likely to result in a "high risk" to the rights and freedoms of individuals. The notification should be without undue delay. A data supervisory authority may also require a data controller to notify the data subject.

Consent:

- Under the GDPR, there are more detailed conditions for using consent to enable data processing. Namely, consent must be "*freely given, specific, informed, and unambiguous*." In cases of sensitive personal data it must also be "explicit."
- The new requirements will make consent more difficult to rely upon as a valid basis for processing and transferring data. Other lawful bases to process personal data may be relied upon if possible, *e.g.*, as part of the performance of a contract with the data subject, to comply with EU law, or for relevant legitimate interests.

Data Subject Rights:

- Data subjects now have expanded rights that include the right to port personal data between service providers (known as data portability) and the right to object to automated decision-making.
- Protocols for dealing with data subject complaints/objections/requests for rectification and erasure as well as to access data (*i.e.*, subject access requests) have also been updated.

What would bring Non-EU fund advisers within the scope of the GDPR?

- If the non-EU fund adviser has an establishment in the EU, then that establishment would be subject to the GDPR, as it will process personal data.
- If a non-EU fund adviser does not have an establishment in the EU, but either (i) offers goods or services in the EU (such as interests in the fund manager's investment funds), or (ii) monitors a data subject's EU behaviour, then the non-EU fund adviser may be subject to the GDPR and its attendant operational requirements as discussed earlier.

What are the next steps fund advisers should be taking to prepare for the GDPR?

EU fund advisers, as well as non-EU fund advisers which are brought within the scope of the GDPR, have to meet the full requirements of the GDPR applicable to them. Advisers should therefore carry out an analysis of how GDPR might apply to their business. This would include carrying out a data mapping exercise and then putting in place appropriate documents and contractual provisions with respect to any personal data, including employee and client data that the manager processes.

U.S. Tax

Comprehensive Tax Reform

On December 22, 2017, President Trump signed a comprehensive U.S. tax bill into law. Unofficially known as the Tax Cuts and Jobs Act (TCJA), the bill introduced a number of significant reforms and additions to the U.S. tax code. Most provisions were effective as of January 1, 2018. However, many of the provisions affecting individuals are scheduled to expire on December 31, 2025, making long-term planning under the new rules complex. The following summary covers the most recent updates to select provisions affecting advisers and the private funds industry.

Selected General Provisions

Carried Interest

The TCJA includes a provision that taxes carried interest attributable to the gains from the sale of capital assets held for three years or less as short-term capital gains. The provision also applies to the sale or redemption of a carried interest that has not been held for more than three years. The provision appears to have no impact on carried interest attributable to qualified dividend income, section 1231 gains or income from section 1256 contracts.

The provision does not apply to carried interests held directly or indirectly by a corporation. Taxpayers considered holding carried interests through S corporations to take advantage of this exception. In response, on March 1, 2018 the IRS issued Notice 2018-18 (link: https://www.irs.gov/pub/irs-drop/n-18-18.pdf), which provides that the exception for corporations does not apply to S-corporations, shutting down this potential loophole. However, the exception for corporations seems to apply to foreign corporations. This means that if a carried interest recipient is organized as a foreign corporation that is a passive foreign investment company (but not a controlled foreign corporation (CFC) (see discussion of CFCs below)), its owners could elect to treat the corporation as a qualified electing fund and continue to obtain the benefit of long-term capital gains rates with respect to investments held for more than one year even if the three-year holding period is not met.

The three-year holding period requirement also does not apply to any capital interest in a partnership which provides the taxpayer with the right to share in partnership capital commensurate with (i) the amount of capital contributed (determined at the time of receipt of such partnership interest), or (ii) the value of such interest is subject to tax under section 83 upon the receipt or vesting of such interest. The provision is drafted in manner that leaves its scope unclear.

Because the provision does not provide grandfathering for existing carried interest arrangements, hedge fund general partners that have been allocated carried interest attributable to investments where the gain has not been realized for tax purposes, and such amounts remain invested in the fund through their general partner interests, are potentially subject to this new rule. This generally would have been an issue for general partners of hedge funds who did not reinvest such amounts through limited partner interests on an annual basis.

The provision also states that transfers of applicable partnership interests to certain related persons may result in short term capital gain. The scope of this section is also unclear.

21% Permanent Corporate Tax Rate

The TCJA reduced the corporate tax rate from 35% to 21% beginning in 2018. The corporate AMT has been repealed.

20% Income Deduction for Pass-through Entities

The TCJA allows individuals and some trusts and estates a deduction of up to 20% of their income from a qualified trade or business that is operated as a sole proprietorship, or through a partnership, S corporation, trust or estate. The deduction results in a maximum effective rate of 29.6% on an individual's "qualified business income" (QBI) that is effectively connected with a trade or business in the United States. For taxpayers with income above a threshold amount, $315,000 for joint filers and above $157,500 for other filers, the deduction with respect to income from a specified service, trade or business (SSTB) phases out, and is excluded completely for joint filers with income above $415,000 and above $207,500 for other filers. The deduction for taxpayers with income above the threshold amount is also limited based on the amount of the W-2 wages paid with respect to the trade or business and unadjusted basis immediately after the acquisition of qualified property used in the trade or business.

An SSTB is defined as any trade or business in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing, investment management, or trading or dealing in securities, or any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners. Proposed regulations narrow the scope of "reputation or skills" to: (a) receiving income for endorsing products or services; (b) licensing or receiving income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity; or (c) receiving appearances fees or income. The proposed regulations also clarify that taxpayers will not be allowed to separate out parts of an integrated SSTB in order to qualify the separated part for the deduction. This strategy, known as "crack and pack," consists of separating the portions of a business that produce qualifying income from the portions that do not in order to take some advantage of the deduction.

Individuals and some trusts and estates are allowed to deduct up to 20% of their combined qualified real estate investment trust (REIT) dividends (*i.e*., dividends not designated by the REIT as capital gain dividends or qualified dividend income) and "qualified publicly traded partnership (PTP) income," including the qualified REIT dividends and qualified PTP income earned from pass-through entities.

If a taxpayer's total QBI amount is less than zero, then the negative number will be treated as a loss in the next succeeding taxable year for purposes of the deduction. Similarly, if the combined qualified REIT dividends and qualified PTP income is less than zero, then the loss must be carried forward and can offset the combined qualified REIT dividends and qualified PTP income in the next succeeding taxable year.

The provision applies to taxable years ending on or before December 31, 2025 (link to client alert.)

No Changes to Self-Employment Tax

The House version of the tax reform bill eliminated the "limited partner exception" to self-employment tax, such that any partner in an entity treated as a partnership for U.S. tax purposes could have had net earnings from self-employment, regardless of the individual's status as a limited partner of the partnership. The TCJA did not adopt the proposed exception.

Limitation on Business Interest Deductions

Former section 163(j) (providing for limitations on deductibility of interest payments in certain "earnings stripping" transactions) was repealed and replaced. New section 163(j) limits the deductibility of business interest to 30% of adjusted taxable income, as specifically adjusted to approximate earnings before interest, tax, depreciation and amortization (EBITDA) for tax years through 2021. Beginning in 2022, taxable income adjustments will exclude depreciation and amortization (EBIT). Section 163(j) does not apply to "investment interest" and also provides an exclusion for businesses with adjusted gross receipts of $25 million or less. Additionally, real property development, construction, acquisition, conversion, rental property management or similar companies may elect out of this limitation. However, businesses that elect out of the limitation are required to use a slower depreciation method for real property and certain improvements thereon, and any portion of such property that otherwise would be eligible for immediate expensing would no longer qualify for this tax benefit.

Section 163(j) could limit the benefits of using leveraged blockers in a fund's investment structure (other than in the case of debt funds that should be able to offset such interest expense against interest income received). Excluded interest deductions are permitted to be carried forward indefinitely (subject to the application of any limitation under section 382).

In the case of partnerships, the limitation on interest deductions is determined at the partnership level. If a partnership has business interest that is less than the permitted deduction amount for a taxable year (less than 30% of the partnership's adjusted taxable income), the "excess taxable income" is allocated to the partners. To the extent a partnership has business interest that is greater than the permitted deduction amount for a taxable year, the excess is not carried forward by the partnership but, instead, is allocated to each partner as "excess business interest." The partner may deduct its share of the partnership's excess business interest in any future year, but only against excess taxable income allocated to the partner by such partnership. Any excess business interest allocated to a partner immediately reduces the partner's basis in its partnership interest; however, any amounts that remain unused upon disposition of the partnership interest (including pursuant to a nonrecognition transaction) are restored to basis immediately prior to disposition.

Limitation on Use of Net Operating Losses:

For net operating losses (NOLs) arising in taxable years beginning in 2018 and later, deductions for NOLs are limited to 80% of taxable income. Any NOLs can be carried forward indefinitely to future tax years, rather than expiring after 20 years, as was the case prior to the TCJA. Carrybacks are now disallowed; however, NOLs incurred before taxable years ending in 2018 are governed by the old rules.

Excess Business Losses

For taxable years before January 1, 2026, deductions for "excess business losses" of noncorporate taxpayers for a taxable year are not permitted. Rather, these losses will be treated as NOLs and carried forward into subsequent tax years. An "excess business loss" is defined as the excess of a taxpayer's aggregate deductions attributable to trades or businesses of the taxpayer, over the sum of (1) the taxpayer's aggregate gross income and (2) a threshold amount ($250,000 for single filers and $500,000 for joint return filers, indexed for inflation). In the case of a pass-through entity, the determination of whether a net business loss exceeds the threshold amount is made at the individual partner or shareholder level. This new limitation applies in addition to the other existing loss limitation rules, including the at-risk rules and the passive activity rules. In calculating the allowable losses from any activity, taxpayers must apply the at-risk rules first, then the passive activity rules, and finally the new excess business loss rules.

International Tax Provisions

Changes to the Determination of Controlled Foreign Corporation

For taxable years beginning after December 31, 2017, a foreign corporation is classified as a CFC if U.S. persons that own at least 10% of the voting power or the value of the foreign corporation (U.S. Shareholders) own in aggregate more than 50% of the voting power or value of the foreign corporation. Prior to the TCJA, only U.S. persons owning at least 10% of the voting power of the foreign corporation were included in the 50% vote or value calculation. Furthermore, U.S. Shareholders had to own more than 50% of the foreign corporation for thirty continuous days during the year for the corporation to be classified as a CFC. The 30-day safe harbor has been repealed and CFC status is CFC tested every day of the year.

Prior to the enactment of the TCJA, the tax code contained a limitation on inbound attribution of stock for purposes of determining whether a foreign corporation is a CFC. Effective retroactively to a foreign corporation's last taxable year beginning before January 1, 2018 and each subsequent taxable year, the limitation on inbound attribution has been repealed and now downward attribution from a non-U.S. person applies. This broader attribution rule also applies to taxable years of U.S. Shareholders in which or with which the taxable years of those foreign corporations end.

Apart from significantly increasing the number of foreign corporations that will now be CFCs, this change may cause some inbound financing structures to fail to qualify for the portfolio interest exemption from withholding on interest because interest payments received by a CFC from a related person are excluded from the portfolio interest exemption.

Global Intangible Low-Taxed Income (GILTI)

Under these new rules, a U.S. Shareholder of a CFC is required to include in income its share of the CFC's GILTI in a manner similar to subpart F income. GILTI is described as a foreign subsidiary's earnings (excluding its subpart F income and certain other income items) in excess of 10% of allocable depreciable tangible property basis (reduced by certain related interest expense). A U.S. Shareholder must include this amount in income on a current basis, whether or not corresponding cash distributions are made by the CFC. The actual distribution of such earnings is then tax-free.

The effective tax rate on such income for a corporate U.S. Shareholder is 10.5% (through a 50% deduction, assuming no underlying foreign income taxes paid on such income) for taxable years beginning after December 31, 2017 and before January 1, 2026. Because of the interplay of revised foreign tax credit rules, the minimum foreign tax rate, at which no U.S. income tax would be due on such income, is 13.125%. The effective tax rate increases to 13.125% (through a reduction of the deduction to 37.5%, assuming no underlying foreign income taxes paid on such income) for taxable years beginning after December 31, 2025. Similarly, because of the interplay of the revised foreign tax credit rules, the minimum foreign tax rate, at which no U.S. income tax would be due on such income for such years, is 16.406%.

Because the GILTI rules apply to CFCs, U.S. Shareholders who are individuals can also have a GILTI inclusion. However, unlike U.S. corporate shareholders, the GILTI deduction will not be available to them and, therefore, they will be subject to regular U.S. federal income tax at a top rate of 37% on their GILTI inclusion. Further, a U.S. individual who invests in a CFC through a U.S. partnership or S corporation can have a GILTI inclusion through the partnership or S corporation notwithstanding that the individual's indirect ownership of the CFC is less than 10%.

An election is available to individuals (but not partnerships) that are U.S. Shareholders for their GILTI and other subpart F inclusions, to be taxed at the corporate tax rate and reduced by applicable foreign tax credits. Although corporate U.S. Shareholders may deduct 50% of their GILTI inclusions, it is not clear whether this deduction is available to individuals making the election to be taxed at the corporate rate. Even if an individual elects to be taxed at the corporate rate on GILTI and other subpart F inclusions, the dividends received from the CFC are not taxed as qualified dividend income. Making such an election may, under certain circumstances, result in a lower effective tax rate for an individual with respect to GILTI and subpart F inclusions than without such election.

Deduction for Foreign Derived Intangible Income

For tax years beginning after December 21, 2017 and before January 1, 2026, the TCJA allows a U.S. corporation to deduct up to 37.5% of its "foreign-derived intangible income" (FDII). Beginning in 2026, the deduction percentage is reduced to 21.875%. The deduction for FDII is limited when a corporation's GILTI inclusion and FDII exceed its taxable income, determined without regard to GILTI and FDII deductions. The deduction is not available for S- corporations or domestic corporations that are RICs or REITs. The rules for determining the amount of a U.S. corporation's FDII are complex. Generally, a domestic corporation is subject to the standard 21% tax rate to the extent of a fixed 10% return on depreciable assets and a 13.125% (increased to 16.406% as of 2026) tax rate on any excess return that is attributable to exports of goods or services.

Participation Exemption

The foreign-source portion of dividends paid by a foreign corporation to a U.S. corporate shareholder that owns 10% or more of the foreign corporation is exempt from taxation. No foreign tax credit or deduction is permitted for any exempt dividend, and no deductions for expenses allocable to the exempt dividend are taken into account for purposes of determining the U.S. corporate shareholder's foreign-source income.

Excise Tax on Payments by a Domestic Corporation to Certain Related Foreign Corporations

To manage the "erosion" of the U.S. tax base through payments by U.S. corporations to foreign affiliates giving rise to U.S. deductions, the TCJA also adds a base erosion anti-abuse minimum tax (the BEAT). The BEAT applies to "base erosion payments" made or accrued in taxable years beginning after December 31, 2017 by U.S. corporations with average annual gross receipts of at least $500 million over the prior three-year period (aggregating related U.S. corporations and certain foreign subsidiaries) and a "base erosion percentage" generally of three percent or more.

The BEAT is an add-on minimum tax and is due in any year in which it exceeds the U.S. corporation's regular tax liability. The BEAT base is equal to the sum of the corporation's regular tax base and in general payments by the corporation to foreign affiliates that give rise to U.S. tax deductions. The BEAT rate is five percent for a taxable year beginning in 2018, 10% for taxable years beginning after December 31, 2018 and before January 1, 2026, and 12.5% for taxable years beginning after 2025.

Treatment of Offshore Insurance Companies as PFICs

A foreign insurance company is now treated as a PFIC unless the foreign company would be taxed as an insurance company were it a U.S. corporation and if its loss and loss adjustment expenses, unearned premiums, and certain reserves constitute more than 25% of the foreign corporation's total assets (or 10% if the corporation is predominately engaged in an insurance business and the reason for falling below the 25% threshold is solely due to temporary circumstances). Because of the changes to the definition of U.S. Shareholder, as described above under "Changes to the Determination of a Controlled Foreign Corporation," offshore insurance companies are now more likely to be classified as CFCs.

Limitations on the Deductibility of Certain Related-Party Amounts Paid or Accrued in Hybrid Transactions or With Hybrid Entities

Effective for tax years beginning after December 31, 2017, a new provision disallows a deduction for any disqualified related-party amount paid or accrued pursuant to a hybrid transaction, or by, or to, a hybrid entity. A disqualified related-party amount is any interest or royalty paid or accrued to a related party if (i) there is no corresponding income inclusion to the related party under local tax law or (ii) such related party is allowed a deduction with respect to the payment under local tax law. A disqualified related-party amount does not include any payment to the extent such payment is included in the gross income of a U.S. shareholder under subpart F.

A hybrid transaction is any transaction, series of transactions, agreement, or instrument under which one or more payments are treated as interest or royalties for U.S. federal income tax purposes but are not so treated for purposes of the tax law of the foreign country of which the entity is resident or is subject to tax. A hybrid entity is one that is treated as fiscally transparent for U.S. federal income tax purposes, such as a disregarded entity or partnership, but not for purposes of the foreign country of which the entity is resident or is subject to tax (hybrid entity), or an entity that is treated as fiscally transparent for foreign tax law purposes but not for U.S. federal income tax purposes (reverse hybrid entity). The new provision provides the Secretary of the Treasury Department authority to issue regulations or other guidance to carry out the purposes of the provision.

Denial of Deduction for Entertainment Expenses

The TCJA repeals the exception to the deduction disallowance for entertainment, amusement or recreation that is directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business (and the related rule applying a 50% limit to such deduction). Consequently, taxpayers may no longer be able to take deductions for costs such as tickets to sporting events purchased to entertain clients or other business prospects.

Taxpayers still may generally deduct 50% of the food and beverage expenses associated with operating their trade or business (*e.g.*, meals consumed by employees during work travel). On October 3, 2018, IRS issued Notice 2018-76 (link), which provides guidance for the deductibility of business meals as business expenses. Business meal expenses continue to be 50% deductible, including meals purchased in the same transaction as non-deductible entertainment expenses so long as the food and beverages are listed separately on the receipt or invoice. The Notice allows taxpayers to deduct 50% of an otherwise allowable business meal expense so long as: (1) the expense is ordinary, necessary, and paid or incurred in the carrying on of any trade or business during the taxable year; (2) the expense is not lavish or extravagant under the circumstances; (3) the taxpayer or its employee is present at the furnishing of the meal; (4) the meal is provided to a current or potential business customer, client, consultant, or similar business contact; and (5) if provided at an entertainment activity, either (a) the food and beverages are purchased separately from the entertainment or (b) the food and beverages' cost is stated separately from the entertainment costs on the bill, invoice or receipt.

The TCJA also expands this 50% limitation on the deduction to expenses of the employer associated with providing food and beverages to employees through an eating facility that meets requirements for *de minimis* fringe benefits and for the convenience of the employer; however, this deduction will be disallowed entirely in tax years beginning after December 31, 2025.

Elimination of Deductibility of Management Fees

The deductibility of certain investment expenses such as management fees is suspended until January 1, 2026. These expenses were formerly deductible as miscellaneous itemized expenses (subject to a 2% adjusted gross income floor and other limitations). However, investors in any fund that is classified as a "trader" for U.S. federal income tax purposes will still be allowed a deduction for these expenses.

Individual Tax Rates

For tax years beginning after December 31, 2017 and before January 1, 2026, the top marginal income tax rate for individuals is 37%.

Limit on Deduction of State and Local Income and Property Taxes up to $10,000

The individual deduction for state and local income taxes and property taxes is now limited to $10,000 for taxes that are not incurred in connection with a trade or business. State and local taxes incurred in connection with a trade or business continue to be fully deductible. The denial of a federal deduction for state and local income taxes is expected to have the greatest impact on individuals living in high-tax states, like New York, California and New Jersey.

Several states have enacted or proposed legislation that may benefit taxpayers by helping to mitigate the impact of the $10,000 limit. In response to some of these proposals, the IRS announced, in Notice 2018-54 (link: https://www.irs.gov/pub/irs-drop/n-18-54.pdf) that it intends to propose regulations to disallow the use of such state-level workarounds for the state and local deduction limitation. The Notice specifically addresses proposals that allow taxpayers to receive state and local tax credits for certain transfers to funds controlled by state or local governments; however, it is likely that, with time, the federal government will work to disallow additional workarounds for the state and local deduction limitation (link to client alert: https://www.law360.com/articles/1067350/states-responding-to-salt-cap-carried-interest-provisions).

Deferral of Income Recognition for Certain Stock Options or Restricted Stock Units

The TCJA enacted new section 83(i), which provides that certain employees who receive stock options or stock-settled restricted stock units as compensation for the performance of services may elect to defer recognition of income, subject to certain conditions, generally until the date that is five years after the date such options or units vest, provided the corporation's stock is not publicly traded. The 83(i) election must be made within 30 days of the employee's right to the stock becoming substantially vested or transferable, whichever is earlier, and would be made in a manner similar to an election under section 83(b). If an election is made to defer under section 83(i), income will be recognized in the year that includes the earliest of (i) the qualified stock becoming transferable (including to the company), (ii) when the employee becomes an "excluded employee," (iii) the stock becoming readily tradable on an established securities market, (iv) five years after rights in the stock are first transferable or are no longer subject to substantial risk of forfeiture, whichever is earlier, or (v) when the election is revoked. The amount of income recognized at the end of the deferral period is based on the value of the stock on the original exercise or settlement date, even if the value declines (or increases) during the deferral period. The company's tax deduction will be in the same amount, but will also be delayed until the year of the employee's income inclusion.

Accrued Market Discount is Not Includable in Income Under Section 451(b)

Notice 2018-80 (link), issued September 27, 2018, provides that the IRS intends to issue proposed regulations confirming that taxpayers may continue to defer including market discount income in income for tax purposes until there is a payment or sale at a gain. The proposed regulations will provide that Section 451(b), which generally requires the recognition of income for tax purposes no later than when it must be recognized as revenue for financial accounting purposes, will not apply to market discount income. Accordingly, even though market discount may have to be included in income currently as it accrues for financial accounting purposes, taxpayers may defer the income for tax purposes. The Notice further provides that the guidance will apply as of the same date Section 451(b) became effective, January 1, 2018.

Tax-Exempt Organizations

Tax Exempt Organizations Required to Compute Unrelated Business Taxable Income Separately for Each Unrelated Trade or Business

For taxable years beginning after December 31, 2017, unrelated business taxable income (UBTI) must be computed separately with respect to each unrelated trade or business, and the UBTI as separately computed for each trade or business cannot be less than zero for any such trade or business. As a result, tax-exempt organizations can no longer use losses or expenses from one unrelated trade or business to offset gains or income from another unrelated trade or business.

The statute itself does not specify how to identify separate unrelated trades or businesses. To address some of the issues arising under the new provision, the IRS issued Notice 2018-67 (link) on August 21, 2018. The Notice provides that tax-exempt organizations can rely on a reasonable, good-faith interpretation of Sections 511 through 514 of the Code and should consider all "facts and circumstances" when determining separate unrelated businesses (although the Notice acknowledges that further guidance requires a "more administrable method.") The Notice provides that the North American Industry Classification System (NAICS) six-digit codes may be used to make such determination until regulations are published.

The Notice provides a special rule that allows tax-exempt organizations to treat all "qualifying partnership interests" as a single trade or business. For these purposes, a partnership interest is a qualifying partnership interest if the tax-exempt organization (and its disqualified persons, supporting organizations, and controlled entities) either (1) directly holds no more than 2% of the profits and capital of the partnership or (2) directly holds no more than 20% of the capital of the partnership and lacks "control or influence" over the partnership (the 2 or 20 Test). For purposes of determining ownership of partnership capital and/or profits under the 2 or 20 Test, the ownership percentage is based on an average of the tax-exempt organization's ownership of the partnership at the beginning and end of the partnership's tax year (or the tax-exempt organization's ownership of the partnership at the beginning and end of the ownership period in the applicable year, where the tax-exempt organization does not hold an interest in the partnership for the entire year). In determining the existence of "control or influence," all facts and circumstances are relevant.

Please see our August 30, 2018 blog post for more information.

Imposition of Excise Tax on Certain Private Colleges and Universities

A 1.4% excise tax is now imposed on the annual net investment income of private institutions of higher education owning assets with an aggregate fair market value of at least $500,000 per student (other than those assets which are used directly in carrying out the institution's exempt purpose) with a student population of at least 500 students (more than 50% of whom are located in the United States), and on related tax-exempt organizations. This provision effectively parallels the existing excise tax on the net investment income of private foundations.

Please see link.

Withholding Required for Gain on Sale by Non-U.S. Partner of Interest in ECI-Generating Partnership

In *Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3, July 13, 2017 (link), the Tax Court held that any gain from the redemption by a non-U.S. taxpayer of its direct or indirect interests in any "partnership engaged in a U.S. trade or business" (U.S. Operating Flow-through Entity), generally should not be subject to U.S. federal income tax as income effectively connected with the conduct of a U.S. trade or business (ECI) unless the proceeds are attributable to the disposition of U.S. real property interests. This conclusion was in opposition to the position taken by the IRS in Revenue Ruling 91-32, which holds that a non-U.S. partner's gain on the sale or taxable exchange of its interest in a U.S. Operating Flow-through Entity is ECI and subject to U.S. federal income tax to the extent attributable to property of the entity that is used or held for use in the entity's U.S. trade or business.

The TCJA essentially codifies Revenue Ruling 91-32, requiring non-U.S. partners to recognize ECI gain or loss on the disposition of a U.S. Operating Flow-through Entity on or after November 27, 2017. The determination of ECI gain or loss is based on a hypothetical liquidation of the partnership's assets (through all lower-tier partnerships, including ECI-generating flow-through operating companies) as of the date of disposition. Effective for dispositions after December 31, 2017, buyers are required to withhold 10% of the amount realized on the disposition by a non-U.S. person of a partnership interest. If a buyer fails to withhold, partnerships are required to withhold the amount the buyer failed to withhold, plus interest, from distributions that would otherwise be made to the buyer.

On April 2, 2018, the IRS released Notice 2018-29 (link), announcing its intention to issue regulations regarding the withholding requirements. The Notice also provided interim guidance that taxpayers may rely on until further guidance is issued. Pending the issuance of those regulations, the Notice (upon which taxpayers may currently rely) provides for a series of certifications which may be made by either the seller of the interest or the manager of a fund whose interest is being sold to allow a buyer to not withhold on the proceeds from the purchase of the fund interest. The Notice also suspended the withholding liability on the partnership itself.

The Notice did not affect the suspension of withholding for publicly traded partnerships under Notice 2018-08 (link), issued in December of 2017, nor does the guidance in the notice affect a transferor's tax liability under related ECI provisions.

Please see our blogpost here.

Family Office Found to be Engaged in an Active Trade or Business

In *Lender Management LLC*, T.C. Memo. 2017-246 (link), the Tax Court concluded that a taxpayer was engaged in the trade or business of providing investment management services and, therefore, could benefit from having its expenses treated as fully deductible business expenses rather than being treated as expenses incurred for the production of income and thus subject to the 2%-of-adjusted-gross-income floor for miscellaneous itemized deductions that applied prior to the TCJA. The court ruled that the company's primary source of income was an allocation of profits (*i.e.*, carried interest) from various partnerships to which it provided investment management services and the operations of the company consisted of activities that were beyond those of an investor even though the clients it provided investment management services to were primarily family entities.

Decided on December 13, 2017, this case is particularly significant because of provisions in TCJA. As discussed above, the TCJA disallows all miscellaneous itemized deductions for tax years beginning after December 31, 2017, and ending before January 1, 2026. In Lender Management's case, because the Tax Court held it was engaged in a trade or business, its business expenses were deductible in full rather than being nondeductible. While the specific reasoning of the case is beyond the scope of this update, its result may have significant implications for the asset management industry and may, depending on the particular facts, provide a way for investment management fees to effectively be deductible for U.S. federal income tax purposes.

Tax Treatment of Partnership Audits

Effective for audits of tax years that begin after December 31, 2017, the Bipartisan Budget Act of 2015 (the BBA) significantly altered the U.S. tax rules applicable to audits of partnerships (including LLCs taxed as partnerships). The BBA created 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 change from these new audit rules is that the designated partnership representative who acts on behalf of the partnership and deals with the IRS no longer needs to be a partner or member of the relevant partnership or LLC, although such partnership representative must have a "substantial presence" in the United States. Recently finalized regulations provide that a person has "substantial presence" if (i) the person makes itself available to meet in person with the IRS in the United States at a reasonable time and place as determined by the IRS and (ii) the person has a United States taxpayer identification number, a street address that is in the United States and a telephone number with a United States area code. Funds that do not have a substantial presence in the U.S. may outsource the role of partnership representative to a third party. In addition, if the partnership representative is an entity, it must choose a designated individual to serve as the contact for the IRS.

The IRS and the Treasury Department have released both proposed and final regulations that provide additional guidance on the new partnership-level audit rules. The regulations include guidance on the scope of the new partnership audit regime; procedural rules on electing out of the regime; the requirement that a partner's treatment of items on its tax return must be consistent with the treatment of such items on the partnership's return; and details regarding the "imputed underpayment" (the amount by which the taxpayer is determined to have underpaid tax upon completion of the audit), including a so-called "push out" election.

The "push out" election would permit a partnership to avoid paying anything at the partnership level, as any liabilities would be "pushed out" to the partnership's partners. The "push out" election must be made within forty-five days of the mailing of the final partnership adjustment. If a "push out" election is made, the underpayment rate is increased from the applicable federal rate plus 3%, to the applicable federal rate plus 5%. IRS guidance further confirms that the "push out" election would be permitted in the case of tiered partnership structures. However, "push-out" elections come with an administrative cost. Any partnership that makes a "push out" election must send a statement to each of relevant year partners, with a copy to the IRS, including each partner's share of the audit adjustments. These statements must be circulated to the partners, and filed with the IRS, on or prior to the extended due date for the partnership's tax return for the audit year. This deadline may be difficult to meet for audited partnerships that are multi-tiered partnerships that wish to push out audit adjustments to their ultimate beneficial owners, because making the "push-out" election through each intervening partnership would require the distribution of such statements in a potentially short period of time. Partnership agreements may require that the partnership representative make the "push out" election in every instance where the partnership has an imputed underpayment, without further consultation or consent by the partners.

In addition, the Tax Technical Corrections Act of 2018 (link) which was signed into law on March 23, 2018, contains a provision that simplifies partnerships' ability to reduce their imputed underpayment and shift all or part of the liability to their partners who were partners during the year subject to audit without requiring such partners to file one or more amended tax returns. In lieu of a partner amending his or her prior year returns, the partner may, no later than 270 days after the date on which the proposed partnership adjustment is mailed to the partnership, simply (i) pay the amount of tax due with respect to its share of the partnership audit adjustments, (ii) agree to reflect the resulting adjustments to such partner's tax attributes, and (iii) provide such additional information as the Secretary may require in connection with such reduction in the partnership's imputed underpayment. This is known as the "pull-in procedure." The partnership representative, or a third party, such as an accounting firm or law firm, may serve as a coordinator to collect such payments and information and remit them to the IRS on behalf of the partners. Partnerships and partners generally should prefer the pull-in procedure, as it should be less burdensome on partners and also should provide the partnership with more control over the process of reducing the underpayment than relying on partners to act independently.

Fund managers should review the operating agreements for their fund vehicles to ensure that such documents take into account these new audit rules, and should be aware that investors are asking increasingly for comfort on certain aspects of the new rules, either in fund documents or side letters. 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, modifying "imputed underpayments" imposed on the partnership to account for partners' tax status (such as tax-exempt or non-U.S.), and the appointment of a partnership representative.

Qualified Opportunity Zone Program

The qualified opportunity zone program is designed to encourage investment in distressed communities designated as "qualified opportunity zones" ("opportunity zones"), by providing tax incentives for equity investments in "qualified opportunity funds" ("opportunity funds") that, in turn, invest directly or indirectly in the opportunity zones. The qualified opportunity zone program provides three potential benefits to taxpayers who invest in an opportunity fund. First, a taxpayer may elect to defer tax on capital gain from the sale or exchange of property with an unrelated person by investing the gain in an opportunity fund within 180 days after the sale or exchange. The deferral ends on December 31, 2026, or sooner if the taxpayer sells its interest in the opportunity fund, and at that time the taxpayer must recognize the gain (and pay tax) with respect to the original property. Second, if the taxpayer holds its interest in the opportunity fund for five years, it can eliminate 10% of the deferred gain with respect to the original property and, if the taxpayer holds its interest in the opportunity fund for seven years, it can eliminate an additional 5% of the deferred gain with respect to the original property (for a total of 15%). Finally, if the taxpayer holds its interest in the opportunity fund for 10 years, it can sell its interest in the opportunity fund without being subject to tax attributable to appreciation in the value of the taxpayer's interest in the opportunity fund.

Please see our October 23, 2018 post on the proposed opportunity zone regulations

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 2015 Regulations) of the Code that provided rules for withholding on "dividend equivalent payments" on derivatives that reference U.S. equity securities. The 2015 Regulations initially were set to apply to transactions issued on or after January 1, 2017. However, in December 2016, the IRS issued Notice 2016-76, announcing that the IRS intended to issue additional final regulations and would therefore phase in application of the new provisions. On January 19, 2017, the IRS and the Treasury Department issued new final, temporary and proposed regulations that provide some clarifications to the 2015 Regulations and are substantially similar to the 2015 Regulations. In August 2017, the IRS issued Notice 2017-42 (link: https://www.irs.gov/pub/irs-drop/n-17-42.pdf) extending the phase-in application of section 871(m) to certain transactions.

Notice 2018-72 (link) describes the extension of the phased-in application of the regulations to delta-one and non-delta-one transactions, the extension of the simplified standard for determining whether transactions are combined transactions, and the extension of phased-in relief for qualified derivatives dealers. The guidance also provides that withholding agents may apply some of these transition rules for payments made in 2020.

Section 385 Regulations

Since their release in October 2016, the final and temporary regulations under Section 385 of the Code (the 385 Final Regulations) have been the subject of much commentary and debate. The 385 Final Regulations would 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.

In July 2017, in Notice 2017-38, the IRS included the 385 Final Regulations (as defined and discussed further below) in a list of regulations that are significant and either (i) impose an undue financial burden on U.S. taxpayers or (ii) add undue complexity to federal tax laws. This list was compiled in response to an executive order from the Trump administration directing the Treasury Department to review "significant tax regulations" issued on or after January 1, 2016 in order to identify whether any can be modified or withdrawn, in an attempt to simplify the federal regulatory system.

Further to this Notice, in October 2017, the Treasury Department issued a report in which the 385 Final Regulations were included on a list of "Regulations to Consider Revoking in Part." The report provides that the Treasury Department and the IRS are currently considering a proposal to revoke the documentation requirements as issued in favor of revised regulations that would be substantially simplified and streamlined. With respect to the other parts of the regulations, the report states that the

Treasury Department is working with Congress on fundamental tax reform that should prevent base erosion in a manner that may make these aspects of the 385 Final Regulations unnecessary.

On September 21, 2018, the Treasury Department issued proposed regulations (link) removing the portion of the 385 Final Regulations dealing with the documentation requirements. Accordingly, the final destiny of the 385 Final Regulations remains unclear.

BEPS and Country by Country Reporting

On a more global scale, multiple countries, including the United States, the United Kingdom, and Ireland have adopted Country by Country Reporting (CbCR) in furtherance of Action 13 of the Organisation for Economic Co-operation and Development (OECD)'s Base Erosion and Profit Shifting (BEPS) project. All multinational enterprises (MNEs) with revenues of €750 million/U.S. $850 million or greater are required to file a Country by Country (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. The first automatic exchanges of CbC reports took place in June 2018.

United States

In the United States, U.S. MNEs must file Form 8975 with their annual tax returns. Form 8975 requires an MNE to provide a wide array of information, including the MNE's revenues, profits and losses 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.

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. Therefore, while the broader definitions give MNEs some flexibility, the method used by a MNE with respect to determining how many "full time equivalent" employees it has, for example, will be the method that the MNE is required to use going forward. Therefore, MNEs should give considerable thought to their CbCR filings especially in the first year an MNE makes filings.

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 United States 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).

The CbC reports will be exchanged among competent authorities. As of August 16, 2018, the United States already had negotiated and signed agreements for the exchange of CbC reports with over 30 countries, including the United Kingdom, Ireland, the Netherlands and Canada, with another 7 Agreements currently being negotiated with countries. Notably, the United States negotiated and signed an agreement with the Cayman Islands on March 8, 2018.

ERISA

The U.S. Department of Labor's (DOL) fiduciary rule has been vacated. The fiduciary rule initially became effective on June 9, 2017 and, for a time, significantly expanded when a person is considered to be a fiduciary under the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code of 1986 (Code) as a result of providing investment advice. The expanded fiduciary rule potentially covered certain marketing and other related activities common to the investment management industry (including the private investment fund industry). While in effect, the rule had wide-ranging effects on the industry – in certain cases, resulting in significant changes to investment documentation, and in others, the exclusion of investments by certain "retail" retirement plan investors (such as individual retirement accounts or IRAs, and 401(k) plan participants).

However, on March 15, 2018, in a 2-1 decision, the U.S. Court of Appeals for the Fifth Circuit vacated the DOL's fiduciary rule and the associated exemptions (including the "Best Interest Contract Exemption" and the "Principal Transactions Exemption") – discussed here. On June 21, 2018, the Court issued its mandate that finalized its earlier decision vacating the rule. Accordingly, after nearly a decade in the making, the DOL's fiduciary rule is officially dead and it appears as though we are back to the old "five-part test" under the DOL's 1975 regulation for determining fiduciary status by reason of providing investment advice. However, the story may not be over just yet.

Recognizing that many fiduciaries had invested significant compliance resources in reliance on the vacated exemptions, the DOL on May 7, 2018 issued Field Assistance Bulletin No. 2018-02 which included a "non-enforcement policy" that continues prohibited transaction relief as if those exemptions were still available. The "non-enforcement policy" applies for fiduciaries who "are working diligently and in good faith to comply with the [exemptions'] impartial conduct standards." It is discussed here and will remain in effect until the DOL issues new guidance. Separately, the SEC published proposed conflict of interest rules for broker-dealers and investment advisers. The comment period for the SEC's proposal expired on August 7, 2018—discussed here.

Although it is hard to predict what will happen next in this ongoing fiduciary rule saga, we do believe that the story will continue.

State Regulation

Form D

An adviser to a private fund conducting an offering under Rule 506 must file a Form D with the SEC on its filer management system, EDGAR, within fifteen 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, it must be amended annually, on or before the first anniversary of the last notice filed. Form D must also be amended to correct a material mistake of fact or error or to reflect a change in the information provided in the previously filed notice as soon as practicable. However, for certain specified types of changes in information, such as a change in the amount of securities sold in the offering, or the number of investors who have invested in the offering, a 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 in connection 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, along with the state's required filing fee, be filed with the relevant state authority within 15 days following the initial sale of securities in that jurisdiction (as stated above, that would be the date on which the first investor in the jurisdiction is irrevocably contractually committed to invest). Some states' blue sky laws require that copies of amended SEC filings also be filed with the state, and a few 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 several states, and may be mandatory for all or most states in the not-too-distant future.

Advisers to 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 use 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 also occasionally request to see copies of the offering materials provided in connection with the offering.

Employment Law

#Me Too

Since the beginning of the #MeToo movement in October 2017, Congress and state and local lawmakers have introduced a series of legislation aimed at eliminating sexual harassment and abuse in the workplace.

The TCJA denies deductions for "payments related to sexual harassment and sexual abuse," specifically "any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement; or attorney's fees related to such a settlement or payment." This new law is effective for all settlement amounts paid or incurred after the date of the Act, December 22, 2017. Although there has been no further guidance as to the scope of what constitutes claims "related to sexual harassment or sexual abuse," it is important for employers to be cognizant of the potential implications this law has on future settlement agreements. Read more on Tax Talks here and more on California employment law update here.

In December 2017 Congress also introduced the "*Ending Forced Arbitration of Sexual Harassment Act.*" If passed, the legislation would amend the Federal Arbitration Act to make it illegal for employers to enforce mandatory pre-dispute employee arbitration agreements in "sex discrimination disputes". Additionally, attorneys general from all 50 states, the District of Columbia, and several U.S. territories sent a joint letter to the U.S. Congressional leadership offering broad support for bipartisan bills in the Senate and House of Representatives prohibiting "forced" arbitration of sexual harassment claims, including the Ending Forced Arbitration of Sexual Harassment Act.

In addition to federal legislation addressing sexual harassment and abuse in the workplace, over the last year, there has also been significant activity at the state level to address these concerns. A number of states have recently enacted or have pending legislation addressing an employer's ability to utilize private settlement agreements for claims of sexual harassment, restricting the use of nondisclosure agreements, and/or addressing sexual harassment training for employees.

Sexual Harassment Training

Set against the backdrop of the "#MeToo" movement and the recent onslaught of allegations of harassment in the workplace, a few states have enacted legislation requiring employers to distribute written anti-harassment policies in the workplace and/or institute anti-harassment training for employees. At the forefront of this legislation are New York, California, and Delaware. New York recently issued final guidance on the new sexual harassment policy and training requirements, outlined below.

New York

Effective **October 9, 2018**, all New York State employers are required to adopt written sexual harassment prevention policies and institute annual anti-harassment training for employees (see below for more details on specific requirements and deadlines). The State has issued a *Model Sexual Harassment Prevention Policy* that employers may adopt as well as *Model Sexual Harassment Training Documents*. Please see an in-depth review, below.

Model Sexual Harassment Prevention Policy

The new law requires employers to adopt and distribute to employees written sexual harassment prevention policies that are compliant with the new law by October 9, 2018. To satisfy this obligation, employers may (1) adopt the State's model sexual harassment prevention policy and complaint form, or (2) implement their own policy and complaint form that equals or exceeds the minimum standards provided under the statute consistent with guidance issued by the State. As outlined in the Minimum Standards provided by the State, the policy must:

- prohibit sexual harassment consistent with guidance issued by the Department of Labor in consultation with the Division of Human Rights;
- provide examples of prohibited conduct that would constitute unlawful sexual harassment;
- include information concerning the federal and state statutory provisions concerning sexual harassment, remedies available to victims of sexual harassment, and a statement that there may be applicable local laws;
- include a complaint form;
- include a procedure for the timely and confidential investigation of complaints that ensures due process for all parties;
- inform employees of their rights of redress and all available forums for adjudicating sexual harassment complaints administratively and judicially;
- clearly state that sexual harassment is considered a form of employee misconduct and that sanctions will be enforced against individuals engaging in sexual harassment and against supervisory and managerial personnel who knowingly allow such behavior to continue; and

- clearly state that retaliation against individuals who complain of sexual harassment or who testify or assist in any investigation or proceeding involving sexual harassment is unlawful.

The final FAQs state that if an employer has already established investigative procedures that are similar to those provided in the State model (in that they provide for a timely and confidential investigation of complaints in a matter that ensures due process for all parties), the employer need not expressly adopt the investigative procedure set forth in the State model. That said, employers must nevertheless outline their investigative procedures in their policy document.

With regard to distribution of the policy, the FAQs state that a signed acknowledgment of receipt is not required, but that employers are "encouraged" to obtain one from employees. Employers must provide employees with a copy of the policy in writing or electronically, and if made available electronically, employees must be able to print a copy for their records.

The State has also finalized its model complaint form, for employees to use when reporting incidents of sexual harassment.

Model Sexual Harassment Training Documents

The new law requires that all New York employees complete sexual harassment prevention training that meets or exceeds the minimum standards under the law by no later than October 9, 2019, after which future training must be completed on an annual basis. The final guidance provides some flexibility to employers by requiring that new employees complete training as soon as possible after their start date.

All full-time and part-time employees, seasonal employees and temporary employees must receive training. Unlike the draft guidance, which indicated that employers would need to train "someone [who] just works for one day for the employer, or . . . works for just one day in NY," the final guidance states that employers need to train individuals who "work[]a portion of their time in New York State, even if they're based in another state."

To satisfy the training requirements, employers may either: (1) adopt the State's model training script, slides, and/or case studies (discussed further below); or (2) provide other live training or interactive online/video training that meets or exceeds the law's minimum standards for training. Of particular note under the new guidance, sections in the State's model training that are "not expressly required in the law" are not required to be included, but instead are "strongly recommended." Therefore, employers can meet the training requirement as long as their training programs meet the minimum standards set by the law, even if the employer does not use the precise language contained in the State's model training materials.

Other notable changes made by the State to the draft model training documents and the associated FAQs include the following:

- There is no requirement to train (or provide a copy of the harassment prevention policy) to third-party vendors or other non-employees, though employers are "encouraged to provide the policy and training to anyone providing services in the workplace."
- There is no minimum number of training hours required per year for employees – that is, there is no minimum length of time for each training session.
- With regard to the requirement that training address "additional responsibilities for supervisors", the final guidance states that all employees (not just managers and supervisors) must be "[made] aware of the extra requirements for those in managerial/supervisory roles."

- The final guidance provides that in order for training to be “interactive”, some form of employee participation is required. Examples given of such participation include:
  - if the training is web-based, it has questions at the end of a section and the employee must select the right answer;
  - if the training is web-based, the employees have an option to submit a question online and receive an answer immediately or in a timely manner;
  - in an in-person or live training, the presenter asks the employees questions or gives them time throughout the presentation to ask questions; and
  - if the training is web-based or in-person, a Feedback Survey is provided for employees to turn in after they have completed the training.

While a live trainer is not required in order to comply with the new requirements, simply having employees watch a training video or read a document, with no feedback mechanism or interaction, would *not* be considered interactive. Where live trainers are used, however, they must appear in person or via phone, video conference, or other similar remote mechanism.

Please see our April 8, 2018, April 13, 2018 and October 2, 2018 posts on Proskauer’s Law and the Workplace Blog for more information.

California

On Oct. 15, 2017, California Governor Jerry Brown signed Senate Bill 396 into law, expanding the scope of mandatory sexual harassment training employers must provide to their supervisory employees. Currently, California’s Fair Employment and Housing Act (FEHA) requires employers with 50 or more employees to provide at least two hours of prescribed training and education regarding sexual harassment to all supervisory employees within six months of their assumption of a supervisory position, and then once every two years thereafter. This new law expands the scope of FEHA’s requirements by mandating that the training must also cover harassment based on gender identity, gender expression, and sexual orientation. Such training must be conducted by individuals with knowledge and expertise in these topics and must include practical examples.

Please see our October 30, 2017 post on Proskauer’s California Employment Law Update Blog for more information.

Settlement Agreements/Non-Disclosure/Arbitration Provisions

On the heels of the recently introduced federal legislation concerning forced arbitration, a number of states, including California, New Jersey, Washington, Massachusetts, and South Carolina have introduced statewide legislation prohibiting mandatory arbitration agreements and/or nondisclosure clauses in settlement agreements relating to claims of sexual harassment. Meanwhile, both New York and Maryland have enacted legislation that prohibits the use of nondisclosure clauses in settlement agreements relating to claims of sexual harassment. The New York State law is described in detail below.

New York

The New York State Legislature and Governor Andrew Cuomo have reached agreement on a $168 billion budget deal for the 2019 fiscal year. The budget includes several significant measures directed at private employers regarding sexual harassment in the workplace.

Many of the measures mirror legislation that has been introduced in several other states as part of a nationwide push to respond to the #MeToo movement and the increased discourse around sexual harassment in the workplace. Among other things, the New York budget measures will:

- prohibit the use of nondisclosure clauses in settlements or agreements relating to claims of sexual harassment, unless the condition of confidentiality is the preference of the complainant;
- prohibit mandatory arbitration clauses for claims of workplace sexual harassment;
- require the New York State Department of Labor and Division of Human Rights to develop a model sexual harassment prevention policy and a model sexual harassment prevention training program for use by employers;
- mandate the distribution of written anti-harassment policies in the workplace and require annual anti-harassment training for all employees; and
- expand protections against sexual harassment under the New York State Human Rights Law to "non-employees," including contractors, subcontractors, vendors, consultants, and other persons providing services pursuant to a contract.

Use of Nondisclosure Clauses Restricted for Sexual Harassment Claims

The budget amends the State's General Obligations Law and Civil Practice Law and Rules (CPLR) to prohibit nondisclosure clauses in any settlement, agreement or other resolution of a claim or cause of action, "the factual foundation for which involves sexual harassment," unless it is the "complainant's preference" to include such a confidentiality provision. Any such provision that would prevent the disclosure of the facts or circumstances that underlie the harassment claim would be deemed void and unenforceable unless agreed to by the complainant.

Specifically, the budget provision requires that any nondisclosure language be provided to all parties to the agreement and that the complainant be given 21 days to consider any such clause and its terms and conditions and to indicate agreement to the inclusion of the clause or mandate its removal. The provision further grants the complainant a 7-day revocation period to revoke a signed agreement containing a non-disclosure provision. The nondisclosure clause does not become effective or enforceable until after the 7-day revocation period has expired.

The restrictions on the use of nondisclosure clauses will take effect 90 days after the budget is signed into law by the Governor.

Prohibition on Mandatory Arbitration Clauses for Sexual Harassment Claims

The budget also amends the CPLR to void any provision in an employment-related contract or agreement entered into following the effective date of the law that requires the parties to submit claims relating to sexual harassment to mandatory binding arbitration and would insulate from "independent court review" any fact-finding made by, or the final determinations of, an arbitrator relating to claims of sexual harassment. The provision does, however, contain a carve-out for arbitration provisions included as part of a collectively bargained agreement, which shall remain enforceable.

The prohibition on mandatory arbitration clauses for sexual harassment claims also takes effect 90 days after the budget is signed into law.

Pay Equity Developments

Salary History Inquiry Laws

Within the past year, new laws restricting an employer's ability to inquire into an applicant's salary history have been passed in Delaware, Oregon, Vermont, and Connecticut, while a number of other states, including Maine, Maryland, and D.C., have pending legislation addressing job applicant salary inquiries. The California State law is described in detail below.

On January 1, 2018 the California statewide salary history inquiry went into effect. The law restricts employers from seeking salary history information from applicants in the hiring process. The law will apply to all private and public sector employees and will prohibit employers from relying on salary history as a factor in determining whether to offer employment to an applicant or what salary to offer, and seeking orally or in writing or through an agent, salary history information about an applicant.

In an attempt to clarify the previous law, on July 18, 2018, California Governor Jerry Brown signed into law new legislation intended to calcify the existing salary history inquiry law. Under the existing law, employers are restricted from relying on salary history information of applicants as a factor in determining whether to offer an applicant employment or what salary to offer an applicant. Employers are also required, upon reasonable request by an applicant, to provide the pay scale for a position. The new law clarifies definitions for several terms for purposes of these provisions, namely:

- "pay scale" is defined to mean a salary or hourly wage range;
- "reasonable request" is defined to mean a request made after an applicant has completed an initial interview with the employer; and
- "applicant" is defined to mean an individual who is seeking employment with the employer and is not currently employed with that employer in any capacity or position.

The new law also specifies that the salary history inquiry provisions do not prohibit an employer from asking about an applicant's salary expectations. The new law further clarifies aspects of the California Equal Pay Act, under which employers may not pay an employee at a wage rate less than the rate paid to employees of the opposite sex or another race or ethnicity for substantially similar work, except where the employer demonstrates the wage differential is based upon one or more specified legitimate factors. The new law specifies that while prior salary may not justify a disparity in compensation, employers are authorized to make a compensation decision based on an employee's current salary as long as any wage differential resulting from that compensation decision is justified by one or more of the specified legitimate factors under the Equal Pay Act. The new law will take effect on January 1, 2019.

Please see our October 13, 2017 post on Proskauer's Law and the Workplace Blog for more.

Equal Pay Laws

Within the past year, New Jersey and Massachusetts have passed equal pay laws in an attempt to rectify gender pay issues, while legislation is still pending in California and Washington.

New Jersey

On April 26, 2018, New Jersey Governor Phil Murphy signed a new pay equity law which, among other things, makes it an unlawful employment practice to pay employees of any protected class under the New Jersey Law Against Discrimination ("LAD") at a lesser rate than other employees who perform "substantially similar work" unless the differential is based on a legitimate business reason. The Diane B. Allen Pay Equity Act (the "Act") is dedicated to raising awareness of the gender pay gap. The law went into effect on July 1, 2018.

Pay Equity Provisions

Pursuant to the Act, it is an unfair employment practice for an employer to pay a member of any protected class under the LAD at a rate of compensation (including benefits) lesser than that paid to employees who are not members of the protected class for "substantially similar" work, encompassing "a composite of skill, effort, and responsibility." Under the LAD, protected classes include sex, race, creed, color, national origin, ancestry, nationality, disability, age, pregnancy or breastfeeding, marital, civil-union or domestic partnership status, affectional or sexual orientation, gender identity or expression, military status, and genetic information or atypical hereditary cellular or blood traits.

Compensation comparisons under the Act will be based on wage information "in all of an employer's operations or facilities." It is noted, however, that the phrase "substantially similar" work is not defined under the Act, which, will leave the provision open to interpretation by the courts.

The Act also states that an employer will be permitted to pay a member of a protected class lower compensation only if the employer can demonstrate that the pay differential is based on a seniority system, merit system, or if the employer can demonstrate that:

- the differential is based on one or more legitimate bona fide factors, other than the characteristics of members of the protected class, such as training, education or experience, or the quantity or quality of production;
- the factors are not based on, and do not perpetuate, a differential based on sex or other protected characteristic;
- each factor is applied reasonably;
- the factors account for the entire wage differential; and
- the factors are job-related and based on a legitimate business necessity.

However, a factor that is purported to be based on business necessity will not satisfy this test if there are alternative business practices that would serve the same business purpose without producing the wage differential. Employers are not permitted to reduce the rate of compensation of any employee in order to achieve compliance with the Act.

Employers in violations of the Act could face damages including back pay and triple damages awards.

Other notable aspects of the law include:

Statute of Limitations Extended

The Act extends the LAD's statute of limitations period for compensation-related claims from 2 years to 6 years. The Act further provides that the limitations period would restart upon the issuance of each paycheck that was made based on a discriminatory compensation decision. In addition, employers are prohibited from contracting with employees to shorten or waive a limitations period or "any of the protections" provided under the LAD.

Definition of Retaliation Expanded

The Act expands the definition of retaliation under the LAD to prohibit employers from taking adverse action against an employee who requests from, discusses with, or discloses to: (i) any other employee or former employee; (ii) the employee's lawyer; or (iii) any government agency:

- any information regarding job title, occupational category, and rate of compensation (including benefits) of the employee or any other current or former employee, or
- information regarding the gender, race, ethnicity, military status or national origin of the employee or any other current or former employee.

Such requests would be protected from retaliation even if they are never responded to by the employer, attorney or government agency. This provision expands the current protections under the LAD, which prohibit retaliation only where the purpose of such a request is to assist in investigating or taking legal action regarding potential discriminatory treatment concerning compensation.

In addition, the Act protects from retaliation individuals who have sought legal advice or shared information with a government entity or legal counsel in connection with their rights under the LAD, and it is an unfair employment practice to require that, as a condition of employment, any employee or prospective employee sign a waiver or otherwise agree not to make any such protected requests or disclosures.

Violations of the retaliation provisions of the Act would also be subject to triple damages awards.

Please see our April 26, 2018 post on Proskauer's Law and the Workplace Blog for more information.

Massachusetts

The Massachusetts Office of the Attorney General recently issued guidance on the new amendments to the Massachusetts Equal Pay Act (MEPA), effective July 1, 2018. Although the guidance is extremely detailed and should be reviewed in full, outlined below are a few of the most relevant provisions.

Coverage

The MEPA and amendments are substantial in scope, covering "nearly all" Massachusetts employers and the "vast majority" of employees, including full-time, part-time, seasonal, per-diem and temporary employees, with few exceptions. There is no minimum number of employees that employers must have to trigger MEPA coverage. State and municipal employers are covered by the law, while employees of the federal government are excluded. The law covers any employee whose "primary place of work" is in Massachusetts; residency is not a dispositive test. Massachusetts is an employee's primary place of work if they "do most of their work" within the state, and thus, according to the guidance, includes: (1) traveling employees who return regularly to Massachusetts between trips; (2) employees who "spent the plurality" of their time in Massachusetts over the prior year; and (3) employees who telecommute to a Massachusetts work location, despite not being physically present in Massachusetts.

Under the MEPA, among other provisions, the law provides a definition of "comparable work" for purposes of analyzing pay equity under the law, prohibits employers from requesting or requiring applicants to reveal salary history information during the hiring process, and prohibits restrictions on employee discussions of compensation. The guidance expands upon the definition of several terms under the law, including "comparable work" and "wages."

It also elaborates upon the circumstances in which variations in pay between men and women may be deemed permissible under the law, setting forth an exhaustive list of examples that includes where salaries reflect sales/production quality or quantity, seniority or merit raises, education, training, travel requirements, and factors like regional differences in pay. It also elaborates upon the circumstances in which variations in pay between men and women may be deemed permissible under the law, setting forth an exhaustive list of examples that includes where salaries reflect sales/production quality or quantity, seniority or merit raises, education, training, travel requirements, and factors like regional differences in pay.

The guidance goes on to state that a pay difference will be permissible under the law "if the entire difference is justified by one of these factors, or by a combination of these factors," and that the law "does not recognize any other valid reasons for variations in pay between men and women performing comparable work." With regard to the restrictions on requesting or requiring salary history, among other things, the guidance affirms that employers may still ask prospective employees about their salary requirements or expectations, though it notes that employers "should proceed with caution when asking such questions and ensure that such questions are not framed or posed in a way that is intended to elicit information from the prospective employee about his or her salary or wage history." For example, the guidance states, "employers should avoid asking follow-up questions such as 'what is that expectation or need based on' that may be reasonably likely to prompt the prospective employee to disclose his or her salary or wage history."

The guidance further clarifies that the prohibitions do not apply to applicants for internal transfer or promotion, and that the law "does not prohibit employers from learning of an employee's wage or salary history through public sources," though again the guidance notes that "regardless of the source of the information, employers should keep in mind that at no time will an employee's salary history justify paying that employee less than an employee of a different gender who performs comparable work."

Please see our March 13, 2018 post on Proskauer's Law and the Workplace Blog for more information.

Updates in Discrimination Law

Gender Identity as a Protected Characteristic

In a memorandum to all U.S. attorneys and the heads of all federal agencies, Attorney General Jeff Sessions reversed the federal government's stance that gender identity is protected as part of Title VII's prohibition against sex discrimination, stating that the statute does not cover bias based on transgender status. The memo reverses a position taken in a December 2014 memo by former Attorney General Eric Holder that said Title VII does encompass discrimination claims based on gender identity, including for transgender workers. In the recently issued memo, Sessions states that while Title VII provides various protections for transgender individuals, the statute "does not prohibit discrimination based on gender identity *per se*, including transgender status." The memo goes on: "This is a conclusion of law, not policy. The sole issue addressed in this memorandum is what conduct Title VII prohibits by its terms, not what conduct should be prohibited by statute, regulation, or employer action. As a law enforcement agency, the Department of Justice must interpret Title VII as written by Congress." As a result, Sessions states in the memo, the DOJ "will take that position in all pending and future matters" except in circumstances where a controlling lower court precedent says otherwise, and that, even in those instances, the issue should be preserved for potential review.

On the heels of this announcement by Attorney General Jeff Sessions, New Hampshire enacted statewide legislation that prohibits discrimination based on gender identity in employment, housing and public accommodation. Please see our June 11, 2018 posts on Proskauer's Law and the Workplace Blog for more information.

Circuit courts have also been active in the area of sexual orientation and gender identity discrimination. First, in an *en banc* decision in *Zarda v. Altitude Express, Inc.* (2d Cir. Feb. 26, 2018), the Second Circuit became the latest federal appeals court to hold that discrimination on the basis of sexual orientation is prohibited sex discrimination under Title VII. Applying similar reasoning as the Seventh Circuit did in its decision in *Hively v. Ivy Tech Community College* (7th Cir. 2017), the Second Circuit held that "the most natural reading of [Title VII]'s prohibition on discrimination 'because of . . . sex' is that it extends to sexual orientation discrimination because sex is necessarily a factor in sexual orientation." To that end, the court observed that sexual orientation refers to a person's predisposition or inclination toward sexual activity or behavior with other males or females, such that "one cannot fully define a person's sexual orientation without identifying his or her sex." The court also found support in the notion that sex stereotyping is prohibited under Title VII and that "sexual orientation discrimination is predicated on assumptions about how persons of a certain sex can or should be, which is an impermissible basis for adverse employment actions." The court concluded that "when, for example, an employer acts on the basis of a belief that men cannot be attracted to men, or that they must not be, but takes no such action against women who are attracted to men, the employer has acted on the basis of [sex]."

Then, in a unanimous panel decision in *EEOC v. R.G. & G.R. Harris Funeral Homes, Inc*. (6th Cir. Mar. 7, 2018), the Sixth Circuit held that discrimination on the basis of transgender status is "necessarily" discrimination on the basis of sex and therefore prohibited under Title VII. The court found that, because Title VII protects against sex stereotyping and "transgender discrimination is based on the non-conformance of an individual's gender identity and appearance with sex-based norms or expectations … discrimination because of an individual's transgender status is always based on gender stereotypes: the stereotype that individuals will conform their appearance and behavior—whether their dress, the name they use, or other ways they present themselves—to the sex assigned them at birth."

Please see our April 5, 2017, February 27, 2018, and March 12, 2018 posts on Proskauer's Law and the Workplace Blog for more information.

Breastfeeding in the Workplace

Over the last year, Illinois, Massachusetts, and New Jersey have each enacted new legislation or expanded protections for breastfeeding employees. Each states provides protections to breastfeeding mothers

Illinois

On August 21, 2018, Illinois expanded protections for employees needing to express breast milk in the workplace. The amendments require that an employer <u>must</u> provide a break time for breastfeeding employees, unless they can demonstrate that providing a break time would "create an undue hardship," as defined under the Illinois Human Rights Act. Additionally, the law amends the Nursing Mothers in the Workplace Act in several significant ways — most notably, that break time provided for the expression of milk "may not reduce an employee's compensation" regardless of the length of the break. Under the amendments, break time provided for lactation purposes may run concurrently with any other break time and employers must provide breaks for expression of milk for a minimum of one year after a child's birth.

New Jersey

On January 8, 2018, newly enacted amendments to the New Jersey Law Against Discrimination expanded the state anti-discrimination protections in the workplace, housing and public accommodations to include individuals who are breastfeeding or expressing milk. The amendments also require employers to provide reasonable accommodation to breastfeeding employees. The amendments make it unlawful for an employer to refuse to hire, discharge, or otherwise discriminate against an individual on the basis of breastfeeding. Employers are further required to provide the breastfeeding employee with reasonable accommodations, including reasonable breach time each day to express milk and a room or other private location, other than a toilet still, in close proximity to the employee's work location for the expression of milk.

Massachusetts

The Massachusetts Pregnant Workers Fairness Act became effective on April 1, 2018. The Act requires that employers allow employees to take breaks to breastfeed or express breast milk as often as is needed, absent undue hardship. The number and frequency of such breaks should be determined on an individual basis and may require adjustment over time. There is no statutory time designated for such breaks, but employers "must allow the time needed." Employers are not required to pay employees for such breaks, but if paid breaks are provided, employees must be permitted to use those paid breaks for breastfeeding or expressing breast milk. The law provides that employees are permitted to breast feed and express breast milk in their personal work space if it is equivalent to a private, non-bathroom space, and may continue working while doing so. A separate space for breastfeeding or expressing breast milk, if one does not already exist, must be prepared "promptly" once an employer is on notice that an employee will need it. That space should include electrical outlets and a surface or table capable of holding a breast pump.

Please see our January 18, 2018, July 2, 2018, and August 27, 2018 posts on Proskauer's Law and the Workplace Blog for more information.

Newly Enacted State Paid Sick Leave Laws

Within the past year, new laws and regulations regarding paid sick leave have been passed in New Jersey, Rhode Island, Austin and San Antonio, Texas, Massachusetts, and Maryland, while a number of other states have pending legislation, including Nevada, Michigan, and Minneapolis, Minnesota. The New Jersey State law is described in detail below.

New Jersey

The New Jersey Paid Sick Leave Act (the "Act"), which will provide eligible employees with paid leave for their own medical needs, those of a family member, or other covered reasons will take effect on October 29, 2018.

Covered Employers and Employees

The Act applies to all employers with employees working in New Jersey, including temporary help service firms, regardless of employer size. All employees working in the state will be eligible for paid leave under the Act, with the exception of:

- construction employees working under a collective bargaining agreement;

- per diem health care employees; and
- public employees, who are already required to receive paid sick leave.

Employees may begin using paid sick leave on the 120th day of employment, unless the employer agrees to an earlier date.

Accrual of Paid Sick Leave

Eligible employees are entitled to accrue sick leave at a rate of one hour of sick leave for every 30 hours worked in a benefit year (which may be any period of 12 consecutive months as established by the employer). An employer shall not be required to permit an employee to accrue more than 40 hours of sick leave in a given benefit year. As an alternative to an accrual system, an employer may provide employees, in the beginning of each benefit year, with the full amount of earned sick leave that each employee would otherwise be entitled to accrue under the Act (the "front-loading method"). An employer that currently offers its employees paid time off (which may include personal, sick, and/or vacation days) that accrues at a rate equal to or greater than that required by the Act, and that can be used for the same purposes and in the same manner as provided by the Act, may use such time to satisfy its obligations under the Act.

Carry Over and Payout of Unused Leave

When sick leave is provided using an accrual system, employees may carry over up to 40 hours of earned but unused sick time into the following benefit year. Alternatively, employers may offer employees the option to receive payment of their unused sick days in the final month of the employer's benefit year. When sick leave is provided using the front-loading method, the employer must either provide the employee with a payment for the full amount of unused earned sick leave in the final month of the employer's benefit year or allow the employee to carry forward any unused sick leave to the next benefit year.

Permissible Reasons for Taking Sick Leave

Paid sick leave under the Act can be used for any one or a combination of the following reasons:

- time needed for diagnosis, care, or treatment of, or recovery from, an employee's mental or physical illness, injury or other adverse health condition, or for preventive medical care for the employee;
- time needed for the employee to aid or care for a family member of the employee during diagnosis, care, or treatment of, or recovery from, the family member's mental or physical illness, injury or other adverse health condition, or during preventive medical care for the family member;
- for covered reasons resulting from the employee, or a family member of the employee, being a victim of domestic or sexual violence;
- when an employee is not able to work because of a closure of the employee's workplace, or the school or place of care of a child of the employee, by order of a public official due to an epidemic or other public health emergency, or because of a determination that the presence in the community of the employee, or a member of the employee's family in need of care by the employee, would jeopardize the health of others; or
- time needed by an employee to attend a child's school-related conference, meeting, function or other event requested or required by a school administrator, teacher, or other professional staff member, or to attend a meeting regarding care provided to the child in connection with the child's health conditions or disability.

A "family member" is defined as "child, grandchild, sibling, spouse, domestic partner, civil-union partner, parent, or grandparent of an employee, or a spouse, domestic partner, or civil-union partner of a parent or grandparent of the employee, or a sibling of a spouse, domestic partner, or civil-union partner of the employee, or any other individual related by blood to the employee or whose close association with the employee is the equivalent of a family relationship."

Employee Notice Requirements

If the need to use earned sick leave is foreseeable, an employer may require up to seven calendar days' advance notice, and may further require employees to make a reasonable effort to schedule the use of sick leave in a manner that does not unduly disrupt the employer's operations. If the leave is not foreseeable, an employer may require notice as soon as practicable. In addition, employers may prohibit employees from using foreseeable earned sick leave on certain dates, and require reasonable documentation if sick leave that is not foreseeable is used during such dates.

Employers may require medical or other reasonable documentation for earned sick leave of three or more consecutive days to ensure that the reason for the leave is permissible under the Act. Employees may not be required to find coverage for missed hours or shifts, but the employer and employee may agree to have the employee work additional hours or shifts during the same or following pay period in lieu of the hours or shift missed.

Retaliation Is Prohibited

Employers may not retaliate against employees for exercising their rights under the Act. The Act creates a rebuttable presumption of unlawful retaliatory conduct when an employer takes adverse action against an employee within ninety days of when that employee files a complaint, informs others of a violation of the Act, cooperates with an investigation or prosecution made pursuant to the Act, opposes any policy that is made unlawful by the Act, or informs any person of his or her rights under the Act.

Employer Notice and Recordkeeping Requirements

Employers shall be required to conspicuously post a notice, as well as provide written notification to employees, of their rights under the Act. Such notice will be required to include the amount of earned sick leave to which employees are entitled and the terms of its use, as well as remedies provided by the Act if an employer fails to provide the required benefits or retaliates against employees exercising their rights. A form notice will be issued by the Commissioner of Labor and Workforce Development. Each covered employee must be provided with a written copy of the notification no later than 30 days after the form notification is issued and, for new employees, at the time of hire.

Employers will be required to maintain records reflecting both the hours worked and sick hours used by employees for a period of five years, which must be made available for inspection upon a request from the Department of Labor and Workforce Development.

Preemption

About a dozen New Jersey cities had previously enacted paid sick leave ordinances. The Act preempts those ordinances and prevents municipalities from passing resolutions concerning paid sick leave going forward.

Please see our January 16, 2018, June 27, 2018, July 2, 2018, August 22, 2018, September 26, 2018 posts on Proskauer's Law and the Workplace Blog for more information.

Arbitration Agreements Containing Class Action Waivers

In May 2018, the Supreme Court of the United States ruled that class action waivers in employment arbitration agreements violated the National Labor Relations Act (NLRA), which regulates unionization and protects employees' collective rights. In *Epic Systems Corp. v. Lewis*, the court ruled that employers can require employees to arbitrate disputes with the employer and waive their right to pursue or participate in class or collective actions against their employer, finding that class action waivers in arbitration agreements do not violate the NLRA. This case resolved a circuit split between the Fifth Circuit Court of Appeals, which held that such waivers do not violate the NLRA, and the Seventh and Ninth Circuit Courts of Appeals, which found that such waivers do in fact violate the NLRA.

Please see our May 23, 2018 post on Proskauer's Law and the Workplace Blog for more information.

DOL Opinion Letters

On August 28, 2018, the DOL issued three new letters offering guidance on compensable time, qualifying FMLA leave and the interaction between attendance policies and FMLA leave. Below are overviews of the three letters.

Compensable Time

In FLSA2018-20, the DOL concluded that an employer need not pay an employee for time spent voluntarily participating in certain wellness activities, biometric screenings, and benefits fairs, whether during or outside of regular working hours.

The activities at issue, which the employee could choose to participate in or not to participate in, included:

- Biometric screening, which tests, among other things, cholesterol levels, blood pressure, and nicotine usage;
- Wellness activities, including: (1) attending an in-person health education class and lecture; (2) taking an employer-facilitated gym class or using the employer-provided gym; (3) participating in telephonic health coaching and online health education classes through an outside vendor facilitated by the employer; (4) participating in Weight Watchers; and (5) voluntarily engaging in a fitness activity; and
- Attending a benefits fair to learn about topics such as financial planning, employer-provided benefits, or college attendance opportunities.

With respect to each of these activities, the DOL noted that participation is entirely optional on the employee's part (although participation in certain activities could decrease his or her insurance premiums or deductibles), the activities are not related to the employee's job duties, and the employer receives no direct financial benefit as a result of employee participation. The DOL explained that compensability of an employee's time depends on whether the time is spent predominantly for the employer's benefit or for the employee's benefit. Because the activities at issue in the opinion letter predominantly benefit the employee, they do not constitute compensable worktime under the FLSA

Overriding all of these principles is the federal break time rule, under which breaks of "up to 20 minutes" are ordinarily compensable, regardless of how the employee chooses to spend his or her time during the break. Applying this rule to the activities at issue here, the DOL noted that "if the employer provides all employees with a 20-minute break each day, the employer must still compensate an employee for that break if he or she chooses to spend it participating in wellness activities, biometric screenings, and benefits fairs."

Please see our August 29, 2018 post on Proskauer's Law and the Workplace Blog for more information.

FMLA Leave for Organ Donation

In FMLA2018-2-A, the DOL found that organ donation is a qualifying reason for leave under the FMLA. The letter states that "[a]n organ donation can qualify as an impairment or physical condition that is a serious health condition under the FMLA when it involves either 'inpatient care' . . . or 'continuing treatment'" as defined under the statute. Thus, concluded the letter, an organ donation "would qualify as a serious medical condition whenever it results in an overnight stay in a hospital," as is generally common, or otherwise meets the FMLA's requirements for inpatient care or continuing treatment.

FMLA and Attendance Policies

In the FMLA2018-1-A, the DOL found that an employer's attendance policy that "freezes" previously accrued attendance points during an FMLA leave was permissible under the law, so long as other equivalent types of leave are not treated more favorably. Specifically, under the policy in question, employees would accrue points for tardiness and absences and would be automatically discharged once they accrued 18 points. The policy further stated that points remained on an employee's record for twelve months of "active service," a phrase not defined under the policy. As implemented, the policy would "freeze" any previously accrued points during certain types of leave, including FMLA and workers' comp leaves, so that the employee would return to the same number of points they had prior to the start of the leave—effectively, the employee would neither accrue new points nor would any already-accrued points drop off during the leave period. The opinion letter found that "[r]emoval of absenteeism points is a reward for working and therefore an employment benefit under the FMLA," and, under the policy as implemented here, "[a]n employee neither loses a benefit that accrued prior to taking the leave nor accrues any additional benefit to which he or she would not otherwise be entitled." Therefore, the practice "do[es] not violate the FMLA, as long as employees on equivalent types of leave receive the same treatment." That is, "[i]f the employer . . . counts equivalent types of leave as 'active service' under the no-fault attendance policy—meaning the employer counts such leave toward the twelve months necessary to remove points—then the employer may be unlawfully discriminating against employees who take FMLA leave."

The DOL has established a new sub-office and launched two new webpages - www.worker.gov and www.employer.gov - that will help employers comply with the numerous wage and hour, leave, safety and other benefit laws it administers.

Please see our August 29, 2018 post on Proskauer's Law and the Workplace Blog for more information.

Update to the Joint Employer Standard

The NLRB has published a Notice of Proposed Rulemaking regarding its joint-employer standard. The proposed rule states that an employer may be considered a joint-employer of another employer's employees only if it possesses and exercises substantial, direct and immediate control over the essential terms and conditions of employment in a manner that is not limited and routine. Indirect influence and contractual reservations of authority would no longer be sufficient to establish a joint-employer relationship. The public may submit comments to the Board on the proposed rule for sixty days following its publication on September 14.

Please see our September 14, 2018 and February 26, 2018 posts on Proskauer's Law and the Workplace Blog for more information.

Executive Compensation

In August, 2018, Massachusetts passed sweeping legislative reforms pertaining to non-compete agreements and the protection of trade secrets, which took effect on October 1, 2018. As described more comprehensively in Proskauer's Law and the Workplace Blog and corresponding podcast (available here and here), the new law provides guidelines regarding the enforceability of non-compete agreements, an analysis that had previously been developed through common law analysis in the courts. In particular, the law carves out categories of employees who may not be governed by a non-compete agreement, including non-exempt workers, as well as workers who have been terminated without cause or laid off. For those employees who may still be governed by non-competes, the law provides a number of requirements pertaining to the timing in which the employee receives the agreement, the scope of the activities protected by the agreement, as well as the geographic reach and other procedural necessities (such as requiring that the employer sign the non-compete agreement along with the employee). Perhaps most significantly, the law also requires that employees subject to non-compete restrictions either receive a form of "garden leave" payment during the restricted period, or other "mutually agreeable consideration," a term left undefined by the legislation, seemingly giving employers a great deal of latitude with respect to how to satisfy this obligation.

It bears noting, however, that the new law applies exclusively to non-compete agreements between employers and employees (including "forfeiture for competition agreements"). It does not apply to other contracts or provisions within a contract, including non-disclosure agreements, non-solicitation agreements, certain agreements applying to the sale of a business, invention assignment agreements, and forfeiture agreements that are not contingent on the employee engaging in competitive activity. Moreover, the new law does not apply to "non-compete agreements entered in connection with an employee's separation, provided the employee has seven days to rescind acceptance."

To the extent existing language used in non-compete agreements has not yet been revised pursuant to the new legislation, we recommend that counsel re-evaluate that language to account for the new restrictions and requirements under Massachusetts law.

Insurance

During 2018, Proskauer continued to work with a wide variety of advisers of all sizes to improve their insurance programs and recover on their insurance claims. 2018 was a tale of contrasts in the insurance world. On one hand, the insurance market continued to be "soft" in 2018 when it came to underwriting, providing significant opportunities to negotiate and obtain enhanced coverage for funds, advisers, and their key individuals if they took advantage of this opportunity. On the other hand, we saw a significant uptick in claim denials and coverage fights during 2018, as insurers sought to avoid coverage for claims based on various policy exclusions and conditions. This "hard" claim environment has made it all the more important to take advantage of the opportunity to negotiate strong coverage terms when obtaining or renewing insurance policies. Below are a few of the key trends we saw in 2018 along with our thoughts on where we see things headed in 2019.

Increased Coverage Disputes

During 2018, we have seen many insurers become more aggressive in handling and denying claims in the adviser space. Insurers have taken more aggressive positions in seeking to deny coverage both on substantive grounds – such as contending that claims are not covered under the policy or subject to exclusions in the policy – and based on purported failures to comply with conditions in the policy – such as the insured not providing sufficient cooperation to the insurer or failing to obtain the insurer's consent before settling a claim. We have represented a number of adviser clients in coverage disputes with their insurers during the past year.

Continued Ability to Obtain Significant Coverage Enhancements

Despite the difficult claims environment, there has continued to be significant opportunity to negotiate substantial coverage enhancements to policies, usually with little or no increase in premiums. Clients that have shopped for the best coverage possible and negotiated with their insurers have often been able to improve their coverage in critical areas such as: broadening coverage for government investigations; narrowing or eliminating exclusions to coverage; improving coverage for trade errors or costs of correction; and limiting insurers' ability to deny coverage based on purported violations of policy conditions. These improvements to coverage are especially important given the more aggressive positions insurers have been taking when handling claims.

Enhancing Coverage for Government Investigations

The risk of SEC and other government investigations continues to be a key concern for advisers, but the opportunity to protect against these risks through insurance has continued to significantly expand. Whereas traditionally the coverage offered by management liability policies for government investigations had been limited in that coverage was not triggered until late in the investigation (after significant costs had already been incurred), there are now numerous insurers that will agree to provide coverage for the costs of defending government investigations from the very earliest stages. This enhanced coverage is not a part of the insurers' standard forms, however, and must be demanded and negotiated. We anticipate that the opportunity for such enhanced coverage for government investigations will continue into 2019, and given its wide availability and critical importance, it is a significant missed opportunity for an adviser not to seek and obtain such enhanced coverage.

Focus on Protecting Individuals

We have continued to see an increased emphasis on obtaining dedicated insurance limits for individuals (called "Side A policies") or for independent directors (called "IDL" policies) and to negotiate enhancements to such policies. We expect this trend to continue as advisers, key individuals, and Boards continue to become more savvy about the availability of insurance to protect against the legal and regulatory risks they face for managing investment funds.

Increased Attention to Protecting against Risks Arising from Portfolio Companies

Private equity firms continue to face growing risks from lawsuits against their individuals who serve as directors of portfolio companies and against the sponsor private equity firm itself. As a result, the importance of coordinating indemnification and insurance coverage at the fund level and portfolio company level, and carefully reviewing both sets of policies, to ensure the risks associated with portfolio companies has been addressed, continues to grow.

Protection Against Cyber Risks

Although cyber-risks remain a significant concern to advisers, the market still has not yet developed a single product that fully and comprehensively protects against all of the cyber risks faced by advisers. Thus, many advisers still do not purchase any cyber coverage. Those that seek maximum protection still must address different types of cyber risks through a combination of products, such as stand-alone 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. During 2018, some insurers broadened their cyber policies or enhanced the endorsements to their bonds in ways that have continued to enhance the available coverage for key risks such as social engineering. Others are beginning to address business income losses, including declines in management fees, resulting from cyber events. The cyber market is still not mature and significant manuscripting of policy language is required to obtain effective insurance coverage. Proskauer has made this area a priority for 2019. How such coverage continues to expand, and whether any insurer creates a comprehensive product addressing cyber risks in the fund space, will be a development to watch in 2019.

Looking Ahead to 2019

We expect that the claim environment in 2019 will continue to be difficult, as insurers have continued to be aggressive in handling claims during the second half of 2018. Fortunately for policyholders, however, the ability to negotiate coverage enhancements when purchasing or renewing policies also appears to be continuing. Thus, there should be continued opportunities for advisers to obtain enhancements in their coverage if they explore the market and negotiate with potential insurers during 2019. Advisers that take advantage of this opportunity 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, particularly during the current challenging claim environment.

Estate Planning

Lifetime Estate, Gift and GST Tax Exemptions

The estate and gift tax regimes have been permanent and unified since the passage of The American Taxpayer Relief Act of 2012 (the “2012 Act”). In 2017, the Tax Cuts and Jobs Act (the “TCJA”) significantly increased the estate, gift and generation-skipping transfer (“GST”) tax exemptions for 2018, which will continue to be increased for inflation through December 31, 2025. The increases under the TCJA are as follows:

- In 2018, there is an $11,180,000 federal estate tax exemption and a 40% top federal estate tax rate.
- In 2018, there is an $11,180,000 GST tax exemption and a 40% top federal GST tax rate.
- In 2018, the lifetime gift tax exemption is $11,180,000 and a 40% top federal gift tax rate.
- In 2018, the annual gift tax exclusion is $15,000.

The exemptions for the estate, gift and GST transfer tax are scheduled to increase further for inflation in 2019 under the TCJA, while the annual gift tax exclusion is likely to remain at $15,000 in 2019. However, the increased exemption is scheduled to sunset on December 31, 2025. Thereafter, the exemptions are set to return to the $5 million exemption, indexed for inflation, which applied under the 2012 Act.

These increased exemptions under the TCJA create opportunities to make larger lifetime gifts, to leverage more assets through a variety of estate planning techniques (such as a sale to a grantor trust) and to 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.

In particular, those who used substantially all of their exemptions prior to 2018 should now consider making additional lifetime gifts to utilize the increased exemptions before they sunset at the end of 2025.

Gift Tax Annual Exclusion

In 2019, the gift tax annual exclusion amount per donee will remain $15,000 for gifts made by an individual and $30,000 for gifts made by a married couple who agree to “split” their gifts. If you have not already done so, now is the time to take advantage of your remaining 2018 gift tax exclusion amount, being $15,000 for gifts made by an individual and $30,000 for gifts made by a married couple who agree to "split" their gifts, so that you can ensure that gifts are "completed" before December 31, 2018.

In lieu of cash gifts, consider gifting securities or interests in privately held companies or other family-owned entities. The assets that you give away now may be worth significantly less than they once were, and their value hopefully will increase in the future. So the $30,000 gift that your spouse and you make today (and the $30,000 gifts that your spouse and you make in 2019) may have a built-in discount that the Internal Revenue Service cannot reasonably question. That discount will inure to the benefit of your beneficiaries if the value of those assets rises.

Your annual exclusion gifts may be made directly to your beneficiaries or to trusts that you establish 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 you have created a trust that contains beneficiary withdrawal powers, it is essential that your Trustees send Crummey letters to the beneficiaries whenever you (or anyone else) make a trust contribution.

If you have created an insurance trust, 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.

2018 Gift Tax Returns

Gift tax returns for gifts that you made in 2018 are due on April 15, 2019. You can extend the due date to October 15, 2019 on a timely filed request for an automatic extension of time to file your 2018 income tax return, which also extends the time to file your gift tax return. If you created a trust in 2018, you should direct your accountant to elect to have your generation-skipping transfer ("GST") tax exemption either allocated or not allocated, as the case may be, to contributions to that trust. It is critical that you not overlook that step, which must be taken even if your gifts do not exceed the annual gift tax exclusion and would, therefore, not otherwise require the filing of a gift tax return. You should call one of our attorneys if you have any questions about your GST tax exemption allocation.

IRA Required Minimum Distributions Deadline

If you are the owner of a traditional IRA, you must begin to receive required minimum distributions ("RMDs") from your IRA and, subject to narrow exceptions, other retirement plans, by April 1 of the year after you turn 70½. You must receive those distributions by December 31 of each year. If you are the current beneficiary of an inherited IRA, you must take RMDs by December 31 of each year regardless of your age. The RMDs must be separately calculated for each retirement account that you own, and you, not the financial institution at which your account is held, are ultimately responsible for making the correct calculations. The penalty for not withdrawing your RMD by December 31 of each year is an additional 50% tax on the amount that should have been withdrawn. Please consult us if you need assistance with your RMDs.

Additionally, once you have attained the age of 70½, you can donate up to $100,000 a year from your IRA directly to a qualified charity. This donation can include your RMD amount and the distribution to a qualified charity will be totally excluded from your taxable income.

If you wish to discuss any aspect of this material as it may relate to your estate planning, please contact one of the lawyers in the Private Client Services Department at Proskauer.

Reorganization and Chapter 11

Over the past year, important decisions have been rendered by federal courts (i) making it easier for debtors to obtain the necessary number of "impaired accepting classes" and thereby to cramdown plans of reorganization, (ii) opining on what the correct test should be for non-statutory insiders, and (iii) deciding whether section 546(e) of the Bankruptcy Code can shield transfers made through financial institutions acting merely as "conduits" from attack as fraudulent transfers.

The Impaired Accepting Class: One *Per Plan* or One *Per Debtor*?

The Bankruptcy Code allows for the nonconsensual confirmation of a plan of reorganization over the objection of a class of claims only if certain safeguards are satisfied. One of those safeguards is the "impaired accepting class:" the requirement that "at least one class of claims that is impaired under the plan has accepted the plan." 11 U.S.C. § 1129(a)(10). This requirement is a critical protection for creditors, giving them greater leverage and ensuring that a plan of reorganization has at least some minimal level of creditor support. It raises a question of interpretation, however, in modern bankruptcy practice, where a large number of affiliated debtors' cases are jointly administered and a single, joint plan of reorganization is proposed restructuring a multitude of debtors at once. The question is whether section 1129(a)(10) requires there to be simply one impaired accepting class *per plan*, even if that plan encompasses multiple debtors, or one impaired accepting class *per debtor*, a much harder standard to satisfy. The Ninth Circuit recently attempted to resolve this controversy, which has been answered differently by bankruptcy courts in the Second and Third Circuits.

The Transwest Decision

The Ninth Circuit came out firmly on the side of the *per plan* interpretation. In *JPMCC 2007-C1 Grasslawn Lodging, LLC v. Transwest Resort Properties Inc., (In re Transwest Resort Props, Inc.)*, 881 F.3d 724 (9th Cir. 2018), the debtor companies owned and operated two hotel resorts. The debtors were composed of two operating companies, which were wholly owned by two intermediate, mezzanine holding companies, which were in turn wholly owned by one ultimate holding company. In 2008, JPMCC 2007-C1 Grasslawn Lodging, LLC provided financing to the operating company debtors, secured by liens over the resorts. Another entity provided financing to the mezzanine companies, secured by the mezzanine company's ownership interests in the operating companies. In 2010, all five debtors filed for bankruptcy. After the bankruptcy had been filed, Grasslawn bought the claim against the mezzanine companies, making Grasslawn their only creditor.

The Debtors proposed a joint plan for all five debtors. Under the joint plan, a third-party investor would acquire the operating companies, extinguishing the mezzanine companies' ownership interests. Moreover, Grasslawn's loan to the operating companies would be restructured, being extended to a 21-year term and provided with deferred cash payments, among other things. Various creditors of the operating companies voted in favor of the plan, giving it one impaired accepting class on a *per plan* basis (*i.e.*, with respect to the single, joint plan). However, Grasslawn was no fan of the plan, and voted all of its claims to reject it. As a result, in relation to the mezzanine company debtors, there was no impaired accepting class, and as such, the plan would not be confirmable under the *per debtor* approach. Grasslawn objected to confirmation of the plan, because the plan failed to satisfy the "impaired accepting class" requirement for nonconsensual confirmation when applied on a *per debtor* basis.

The Bankruptcy Court for the District of Arizona confirmed the plan over Grasslawn's objection, a decision upheld by the District Court. Grasslawn appealed to the Ninth Circuit, which affirmed the lower courts' decision. It gave short shrift to Grasslawn's arguments for a *per debtor* approach, holding that the "plain language of the statute supports the 'per plan' approach" after highlighting the fact section 1129(a)(10) only stated "at least one class of claims that is impaired under *the plan* has accepted *the plan*." The court pointed out that the section "makes no distinction concerning or reference to the creditors of different debtors under 'the plan,' nor does it distinguish between single-debtor and multi-debtor plans."

Moreover, the Ninth Circuit rejected the argument that section 102(7), mandating that the "the singular includes the plural," supported Grasslawn's argument, instead finding section 1129(a)(10) perfectly amenable to a *per plan* interpretation even if it was emended to read "the plans." The court further dispatched arguments contending that section 1129(a)(10) had to be interpreted on a *per debtor* basis because other subsections of section 1129(a) were interpreted on a *per debtor* basis, suggesting—rather summarily—that none of the subsections of section 1129(a) required a *per debtor* approach, but that even if they did section 1129(a)(10) still did not, by its plain language. Finally, the Ninth Circuit made short work of a consequentialist argument by Grasslawn that endorsing the *per plan* approach would harm secured creditors' positions, holding that "to the extent [Grasslawn] argues that the 'per plan' approach would result in a parade of horribles for mezzanine lenders, such hypothetical concerns are policy considerations best left for Congress to resolve."

In Judge Friedland's concurring opinion, she noted that, while the "the statutory language is somewhat ambiguous," the better reading of section 1129(a)(10) was that it applied on a *per plan* basis. And while Judge Friedland was sympathetic to Grasslawn's arguments they had been unfairly treated, she laid the blame on Grasslawn's failure to object to the plan on substantive consolidation grounds.

Raining on the Per Plan Parade of Horribles

The Ninth Circuit's decision is a significant boon for debtors, giving them more flexibility to cram down plans than they would have if the court had applied a *per debtor* approach. The increasing split among circuits on this point may encourage debtors to forum shop, looking for favorable jurisdictions that abide by the *per plan* approach. It is not, however, clear that the Ninth Circuit is correct that the "plain language" of the Bankruptcy Code provides for the *per plan* approach, as not a single section of the Bankruptcy Code permits joint plans or so much as mentions cases involving more than one debtor. As such, it is not actually evident Congress intended—or even foresaw—the rise of the *per plan* approach and its concomitant effect of diluting the requirements for nonconsensual confirmation. Whether the Ninth Circuit's view becomes the predominant one across the circuits remains to be seen.

Inside the Incidents of the (Non-Statutory) Insider

The Bankruptcy Code places a variety of limitations on "insiders," parties thought to have connections so close to the debtor they ought to be given special treatment. The Bankruptcy Code lists a long line of parties who qualify as "insiders" *ipso facto*, *see* 11 U.S.C. § 101(31), but courts have built on this list to include other parties who would not otherwise qualify under the Bankruptcy Code's definition—so called "non-statutory insiders." The courts have not unanimously settled on a test to determine whether a party qualifies as a non-statutory insider, however. Many courts, including the Ninth Circuit, focus on whether a person's transaction with the debtor was made at arm's length. *See, e.g., In re U.S. Medical, Inc.*, 531 F.3d 1272, 1280 (10th Cir. 2008). However, others courts and commentators are not enamored with this approach, and the Supreme Court has not yet opined on the issue.

Justice Sotomayor's Concurring Opinion

Nonetheless, the Supreme Court came close to addressing the scope of "non-statutory insiders" in *U.S. Bank N.A., Trustee, by and through Capital Asset Mgmt. LLC v. The Village at Lakeridge, LLC*, 583 U.S. ____ (2018), where Justice Sotomayor provided insight on the issue in her concurring opinion.

The facts of *The Village at Lakeridge* are fairly simple. The debtor, Lakeridge, was at all relevant times owned by one party, MBP Equity Partners, and owed two substantial debts: one to U.S. Bank for $10m, and another to MBP for $2.76m. Lakeridge sought to confirm a plan, separately classifying and impairing both claims, but U.S. Bank voted to reject the plan. Lakeridge wished to cramdown the plan over MBP's objection, but this was only possible if there was at least one "impaired accepting class" which had accepted the plan. *See* 11 U.S.C. § 1129(a)(10). The only other class that could serve as this "impaired accepting class" was the class containing MBP's claim. However, the requirements of section 1129(a)(10) had to be satisfied "without including any acceptance of the plan by any insider," and MBP was as thoroughly an insider as could be, being 100% owner and completely in control of the debtor. *See* 11 U.S.C. § 101(31)(B)(iii). The plan was therefore doomed to the extent MBP remained holder of the claim.

To solve this otherwise intractable issue, Kathleen Bartlett, a member of MBP's board and an officer of Lakeridge, came up with a plan: transfer the claim to a non-insider who could and would vote for the plan. She found a willing participant in Robert Rabkin, a surgeon with whom Bartlett was in a "romantic" relationship. Rabkin purchased the claim and voted in favor of the plan. Rabkin did not qualify as an "insider" pursuant to the categories contained in section 101(31), but U.S. Bank nevertheless sought to designate Rabkin's vote because, they argued, he was a non-statutory insider by virtue of his relationship with Bartlett.

The Bankruptcy Court rejected this argument and ruled Rabkin was not an insider, finding that while Bartlett and Rabkin's relationship may well have been "romantic," Rabkin did adequate diligence and bought the claim as a "speculative investment." On appeal, the Ninth Circuit stated that, to decide whether a person qualified as a non-statutory insider, a bankruptcy court must consider two things: "(1) [whether] the closeness of its relationship with the debtor is comparable to that of the enumerated insider classifications in [the Bankruptcy Code], and (2) [whether] the relevant transaction is negotiated at less than arm's length." The court deferred to the Bankruptcy Court's determination that Rabkin was not an insider as he had engaged in an arm's length transaction with MBP, which decision was not in "clear error."

U.S. Bank petitioned for certiorari, which the U.S. Supreme Court granted, but only as to the narrow question of whether the Ninth Circuit appropriately applied the "clear-error" standard of review—specifically refusing to consider whether the Ninth Circuit's test for a non-statutory insider was the correct test or whether the Bankruptcy Court had made a clear error on the facts. Sticking to its limited mandate, the Supreme Court upheld the Ninth Circuit's determination that clear-error review was appropriate, deciding that the issue of whether a transaction qualified as "arm's length" or not should only be reviewed "with a serious thumb on the scale for the bankruptcy court," as it involved predominantly factual questions.

The Supreme Court's limited mandate, however, did not stop Justice Sotomayor from opining on what she thought was the correct test for a non-statutory insider. Joined by Justices Kennedy, Thomas and Gorsuch, Justice Sotomayor wished to express her concerns about the Ninth Circuit's test. Reiterating its dual pronged evaluation, which looked at both (a) the quality of the entity's relationship with the debtor *and* (b) the nature of the transaction, Justice Sotomayor noted it was hard to reconcile with the plain meaning of the term "insider" as used in the Bankruptcy Code. This was because the Bankruptcy Code's definition looked just to (a) and did not consider (b), the quality of the entity's relationship with the debtor. For example, Justice Sotomayor alluded to the fact the spouse of the debtor would be considered, *ipso facto*, an insider by virtue of his/her intimate relationship alone, *see* 11 U.S.C. §§ 101(31), (45), and her vote would be designated regardless of whether or not she engaged in an arm's length transaction with the debtor. But under the Ninth Circuit's test, another romantic partner, "even one who in all or most respects acts like a spouse," would not be considered an insider unless it could be shown that he or she had not dealt with the debtor at arm's length. As noted by Justice Sotomayor "the basis for the disparate treatment of two similar individuals is not immediately apparent." Why, she questioned, was it presumed a "lack of arm's length . . . follows from [a relational] label" when it came to statutory insiders, but had to be proven as a separate requirement when it came to non-statutory insiders?

Failing to find a satisfactory answer, she proposed two potential alternate tests that would be "consistent with the understanding that insider status inherently presumes that transactions are not conducted at arm's length." First, Justice Sotomayor proposed that the inquiry could "focus solely on a comparison between the characteristics of the alleged non-statutory insider and the enumerated insiders, and if they share sufficient commonalities, the alleged person or entity should be deemed an insider regardless of the apparent arm's length nature of any transaction." Second, Justice Sotomayor also mooted a test which focused on "a broader comparison that includes consideration of the circumstances surrounding any relevant transaction," under which the arm's length (or not) nature of a transaction would color the finding of whether a given party was an insider, but would not be determinative. And Justice Sotomayor speculated that under either test the appropriate standard of appellate review could very well be the less deferential *de novo* standard, rather than the difficult to satisfy "clear-error" standard. Engaging in an abbreviated form of such review, Justice Sotomayor expressed considerable doubt as to whether Rabkin would have escaped from the definition of non-statutory insider under either of her tests.

The Future of Non-Statutory Insiders

Justice Sotomayor's thought-provoking opinion, joined by Justices Kennedy, Gorsuch and Thomas, will no doubt prove influential for years to come, and, given its apparent simplification of the law, may expand the universe of persons who are deemed insiders. However, it may be questioned whether this is desirable. Justice Sotomayor's opinion could be said to have been motivated largely by the apparent miscarriage of justice on the facts of *Lakeridge*. Reading the facts from the Supreme Court's decision, it is hard to see how the lover of one of the debtor's board members, who bought the debtor's $2.7m claim for an unstated price (apparently below $5,000) and for the singular purpose of effectuating a cramdown dreamt up by the debtor did not qualify as an insider. That Justice Sotomayor was obviously perturbed by this is clear from the fact she devotes a page and a half of her judgment to speculating why Rabkin would have been considered an insider under either of her newly minted tests and why the appellate courts would have been entitled to exercise greater scrutiny under all of them.

Application of Bankruptcy Code 546(e)'s Fraudulent Transfer Safe Harbor to Financial Institutions

The Bankruptcy Code provides a debtor the power to avoid certain fraudulent transfers made when an insolvent debtor received less than reasonably equivalent value in exchange for transfers of cash or other assets. The Bankruptcy Code, however, provides protections from a debtor's avoidance powers to certain transactions, such as the "securities safe harbor" under Bankruptcy Code section 546(e), which shields transfers that are margin payments, settlement payments, or related to securities contracts, when "made by or to (or for the benefit of) . . . financial institutions" or other securities markets participants. As transactions become more sophisticated, they invariably involve transfers effectuated through a series of steps or through a series of entities, and in some instances where the intermediary entity fleetingly holds the transferred assets as a "mere conduit" for the transfer. In such instances where the intermediary entity is a financial institution, it is unclear whether the securities safe harbor under Section 546(e) should apply to insulate the transfer from a debtor's avoidance powers.

The Merit Management Decision

The Supreme Court addressed this issue in *Merit Management Group, LP v. FTI Consulting, Inc.*, 583 U.S. ___, 138 S. Ct. 883 (Feb. 27, 2018). In *Merit Management*, Valley View Downs, LP and Bedford Downs Management Corp. were competing to acquire the last harness-racing license in Pennsylvania. They ultimately decided to join together to compete for the license, and entered into an agreement where Valley View agreed to acquire all of the shares of Bedford for $55 million as part of a larger transaction. Two banks served as intermediaries in the transaction. Credit Suisse was responsible for wiring and disbursing the money from Valley View to Bedford's shareholders, including Bedford's largest shareholder, Merit Management. Citizens Bank of Pennsylvania was the escrow agent responsible for exchanging the purchase money and the stock certificates to close the transaction.

At closing, Valley View received the Bedford Downs stock, and shareholders of Bedford Downs received the purchase money. Merit Management received approximately $16.5 million from the sale of its Bedford Downs stock. However, Valley View never got to open its racetrack, and it (along with its parent company Centaur, LLC) filed for chapter 11 bankruptcy. After plan confirmation, the Centaur litigation trustee sued Merit Management seeking to recover $16.5 million that Merit Management received in exchange for its shares as a constructive fraudulent transfer. The trustee alleged that Valley View was insolvent at the time it paid for the Bedford shares, and that Valley View had "significantly overpaid" for those shares.

Merit Management argued that the trustee was barred from avoiding the transfer under the safe harbor protections of Section 546(e) because the transfer was made by and through two financial institutions, Credit Suisse and Citizens Bank. The Seventh Circuit disagreed, holding that Section 546(e) does not protect "transfers that are simply conducted through financial institutions."

In a unanimous ruling, the Supreme Court agreed with the Seventh Circuit's interpretation of Section 546(e). The court held that the relevant focus for purposes of a safe harbor analysis is on the end-to-end transfer view. Accordingly, the transfer should be looked at merely between Valley View and Merit Management. In *Merit Management*, that means the transfer the trustee seeks to avoid is the $16.5 million payment from Valley View to Merit, and not any flow of funds from Valley View to either Credit Suisse or Citizens Bank. The Court noted that the text and structure of Section 546(e) makes clear that the safe harbor "applies to the overarching transfer that the trustee seeks to avoid, not any component part of that transfer."

The Court reasoned that, after a trustee files an avoidance action identifying the transfer it seeks to set aside, a defendant in that action is free to argue that the trustee failed to properly identify an avoidable transfer under the Code, including any available arguments concerning the role of component parts of the transfer. However, "if a trustee properly identifies an avoidable transfer . . . the court has no reason to examine the relevance of component parts when considering a limit to the avoiding power. . . ." In sum, the Supreme Court affirmed the Seventh Circuit's decision that Section 546(e) did not apply where financial institutions served "as mere conduits."

Implications of the Merit Management Decision

The Supreme Court's decision in *Merit Management* disrupts the existing securities safe harbor that protected many transactions from fraudulent transfer risk, including leveraged buyouts, leveraged recapitalizations, and other transfers effectuated through financial institutions. The decision also invites more aggressive litigation tactics with its focus on the transfer as framed by the trustee.

European Union

Brexit

Brexit: Outcome Still Uncertain

In late March 2017, Theresa May, Prime Minister of the United Kingdom (UK), formally notified the European Union (EU) Council of the UK's intention to leave the EU under Article 50 of the EU's Lisbon Treaty. This triggered a two-year period during which the terms of the UK's exit from the EU must be agreed, which is set to end on 29 March 2019, unless there is an agreement between the UK and all other 27 EU member states (Member States) to extend this period.

The UK and the EU agreed on guidelines for a proposed transitional period following 29 March 2019. Under the terms of such proposed transitional arrangements, it is proposed that most EU legislation would continue to apply in the UK in the same way that it currently does until 31 December 2020. In such a scenario, the short-term impact of the UK leaving the EU on the financial services sector within the UK and the EU should be minimal.

However, to date, there is yet to be any confirmation that this proposed transitional arrangement will come into effect. Consequently, there is still uncertainty as to whether a deal will be agreed, what such a deal would look like and whether a transitional period will be in place. As a result, the UK is currently set to leave the EU on a "hard Brexit" basis on 29 March 2019.

Expected Loss of the Financial Services Cross-Border "Passport" for the UK

From a financial services perspective, firms authorized in the UK currently benefit from an EU financial services "passport" under one or more EU Directives (such as the Markets in Financial Instruments Directive (MiFID) or the Alternative Investment Fund Managers Directive (AIFMD)). This allows such firms to carry out cross-border activities (be this through the provision of services or the establishment of a branch in other EU Member States).

It is widely expected that the UK will not become a member of the European Economic Area (EEA) when it leaves the EU. As a consequence, it would become a "third country" (*i.e.*, a non-EEA country) and the provisions applicable to third countries would become applicable to UK firms. This will result in a curtailment of the freedoms UK firms currently enjoy. For example, UK alternative investment fund managers (AIFMs) would no longer be able to use the cross-border marketing passport when marketing their alternative investment funds across the EU. Instead they would need to market in other EU Member States through making national private placement regime (NPPR) notifications in each Member State into which they wish to market. It is possible that UK firms may be given a special status under a Brexit deal which would allow UK firms to continue to have access to the passport under special conditions, but this remains just one of a number of possible Brexit outcomes.

For U.S. managers marketing their funds in the UK, it is expected the UK will retain the AIFMD regime as it is currently implemented into its domestic law for the foreseeable future (and beyond Brexit). Therefore, U.S. managers would continue to need to submit NPPR notifications to the UK Financial Conduct Authority (FCA) prior to marketing their funds in the UK.

Brexit negotiations between the UK and the EU should be monitored closely and firms potentially impacted should be contingency planning on the potential longer-term effects of the UK leaving the EU, whether or not the proposed transitional period is implemented.

Extension of the Senior Managers' & Certification Regime in the UK

The Senior Managers and Certification Regime (SMCR) currently only applies to banks and systematically important investment firms in the UK. The SMCR will, however, be extended to all firms authorised by the Financial Conduct Authority (FCA) from 9 December 2019. The SMCR will constitute a complete overhaul of the current regulation of individuals at FCA-regulated firms in the UK (including UK investment advisers and fund managers) who are currently governed by the FCA's approved persons regime. Broadly, the SMCR applies to firms which are authorised in the UK, therefore it should not have any impact on non-UK firms (*e.g.*, U.S. fund managers marketing in the UK).

AIFMD Update

No Extension of the Passport Expected in the Foreseeable Future

In July 2016, the European Securities and Markets Authority (ESMA) published its final advice (ESMA Advice) on extending the application of the marketing passport under the AIFMD to non-European managers. This advice was largely positive in extending the marketing passport to the United States, Canada, Guernsey, Japan, Jersey and Switzerland. Further details on ESMA's advice can be found in our previous briefing on the subject. Since the publication of ESMA's advice in July 2016 there has been no further development which indicates that the third country passport will be extended to non-EEA countries in the foreseeable future.

The delay and lack of progress in extending the passport is primarily due to the Brexit vote in the UK and the wider political considerations that accompany any decision to extend the AIFMD marketing passport to one or more non-EEA countries. The consequence of this lack of progress means that the non-EEA managers will continue to only be able to market funds in the EEA via the making of NPPR notifications in each Member States where it is possible (and feasible) to do so.

Harmonised Definition of Pre-Marketing?

The European Commission has been working on a new proposed Omnibus Regulation, designed to address certain issues in the AIFMD and UCITS Directive relating to marketing and passporting issues. As part of this, a harmonised definition of "pre-marketing" is proposed. At the moment, the interlinked concepts of "pre-marketing" and "marketing" are interpreted differently by Member States, with no formal definition in relation to the same. The timeframe for the proposed Omnibus Regulation remains uncertain but developments in relation to it should be monitored.

AIFMD II

The AIFMD contains provisions requiring the European Commission to commence a review of its application and scope by July 2017. The European Commission commissioned a survey to be carried out on the effectiveness of AIFMD and this closed at the end of March 2018. Whilst the outcome of this survey has yet to be published, it is not expected that significant changes will be proposed to the existing AIFMD framework. Fund managers should continue to monitor ongoing developments on any resulting legislative process.

Packaged Retail and Insurance-Based Investment Products

Background

On January 1, 2018, the EU Regulation on Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation ((EU) No 1286/2014) (the PRIIPs Regulation) came into force across EU Member States.

The aim of the PRIIPs Regulation is to encourage efficient EU markets by helping retail investors within the territory of the EU to better understand and compare the key features, risk, rewards and costs of different PRIIPs, through access to a short and consumer-friendly Key Information Document (KID). It is the manufacturer of the PRIIP (which in the case of a fund would generally be the fund manager) that is required to prepare a KID for each PRIIP that they produce and provide this to retail investors within the territory of the EU. The manufacturer is then required to publish each such KID on their website.

The definition of "retail investor" in the PRIIPs Regulation cross-refers to the definition in the Second Markets in Financial Instrument Directive (Directive 2014/65/EU and related EU legislation collectively referred to as MiFID II). The definition essentially applies to all EU investors that do not fall within the definition of "professional client" under Annex II of MiFID II. Natural persons in the EU may only be categorized as a "professional client" under MiFID II if they can be "opted-up." Under the qualitative criteria, the investor must be assessed (taking into account the investor's expertise, experience and knowledge) and deemed to be capable of making his, her or its own investment decisions and understanding the risks involved with the transaction envisaged. Certain disclosures are also required to be made to the investor (normally through a stand-alone notice or letter). To be opted-up they must meet quantitative and qualitative criteria. Under the quantitative criteria, two of the following three conditions must be met:

- the person has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters;
- the size of the person's financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds €500,000; and
- the person works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.

It is therefore difficult for individuals that have high net worth, but no experience of working in the financial sector, to be opted-up to professional client status. In such circumstances, such an investor would be categorized as a retail investor and a KID would need to be produced and provided to the investor before they invest in the fund.

The PRIIPs Regulation applies to PRIIPs manufacturers established anywhere in the world in circumstances where they make their product available to retail investors within the territory of the EU. Consequently, fund managers around the world that do not want to produce a KID should ensure that only investors within the territory of the EU meeting the "professional client" definition under MiFID II are permitted to invest in their funds.

There is a lack of legal clarity on the treatment of carried interest or co-investment vehicles under the PRIIPs Regulation, and an established market view has yet to develop. Within its recitals, the PRIIPs Regulation states that it applies to products "manufactured by the financial services industry to provide investment opportunities to retail investors" and goes on to state that funds "dedicated to institutional investors" are excluded from the scope of the PRIIPs Regulation. As such, if the only retail investors participating in such vehicles are investors "internal" to the fund manager (*e.g.*, executives or employees involved in the management of the fund manager), there is an argument that such vehicles are not "manufactured" to provide investment opportunities to retail investors, and on this basis no KID would need to be prepared. There has yet to be regulatory confirmation or guidance on this approach and so advice should be sought on a case-by-case basis.

Requirements for the KID

The PRIIPs Regulation requires that a KID is a stand-alone, standardized document prepared for each investment. A KID can be up to a maximum of 3 sides of A4-sized paper and may refer to other documents such as a prospectus if the cross-reference is related to the information required to be included in the KID, or refer to where detailed information can be found.

Each KID will need to contain the following information, presented in a predetermined sequence of sections. The sections are:

- What is this product?
- What are the risks and what could I get in return?
- What happens if the PRIIP manufacturer is unable to pay out?
- What are the costs?
- How long should I hold it and can I take money out early?
- How can I complain?
- Other relevant information.

The PRIIPS Regulation outlines the layout of the KID and the delegated regulation (referred to as EU Regulatory Technical Standards) contains detailed rules on: the content and presentation of the KID; how to calculate some of the information in the KID; the review of the KID and revision and republication of the KID; and the timing of delivery of the KID.

Fund managers around the world seeking to raise capital from retail investors in the EU were required to produce a KID for each of their funds made available to such investors in the EU from 1 January 2018. As noted above, fund managers should ensure they have necessary policy and procedures in place to either ensure that no EU retail investors are permitted to invest in their fund or they should ensure that a KID is produced and that they comply with the ongoing requirements under the PRIIPS Regulation. This includes a requirement to review and revise their KIDs on an annual basis and whenever there is a change that is likely to significantly affect the information therein.

MiFID II

Background and Application to Fund Managers

MiFID II came into force on January 3, 2018. Broadly, the MiFID framework regulates firms which provide services to clients linked to "financial instruments" (shares, bonds, units in collective investment schemes and derivatives), and the venues where those instruments are traded.

Fund management is not an investment activity caught under MiFID II; rather such activities would fall within the scope of the Undertakings for the Collective Investment in Transferable Securities Directive or the AIFMD. However, EU fund managers that manage segregated accounts would be carrying out the

MiFID activity of portfolio management and therefore are caught by the requirements under MiFID II as discussed below.

Some of the MiFID II requirements that EU-based discretionary portfolio managers need to comply with are:

Inducement and Investment Research – EU firms providing independent investment advice and portfolio management services are not permitted to accept and retain fees, commissions or any monetary or non-monetary benefits provided by a third party in relation to the relevant client services (these are referred to as “inducements” in MiFID). “Minor non-monetary benefits” capable of enhancing the quality of client service are excluded from this prohibition, although they must be clearly disclosed to clients. Under the MiFID II rules, the provision of research by third parties to portfolio managers are treated as a prohibited “inducement” unless it is unbundled from execution costs and received in return for either: (a) direct payments by the portfolio manager out of its own resources; or (b) payments from a separate research payment account controlled by the portfolio manager.

Best Execution – MiFID II imposes increased requirements on EU investment firms to seek best execution for customer and portfolio orders. Order execution policies are required to be amended to ensure that the factors used to choose trading venues are applied to more subcategories of financial instrument, and firms need to provide greater transparency on the top five execution venues used for each subclass of financial instrument they trade for managed portfolios.

Transaction Reporting – MiFID II has increased the scope of reportable transactions to include financial instruments traded, or admitted to trading, on all EU trading venues, not just EU regulated markets. Discretionary portfolio managers are potentially within this scope, because the reporting requirement will apply to both counterparties that are market-facing and those that are not. In addition, transaction reporting itself is now more onerous because of an increase in the information that must be reported.

Telephone taping – certain investment firms, including discretionary portfolio managers, must comply with new, more burdensome communication-recording requirements. In addition, there is a requirement for telephone conversations that lead to, or are likely to lead to, the conclusion of transactions to be recorded. These recordings are required to be held for five years.

Product Governance – MiFID II has introduced a number of requirements that in broad terms require EU manufacturers and EU distributors of investment products to identify target markets, ensure that such products are compatible with those markets, and carry out regular reviews of how the product is distributed.

Categorization of Local Authorities/Municipalities – local authorities and municipalities in the EU are under MiFID II categorized as retail clients rather than professional clients unless they can be opted up to professional client status. This is relevant for firms that provide services, or sell investment products, to EU local authority pension funds.

Some EU Member States have chosen to “gold-plate” national laws so as to impose MiFID requirements on non-MiFID firms. This is the case in the UK, where the FCA has applied some of the MiFID II requirements to AIFMs. As MiFID II came into force in EU member states in January 2018, UK fund managers should continue to monitor their compliance with the relevant FCA rules as they apply to them.

In general, the requirements of MiFID II apply to EU investment firms and are not directly applicable to non-EU fund managers. However, non-EU fund managers which deal with, or provide services to, EU investment firms are likely to be indirectly impacted by certain MiFID II requirements where EU investment firms have adapted their processes to comply with their own MiFID II requirements. For example, EU investment firms executing trades on behalf of non-EU clients are required to obtain more information from their clients (such as the client's legal entity identifier (LEI)) in order to meet their own MiFID II transaction reporting obligations. Equally, some EU managers that delegate portfolio management services to non-EU managers will have revised their delegation agreements to reflect MiFID II requirements. In so doing, the EU managers may contractually seek to impose some of the MiFID II requirements on their non-EU delegates.

Fund managers should be aware of the requirements and obligations relevant to them under MiFID II and should continue to monitor their compliance with the new rules.

UK Tax

Brexit Tax Update

As the date for the UK's exit from the European Union (the "EU") of 29 March 2019 approaches, we discuss here some of the potential consequences of the UK's exit from the EU ("Brexit") in relation to certain areas of UK tax law.

It should be noted that, if the UK was to leave the EU with no deal and, in addition, no transitional period was agreed, then the effect on UK tax, as well as on the UK more generally, would likely be more acute than as described here.

EU Tax Directives

Interest and Royalties Directive

Currently, this Directive provides relief from withholding taxes on interest and royalties payments made between 25%+ associated companies in different EU Member States. The aim behind this Directive is that the interest and royalties payments between associated companies in different EU Member States should not be taxed more unfavourably than those payments between associated companies in the same EU Member State.

Following the UK's exit from the EU, or the end of any transitional period which may be agreed, this Directive, and the relief which it provides, will no longer be binding for the UK and EU Member States so far as it relates to UK companies. The Directive has been implemented into UK domestic law (ss. 757-767 Income Tax (Trading and Other Income) Act 2005) which provides UK companies with an exemption from withholding tax on interest and royalties paid to 25%+ associated EU resident companies. It is not clear, however, whether this will be repealed post-Brexit. This may mean therefore, if the corresponding domestic law is repealed, that such companies will instead have to rely on the bilateral double taxation agreements in place between the UK and other EU Member States in order to reduce any withholding tax rates on royalties or interest. It is likely that, in having to rely on double taxation agreements rather than the Directive, full relief from such withholding taxes may not be so easily available for UK companies.

Parent-Subsidiary Directive

The Parent-Subsidiary Directive aims to prevent double taxation on profit distributions within corporate groups across the EU. Double taxation occurs when dividends from a subsidiary in one EU Member State are paid to its parent in another EU Member State. A subsidiary will pay tax on its profits before then paying a dividend to its parent company from those taxed profits. Upon receipt of the dividend from its subsidiary, the parent would then be taxed on its dividend. The directive tackles this double taxation by (i) preventing withholding tax on dividends paid by a company of one Member State (*i.e.*, the subsidiary) to an associated company of another Member State (*i.e.*, the parent) provided certain conditions are met and (ii) exempting the distributed profits received by the parent from tax or giving a tax credit for the underlying tax paid by the subsidiary.

The domestic UK legislative framework in this regard is effectively independent of any obligations under the Parent-Subsidiary Directive and so it is unlikely that the UK Government will make changes simply because the UK leaves the EU. The UK does not impose dividend withholding tax (other than on Property Income Distributions by UK REITs) and offers a broad range of exemptions from tax on foreign dividends received by a UK parent company. However, most EU Member States impose withholding tax on dividends as a matter of their own domestic law and so UK parent companies will become reliant on relevant bilateral double tax treaties to mitigate or eliminate such withholding taxes after this Directive ceases to apply to the UK.

Bilateral Tax Treaties

Continuing effect of UK's bilateral treaties

Separate from its membership of the EU, the UK is a party to a large number of bilateral tax agreements with both EU and non-EU countries. These agreements remain in effect and will continue to apply upon the UK's exit from the EU.

With the expected loss of relief under directives such as the Parent-Subsidiary Directive and Interest and Royalties Directive upon the UK's exit from the EU, this existing set of treaties will become the primary means of determining the UK's taxation relationship with other countries, whether part of the EU or not. Generally, the UK does not impose a withholding tax on dividends as a matter of domestic law, but many countries do. Therefore, the reduction or elimination of withholding tax which can be available through bilateral treaties will become more important, although it is likely that full relief may become more difficult to obtain (for associated companies) than under EU Directives or existing EU bilateral agreements with non-EU countries.

Consequences for non-UK entities with UK owners under other bilateral treaties

Furthermore, it is worth noting that the UK's current status as a Member State of the EU has other, more nuanced, benefits in relation to bilateral treaties with countries across the world. For example, certain countries, including the United States, include a "limitation of benefits" clause in bilateral tax agreements which they enter into with other countries. This clause contains certain additional requirements which must be met in order for the reliefs within the treaty to be available and, in some instances, these include indirect owners of a payee being resident in an EU Member State. There is no clarity on how this will be addressed post-Brexit.

Value Added Tax

Value added tax ("VAT") is an indirect tax introduced by the EU and charged on the final consumer of supplies of goods and services provided commercially. As a Member State, the UK has fully implemented the EU VAT Directive, which outlines the principles relating to VAT. Current law in relation to the supply of goods and services across the EU is harmonised to limit the cost to businesses of VAT (by allowing businesses to recover VAT costs) so as to satisfy the EU principle of free movement of goods.

Once the UK has left the EU, it will no longer be required to follow the principles of the VAT Directive. However, VAT generates substantial revenue for HMRC and the UK Government has indicated that it intends to retain VAT. Both the UK and the EU have indicated that the current principles of VAT are expected to continue to be followed, as least in part, in relation to the UK until 31 December 2020. If the UK Government takes no further action before 31 December 2020, VAT in its near-current form will continue in effect after that date. However, the VAT Directive has been implemented on the basis of the UK being an EU Member State and so amendments would be needed to reflect the change in the UK's status in relation to the EU and to update the VAT regime moving forward. In particular, more complex rules in relation to supply of goods and services between the UK and the EU will need to be agreed to limit any negative effect, for UK businesses in particular, on cash flow due to new potential upfront VAT charges on imports of goods from EU Member States (which currently move free of import VAT but will, post-Brexit, likely attract UK import VAT). The UK Government has also indicated that it may change the VAT input tax deduction rules on supplies of financial services from the UK to EU Member States. In addition, and more generally, the UK will need to make certain policy decisions in relation to the exact form which VAT will take in the UK once it has left the EU.

Trade and Customs Duty

Due to the principle of free movement of goods, under EU law there is a prohibition on customs duties on imports and exports of goods across the EU. Therefore, once goods have arrived in the EU, they are freely circulated within the EU without further customs duty or VAT. In addition, a common customs tariff exists in relation to trade by the EU with non-EU countries.

Although the nature of the trading relationship between the UK and the EU after the UK leaves is not yet clear, the UK Government has indicated that it is not seeking membership of the single market and does not intend to remain bound by either the common commercial policy (under which the EU makes agreements and implements policy in relation to trade with non-EU countries) or the common customs tariff.

If no transitional agreement, or long-term free trade agreement at the end of any transitional period, is reached with the EU, UK trade with the EU would revert to the standard World Trade Organisation ("WTO") terms (the UK being a WTO member in its own right). Additionally, the UK will no longer have the benefit of a number of trade agreements which the EU has entered into with non-EU countries which provide for cheaper customs tariffs. Unless the UK introduces replacement bilateral trade agreements with these countries, any trade relationship will again be determined by reference to the WTO rules.

New UK primary legislation, the Taxation (Cross-border Trade) Act 2018 (TCBT Act), which received Royal Assent on 13 September 2018, lays the framework for a stand-alone UK customs regime after the UK leaves the EU. This Act gives the UK Government wide-ranging powers to introduce secondary legislation to reflect developing negotiations with both the EU and non-EU countries with whom new trade and customs agreements are required. Under the TCBT Act, the existing EU customs duties law will be disapplied excepting that which has been domestically implemented into UK law.

As it currently stands, the form of any potential trade agreement with the EU post-Brexit ranges from continuing under the current tariff-free basis to basic WTO rules with no separate agreement but, regardless of the form which any agreement will take, the customs duty interaction with the EU will likely become much more complex.

Other Non-UK domestic tax law consequences of Brexit

The full fiscal effects of the UK's departure from the EU have not yet been determined, and the consequences will extend beyond EU and bilateral treaties. For example, some jurisdictions' local withholding tax exemptions in relation to interest (for example, Ireland) rely on the payee being a resident of the EU or the EEA. Others, such as Germany, may impose increased taxes on receipt of payments such as dividends from non-EU resident companies. Whether local laws are amended to remove or lessen these effects post-Brexit, and whether alternative exemptions may apply, will need to be monitored as the landscape develops.

China

China Financial Regulators Jointly Release New Rules to Regulate Asset Management Sector

On April 27, 2018, the People's Bank of China (PBOC), the China Banking and Insurance Regulatory Commission (CBIRC), the China Securities Regulatory Commission (CSRC) and the State Administration of Foreign Exchange (SAFE) jointly released the *Guiding Opinions on Regulating the Asset Management Business of Financial Institutions* (the "Guiding Opinions"). The Guiding Opinions came into immediate effect but allow a grace period until the end of 2020, by when all covered financial institutions (including banks, trust companies, securities companies, fund management companies, futures companies, insurance asset management companies and financial asset investment companies) must comply with them.

Comprising of a total of 31 articles, the Guiding Opinions aim to transform the regulatory regime of asset management business in China from a segmented model to a more centralized model. Before the release of the Guiding Opinions, asset management products (AMPs) were separately regulated based on the type of financial institutions offering the products. AMPs offered by different types of financial institutions were subject to different sets of rules and regulations issued by different regulators. Consolidating a number of rules and regulations previously issued by different regulators, the Guiding Opinions provide that AMPs should be regulated based on the type of products, rather than the type of financial institutions offering the products. The Guiding Opinions further provide guidelines on categories of AMPs, as well as the investment scope, information disclosure and investor suitability requirements applicable to different categories of AMPs.

Strengthening the supervision of shadow banking and channel businesses is another key focus of the Guiding Opinions. The Guiding Opinions expressly prohibit financial institutions from launching AMPs with the intention of circumventing regulatory restrictions, such as requirements on risk reserves, liquidity ratio and concentration ratio. The Guiding Opinions provide that where an AMP offered by a financial institution substantially invests into an AMP offered by another financial institution, the second financial institution must be a licensed institution with professional investment capabilities and qualifications, and only one layer of such delegation is allowed. This means that AMPs can only have two layers at maximum, and multi-tranche products will no longer be allowed.

The Guiding Opinions also prohibit financial institutions from providing guarantees or repurchase commitments for AMPs. The Guiding Opinions categorize asset management business as an off-balance sheet business of financial institutions. On this basis, financial institutions are not allowed to provide any form of guarantee (implicit or explicit) for AMPs offered by them. Repurchase commitments for AMPs, including the rolling forward of AMPs via new issuance, are also not allowed under the Guiding Opinions.

The Guiding Opinions for the first time set out requirements for robo-advisory services. Under the Guiding Opinions, robo-advisory services can only be provided by qualified investment advisers. Financial institutions are required to set up a risk management system specific to their use of robo-advisers. When providing robo-advisory services, financial institutions are also required to comply with the above-referenced investment scope, information disclosure, investor suitability and certain other requirements provided in the Guiding Opinions.

In general, the provisions of the Guiding Opinions are broad and general, and the regulators are still expected to issue more detailed guidelines on implementation before the Guiding Opinions could be implemented in the real world.

China further opens up its financial service sector to foreign investment

On June 28, 2018, China's National Development and Reform Commission (NDRC) and Ministry of Commerce (MOFCOM) jointly released the 2018 version of *Special Administrative Measures on Access of Foreign Investment into China* (the "2018 Negative List"), which took effect as of July 28, 2018. The 2018 Negative List contains 48 restricted and prohibited sectors for foreign investment, reduced from 63 in the previous version (*i.e.*, the 2017 version) of the negative list (the "2017 Negative List"). Compared with the 2017 Negative List, one of the most significant changes included in the 2018 Negative List is in the financial service sector. Specifically, for commercial banks, the 2018 Negative List has removed the restriction on the percentage of foreign shares of a commercial bank, and allows foreign investors to set up a wholly owned commercial bank in China. For securities companies, fund management companies, futures companies and life insurance companies, the 2018 Negative List has increased the cap on foreign ownership from 50% to 51%. This means that a foreign investor can now be a majority shareholder of these companies. The Chinese government has further promised to remove this foreign ownership limitation completely by 2021.

Hong Kong

Changes in HKEx Listing Rules and impact

On April 30, 2018, the most significant changes to be made to the Hong Kong Stock Exchange (HKEx) Listing Rules in 25 years were introduced. The underlying motivation behind the reforms was to fend off competition from other exchanges and to attract more hi-tech companies. These amendments permit (i) listings of biotech companies that do not meet any of the Main Board financial eligibility tests, and (ii) listings of companies with weighted voting right structures (WVR). The absence of a WVR regime in Hong Kong at the time that Alibaba was seeking a listing venue for an entity with that structure has been a key factor behind the second rule change.

Biotech Companies

This class of eligible applicants for listing will include companies with no revenue or profit, whilst providing appropriate investor protection from the risks associated with such companies. The HKEx had added new Biotech chapter to its Listing Rules (Chapter 18A), and has also published guidance ("Suitability for Listing of Biotech Companies") on the factors that it will take into account when determining an applicant's eligibility and suitability to list under the Biotech chapter. The guidance can be accessed at this link.

Broadly, an applicant in this category will be expected to demonstrate the following features:

- it must have developed at least one "Core Product" beyond the concept stage, which it will have done if it has met the developmental milestones specified for that type of product;
- it must have been primarily engaged in R&D for the purposes of developing that product;
- it must have been engaged with the R&D of the product(s) for a minimum of 12 months prior to listing;
- it must have as its primary reason for listing the raising of finance for R&D to bring its product(s) to commercialization;

- it must have patent(s), registered patent(s), patent application(s) and/or intellectual property in relation to the product(s);
- if the applicant is engaged in the R&D of pharmaceutical (small molecule drugs) products or biologic products, it must demonstrate that it has a pipeline of those potential products; and
- it must have previously received meaningful third party investment (being more than just a token investment) from at least one Sophisticated Investor at least six months before the date of the proposed listing (which must remain at IPO).

Companies with WVR Structures

The HKEx had added a new WVR chapter to its Listing Rules (Chapter 8A), and has also published guidance ("Suitability for Listing with a WVR Structure") on the factors that it will take into account when determining an applicant's eligibility and suitability to list with a WVR structure. The guidance can be accessed at this link.

To be suitable for listing with a WVR structure, an applicant must meet the basic meets requirements including the following:

- the applicant must be an innovative company, *e.g.*, its success is demonstrated to be attributable to the application, to the company's core business, of (1) new technologies; (2) innovations; and/or (3) a new business model, which also serves to differentiate the company from existing players;
- the applicant must demonstrate a track record of high business growth, as can be objectively measured by operational metrics and its high growth trajectory is expected to continue;
- each WVR beneficiary must have been materially responsible for the growth of the business, by way of his skills, knowledge and/or strategic direction in circumstances where the value of the company is largely attributable or attached to intangible human capital;
- each WVR beneficiary must be (i) an individual who has an active executive role within the business, and has contributed to a material extent to the ongoing growth of the business; and (ii) a director of the issuer at the time of listing; and
- the applicant must have previously received meaningful third party investment (being more than just a token investment) from at least one Sophisticated Investor (which must remain at IPO).

Since the rule changes were introduced, there has been a surge in new listing applications, with the bourse attracting the largest number of IPOs for any third quarter period.

Stock Connect

Increase in Quota

With effect from May 1, 2018, the China Securities Regulatory Commission (CSRC) and the SFC agreed to increase the daily quotas under both Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect for the northbound trading links for both markets to RMB52 billion, and the daily quota for each of the southbound trading links from both markets to RMB42 billion.

Launch of Investor Identification for Northbound Trading under Stock Connect

The SFC also reached an agreement with the CSRC to implement an investor identification regime for northbound trading under the Stock Connect on September 17, 2018.

The investor identification regime is intended to facilitate more effective monitoring and surveillance by the CSRC and Mainland stock exchanges to safeguard market integrity. The HKEx is expected to issue an announcement soon to provide more information about the launch of the new regime.

Both regulators have previously signaled their intention, on a reciprocal basis, to introduce a similar investor identification regime for southbound trading to assist one another in performing their regulatory functions under Stock Connect. The regime for southbound trading will be implemented as soon as practicable.

Programme for Conversion of Domestic to H Shares

In a novel development for H-share companies listed on the HKEx, the CSRC is promoting a pilot program enabling selected H-share companies to convert all of their domestic shares into H-shares. The program has started in a modest way with just a handful of companies converting their stock so far. PRC joint stock companies have two classes of shares: H-shares which are listed and tradeable, and domestic shares, which are not listed and not tradeable. There are approximately 250 of these companies listed on the HKEx, and this represents a huge block of non-tradable stock. The move has been fueled by existence of the trading links now in place between the HKEx and the Shanghai and Shenzhen exchanges, and the increased interest by Mainland investors in Hong Kong stocks. It is predicted that if all H-share stocks were converted and made liquid in this way, this could increase trading on the HKEx by up to 50%.

Asset Management Regulation and Point-of-Sale Transparency

The Securities and Futures Commission (SFC) conducted a market consultation putting forward proposals to enhance asset management regulation and point-of-sale transparency motivated by financial policy reforms published by bodies such as the International Organization of Securities Commissions and the Financial Stability Board. The key areas of focus of the proposed changes were (i) securities lending and repurchase agreements (repos), (ii) custodian/safe custody of fund assets, (iii) liquidity risk management, and (iv) disclosure of leverage. Following the conclusion of its consultation, changes have been made to the Code of Conduct for Persons Licensed by or Registered with the SFC (Code of Conduct) and the Fund Manager Code of Conduct (FMCC).

Fund Manager Code of Conduct

Important changes are to be made the FMCC to take effect on November 17, 2018. The FMCC applies to fund managers who are licensed by or registered with the SFC; *i.e.*, their business involves the discretionary management of collective investment schemes (whether or not "authorized" by the SFC) and/or discretionary accounts (in the form of an investment mandate or predefined model portfolio) (Fund Managers).

Certain of the FMCC's requirements apply only to a fund manager which is responsible for the overall operation of a fund. The SFC has published an FAQ as to when a fund manager would be determined to be responsible for the overall operation of a fund, which can be accessed here.

Code of Conduct

In parallel with these changes, the SFC has also made complimentary amendments to the Code of Conduct which took effect on August 17, 2018. A particular consequence of these amendments when combined with those to be made the FMCC is that to clarify that the Code of Conduct and its general principles also apply to Fund Managers.

Further Changes to the OTC Derivatives Regulatory Regime

Hong Kong's OTC derivatives regulatory regime is being implemented in phases. The first phase for clearing was implemented on September 1, 2016, and the first two phases for reporting by July 1, 2017.

Following a further joint consultation of the HKMA and the SFC, the following further changes will be implemented:

- mandating the use of Legal Entity Identifiers (LEIs) for trade reporting over two phases. The first phase will apply only to parties on the reporting entity's side of a transaction and will take effect on April 1, 2019;
- expansion of the product scope to certain standardized interest rate swaps denominated in Australian Dollars (AUD IRS) for phase 2 of clearing. Mandatory clearing of AUD IRS is not expected to commence before Q4 2019; and
- adoption of a trading determination process and criteria for considering which products are appropriate to be subject to a platform trading obligation in Hong Kong. This process would take into account a range of factors including factors considered in the *Report on Trading of OTC Derivatives* published by the Technical Committee of the International Organization of Securities Commissions (IOSCO) in 2011. The report highlights that the standardisation and liquidity of derivatives products are important elements that affect whether a product should be traded on a platform and the type of platform that may provide a practicable venue for trading.

SFC Adopts IOSCO's Enhanced Standard for Cross-Border Enforcement Cooperation

In May 2018, the SFC became one of the first signatories to the Enhanced Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (EMMoU) of IOSCO for cross-border enforcement cooperation. The EMMoU, approved by IOSCO in March 2017, is built upon the current Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information to which the SFC became a signatory in March 2003.

The EMMoU provides IOSCO members with a framework for mutual assistance and exchange of information, for securities regulators to obtain and share audit working papers, telephone as well as internet records, compel attendance at interviews and provide guidance on freezing of assets.

Signatories (Appendix A.1) to the full ambit of powers (including the enhanced powers) so far include the Monetary Authority of Singapore and the Commodity Futures Trading Commission of the U.S.

Signatories (Appendix A.2) to the narrower range of powers (excluding the enhanced powers) so far include the Australian Securities and Investments Commission and the UK's Financial Conduct Authority. Information on the EMMoU can be found at the IOSCO website at this link.

SFC Standardises Rules for Prescribing Professional Investors

The SFC amended the Securities and Futures (Professional Investor) Rules (PI Rules) with effect from July 13, 2018, to standardise the rules for prescribing professional investors. The purpose of the amendments was to incorporate into the PI Rules modifications previously granted by the SFC to the regime on an individual basis under its powers under the SFO, so that they apply uniformly to the whole market.

The amendments allow portfolios held in joint accounts with non-associates and in investment corporations wholly-owned by an individual to count towards meeting the threshold to qualify as a professional investor. The categories of professional investors have been expanded to include corporations which have investment holding as their principal business and are wholly-owned by one or more professional investors, as well as corporations which wholly own another corporation which is a qualified professional investor. In addition, alternative forms of evidence will be allowed to demonstrate qualification as a professional investor.

Open-Ended Fund Companies

We reported in both our 2016 and 2017 Annual Reviews on the steps being taken to implement a regime for the use of Hong Kong incorporated open-ended fund companies (OFCs) as local investment fund vehicles. The legislative regime came into effect on 30 July 2018 allowing investment funds to be established in Hong Kong in corporate form. And the Code on Open-ended Fund Companies took effect on the same day and can be accessed here.

It is expected that this new vehicle may be utilized mostly by retail funds. However, it has also been designed for use by private funds, including hedge funds.

Further details about this new regime published by the SFC can be accessed at this link.

Whilst all OFCs (whether publicly or privately offered) will be required to be registered with the SFC, private OFCs would be allowed flexibility to pursue their investment strategies set out in their instrument of incorporation and offering documents, as long as they met the basic principles in the OFC Code. The investment management function of an OFC would be required to be delegated to an investment manager licensed by the SFC to carry out Type 9 (asset management) regulated activity, so that the investment manager would also be required to comply with the conduct requirements applicable to that licence type, including those set out in the FMCC.

SFC Consults on Changes to Anti-Money Laundering Guidelines

In July 2018, the SFC consulted the securities market on proposed amendments to its Guideline on Anti-Money Laundering and Counter-Terrorist Financing, with the aim of updating it to bring them into line with the latest FATF standards. The key proposals included in the consultation are these:

- expand the types of politically exposed persons (PEPs) to include persons who have been entrusted with a prominent function by an international organisation, and extend the special requirements for foreign PEPs to high risk business relationships with domestic PEPs and international organisation PEPs;
- require licensed corporations (LCs) incorporated in Hong Kong to implement group-wide AML/CFT systems in all of their overseas branches and subsidiary undertakings that carry on the same business as financial institutions, including information sharing and the provision of information to group-level functions subject to adequate safeguards. Where the AML/CFT requirements in the jurisdiction where the overseas branch or subsidiary is located differ from those set out in the Guideline, the LC should require that branch or subsidiary to apply the higher of the two sets of requirements, to the extent that host jurisdiction’s laws and regulations permit;
- require LCs to identify and assess money laundering/terrorist financing risks that may arise from the use of new and developing technologies for both new and pre-existing products prior to the use of these technologies;
- allow LCs to stop pursuing the customer due diligence (CDD) process if they reasonably believe that performing the process will tip off the customer, and require the LCs to file a suspicious transaction report to the Joint Financial Intelligence Unit in these circumstances; and

- require LCs to keep all records obtained throughout the CDD and ongoing monitoring processes, including the results of any analysis undertaken (*e.g.*, inquiries to establish the background and purpose of complex, unusual large transactions).

Latin America

The Enactment of the Brazilian Data Protection Law (BDPL)

On August 14, 2018, the Brazilian Personal Data Protection Law (Law No. 13.709/18) was enacted, representing a comprehensive regulatory framework concerning the protection of personal data in Brazil. The BDPL was based on the EU's General Data Protection Regulation, which became effective on May 25, 2018, after a two-year transition period since its approval and adoption by the EU Parliament.

The BDPL will enter into force on February 15, 2020, but certain matters addressed in the BDPL still require further regulation by Brazilian authorities.

BDPL represents an important landmark in the treatment of personal data in Brazil, as it sets forth strict rules for the processing of personal data of an identified or identifiable individual in Brazil and establishes severe penalties for lack of compliance with such rules.

Overall, the BDPL will have a major effect on how personal data is collected, processed and used. BDPL will likely reshape the data protection system in Brazil and require adjustments by all sectors of consumer and business relations that use data collection and processing for the tracking of the profile, consumption habits or credit scores of customers.

In this sense, individuals and entities that process personal data within the Brazilian territory or offer goods or services to individuals in Brazil must be aware of the implications of the enactment of BDPL in their operations and business. Controllers and processors of data will be required to adopt effective measures for the processing of data in order to comply with BDPL. BDPL does not require data controllers and processors to create policies or manuals. Nevertheless, it is advisable to create manuals in light of the general rules for data collection and processing, the rules concerning the data subjects' rights, and other obligations.

Principles guiding the BDPL

BDPL provides for new principles, guidelines and restrictions on the manner personal data may be processed, such as non-discrimination, transparency, security, prevention and data quality. Among the several principles that guide the application of the BDPL, two are worthy of particular attention: (i) purpose: a legitimate, specific and express purpose must guide the processing of personal data, and (ii) limitation: all data processing must be restricted to the purposes for which such personal data was collected. Therefore, processing must be limited to the minimum required for its purpose and done appropriately in order to avoid excess processing and usage.

Sensitive protected data is defined as "personal data on racial or ethnic origin, religious beliefs, political opinions, affiliation to trade unions or organizations of a religious, philosophical or political nature, data relating to health or sex life, and genetic or biometric data, when related to a natural person." BDPL requires this type of data to be processed only in a limited fashion and that it must be handled with additional care.

Scope and extraterritorial application of BDPL

The BDPL will apply to (i) any person, whether individual or private or public legal entities, engaged in personal data processing, whether or not it is carried out on the internet or using digital media, with the purpose to offer goods, products or services to persons in Brazil; (ii) personal data processing activities in the Brazilian territory or outside Brazil, where personal data is collected in Brazil or are related to individuals located in the Brazilian territory. BDPL does not apply to the processing of personal data in Brazil if the data was collected abroad and was not shared with entities in Brazil or any other country except the country in which the data originated, which must have data protection laws in accordance with the standards set forth in the bill.

It is worth noting international transfers of personal data (*i.e.*, transfers of personal data from Brazil to other countries) are permitted under BDPL if the transfer is made to jurisdiction with adequate levels of data protection, or to ensure the protection of the data subject's or a third party's life or physical integrity, or if specific and highlighted consent regarding such transfer is granted by the data subject.

Permitted data processing

The BDPL is not applicable when the processing of personal data is carried out: (i) by individuals for private and noneconomic purposes; (ii) journalistic, artistic or academic purposes; (iii) in connection with investigations or in the suppression of criminal offenses; (iv) in the interest of public security and national defense; or (v) in other countries or for other countries that only passes through the Brazilian territory provided that any processing is carried out in Brazil.

Accordingly, the processing of personal data is justified under the scenarios described below:

- through consent of the data subject. Consent must be in written or by any other form by which the data subject can express its express consent, provided that implicit consent shall not be accepted. If processing refers to sensitive personal data, consent must be in a specific and highlighted manner;
- in case of a legal or regulatory obligation imposed to the controller;
- by the Brazilian government, to implement public policies;
- to conduct studies and research, provided that anonymization of the personal data is assured, whenever possible;
- if necessary for the execution of an agreement or for preliminary contractual procedures;
- to protect the life or the physical safety of the data subject or of third parties;
- in case of the regular exercise of rights, in court, administrative or arbitration proceedings;
- in the legitimate interest of the controller or a third party, except when the personal data refers to fundamental rights or the freedom of the data subject;
- for health protection, in procedures conducted by heath care professionals or health authorities; and
- for credit protection.

Rights of the Data Subject

The following rights are guaranteed to the data subject by the BDPL: (a) to obtain information about the existence of processing of their personal data; (b) to access their personal data; (c) to correct incomplete, inaccurate or outdated personal data; (d) to have unnecessary or excessive personal data or personal data processed in contravention of the legislation anonymized, blocked, or deleted; (e) to carry out portability of personal data to another provider of a service or product (that is, to have someone who holds their personal data transfer it to a third party, at the request of the data subject); (f) to delete their personal data processed on the basis of their consent (that is, the right to revoke their consent given earlier); (g) to obtain information on the public and private entities with which the controller has shared the data subjects' personal data; and (h) to obtain information about the possibility of not giving consent to the processing of their personal data and the consequences of such denial.

Administrative Sanctions

Noncompliance with the rules set forth in the BDPL may result in the application of several penalties which can be applied on a cumulative basis. Sanctions include a partial or total ban on data processing activities and fines of up to the larger of 2% of the turnover of the sanctioned entity or conglomerate and R$50 million (which currently equals approximately US$14 million) per violation.

Sanctions will be determined considering the seriousness, nature and extent of the violation, as well as other factors such as the good faith of the offender, recurrence, the economic condition of the offender and its cooperation with authorities, its adoption of good practices and governance policies and corrective measures implemented by the offender. Nevertheless, it is important to highlight that the applications of the penalties mentioned above do not preclude the application of additional civil, administrative or criminal sanctions.

Ongoing Developments on the Disclosure of Ultimate Beneficial Owners (UBOs) of FIPs

Brazilian fund administrators continue to place particular emphasis on implementation of know your client procedures (KYC) associated with the Brazilian regulations which require the disclosure of the ultimate beneficial owners of investment structures. These rules are particularly important for international players investing in Brazilian private equity investment funds (*fundos de investimento em participação*, or FIPs), because, as discussed in our 2017 Annual Review, subject to certain requirements, dividends and capital gains distributed by FIPs to non-Brazilian investors are exempt from Brazilian income tax.

On each distribution by a FIP, its Brazilian fund administrator is liable for collecting Brazilian taxes at the appropriate tax rate. For this reason, in addition to proper completion of their KYC procedures, certain Brazilian fund administrators are now requiring the bylaws of FIPs to allow them to refuse investments from, and/or withhold distributions to, non-Brazilian investors which fail to comply with the Brazilian UBO disclosure rules.

In order to avoid delays in closing, early in the fund structuring process sponsors, general partners and non-Brazilian administrators and respective counsel should discuss with Brazilian administrators their KYC procedures and "rules of engagement" in respect of the disclosure of UBOs. These include addressing these requirements in the administration agreement and bylaws of the FIP and also in the limited partnership agreement, the subscription agreement and other documents pertaining to the international feeder.

To recap, Normative Instruction n. 1,634/2016, issued by the Brazilian Revenue Service ("IN 1,634"), regulates the registration of investors before the Brazilian Revenue Service. Non-Brazilian investors investing in Brazilian securities or assets, including quotas of FIPs, are required to obtain a Brazilian Tax ID (*Cadastro Nacional de Pessoas Jurídicas*, or CNPJ). This requirement applies to investment vehicles and feeders used by non-Brazilian investors, as investors-of-record in the FIPs.

Under Section 8 of IN 1,634, all entities registered with the CNPJ must disclose their respective corporate chain up to the level of their final beneficiary or any of the entities which is listed in paragraph 3 of Section 8.

For the purposes of Section 8, the final beneficiary is deemed to be (a) the natural person which, ultimately, directly or indirectly, holds title, controls or significantly influences the entity or (b) the natural person on behalf of whom a transaction is performed. Significant influence is presumed when the natural person: (i) holds more than 25% of the capital of the entity, directly or indirectly or (ii) directly or indirectly holds the right to or actually preponderates in the corporate decisions and in the election of the majority of the managers of the entity, even without controlling it.

The entities listed in paragraph 3 of Section 8 (which represent a “stop point” in the structure, above which no further disclosure is required) are:

- public legal entities in Brazil or abroad, in the latter case provided they are incorporated in countries that require disclosure of the relevant shareholders and not incorporated in low tax jurisdictions or subject to privileged tax regimes;
- not-for-profit organizations that do not act as fiduciary administrators and that are not incorporated in low tax jurisdictions or subject to privileged tax regimes, provided they are regulated and inspected by competent government authorities;
- multilateral agencies, central banks, governmental entities or entities linked to sovereign funds;
- pension funds and similar institutions, provided they are regulated and inspected by competent governmental agencies;
- Brazilian investment funds regulated by the Brazilian Securities Commission, provided that the Tax ID number of the investors are provided to Brazilian tax authorities;
- collective investment vehicles incorporated for the sole purpose of gathering resources from private pension plans and individuals insurance plans, provided they are duly inspected and regulated by the competent governmental authority in their country of origin; and
- foreign collective investment vehicles whose equity interests are traded in organized markets regulated by a body recognized as competent by the Brazilian Securities Commission, or foreign collective vehicles: (a) with a minimum of 100 investors, provided that no investor has significant influence, (b) which portfolio is managed, on a discretionary basis, by a professional manager registered with a competent body recognized by the Brazilian Securities Commission, in its place of incorporation, (c) subject to investor’s protection regulations issued by the competent authority recognized by the Brazilian Securities Commission and (d) with a diversified portfolio, understood as the one in which the concentration of investments in a single asset does not lead to significant influence.

Relaxation of Rules for Investments Abroad by Brazilian Pension Funds

Brazilian regulators have relaxed the rules for Brazilian pension funds to invest in non-Brazilian assets. Among other changes, securities of non-Brazilian funds in which Brazilian pension funds invest are no longer required to have an investment grade. In addition, these non-Brazilian invested funds are now allowed to employ leverage and exceed the previously applicable 5% concentration limitation in assets of the same issuer. On the other hand, a Brazilian pension fund is not allowed to invest more than 15% of its assets in a single investment fund (down from 25%).

In addition, Brazilian regulations require that any investment in non-Brazilian funds are made through Brazilian funds and that the invested non-Brazilian funds are managed by portfolio managers which have (i) been in existence for at least five years and (ii) at least US$ 5.0 billion in assets under management on the date of the Brazilian pension fund’s investment. The invested fund must have a performance record of at least 12 months. In other words, Brazilian pension funds are not allowed to invest in newly formed funds.

Annual and Other Periodic Filing Requirements

Below is a summary of certain key filing requirements applicable to 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, 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 April 1, 2019 for advisers with a December 31 fiscal year-end). Registered advisers must deliver the updated Form ADV Part 2A, or a summary of the changes made, to clients within 120 days following the adviser's fiscal year-end (by April 30, 2019 for advisers with a December 31 fiscal year-end). Although underlying investors of private funds managed by the advisers are not "clients" of the 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, 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 advisers to file their Form ADV with the relevant state securities authorities. Advisers may also be subject to additional state requirements where, for example, the adviser has a place of business in the state and/or has over five non-exempt clients in that state. Advisers may also be subject to certain blue sky requirements, as discussed below. An adviser should review its business on a periodic basis to determine whether any additional state requirements have been triggered.

Form PF

A registered 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 adviser and the type of private funds managed by it.

In general, a registered 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 adviser's fiscal year (by April 30, 2019 for advisers with a December 31 fiscal year-end). However, the reporting requirements for advisers with larger RAUMs will be more frequent and/or more extensive. In particular:

- Large Hedge Fund Advisers. An 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, 2019 for the quarter ending December 31, 2018).
- Large Private Equity Fund Advisers. An 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 April 30, 2019 for investment advisers with a December 31 fiscal year-end).
- Large Liquidity Fund Advisers. An 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 15, 2019 for the quarter ending December 31, 2018).

For purposes of determining whether an adviser meets any of the large adviser classifications above, the 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 blue sky laws, since, under Section 18 of the Securities Act, the states are preempted 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.

Advisers 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 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 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 advisers that exceeded the reporting threshold for the first time in 2018, the first Form 13F filing deadline in 2019 will be February 14, 2019 (for the quarter ending December 31, 2018).

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 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, 2019 for 2018). 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, 2019 for 2018).

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 2018 amendments will be February 14, 2019.

Forms 3, 4 and 5

Form 3. A person, including an 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, 2019 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, 2019 for 2018). 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, 2019 for 2018).

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 April 1, 2018, 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.

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, 2018 will be March 1, 2019 for Large CPOs and April 1, 2019 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, 2018 will be February 14, 2019. 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. adviser (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 adviser 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. 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 be 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 and 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.*, a 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. advisers with aggregate holdings of reportable long-term securities with a fair market value of at least $1 billion by the adviser and its clients are likely to be subject to Form SLT reporting. An 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 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 (*e.g.,* by J**anuary 23, 2019** for December 2018). 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. However, U.S. private funds will not have to report on BE-13 unless a foreign person acquires 10% or more of the voting interests in an operating company indirectly through the U.S. private fund.

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.

Form 8832 Filings. If an entity filed an IRS Form 8832 (an entity classification election) with respect to 2018, 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 2018 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 2018 will be the due date (including any applicable extensions) of that U.S. person's 2018 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 2018 (and subsequent years), the deadline will be the due date (including any applicable extensions) of the private fund's 2018 U.S. federal income tax return.

CbCR Reporting. A U.S. tax resident parent entity of a multinational enterprise (MNE) group that has revenues of $850 million or more during the taxable year must file IRS Form 8975 by the due date (including any applicable extensions) of its 2018 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 generally is not required of U.S. tax-exempt investors);
- 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 2018 U.S. federal income tax return.

Other Annual Requirements and Considerations

Audited Financial Statements Delivery

Rule 206(4)-2 of the Advisers Act (Custody Rule) requires registered 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 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 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 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, 2019, 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 July 1, 2019, 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 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 nonaffiliated 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 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 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 adviser of any subsequent change in its new issues status.

ERISA/VCOC 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" (VCOC) 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 VCOC requirements and/or the 25% benefit plan investor limit. Private funds that accept investments from ERISA investors should conduct the VCOC 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 actually are 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 Financing Law Requirements

The California Financing Law 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.

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." Any party contemplating retention of a placement agent or any solicitation of CalSTRS, CalPERS or the University of California pension system can contact a member of Proskauer 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 previously had not 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.

2019 Federal Filings and Other Document Delivery Calendar

Filing / Delivery	Who must file	Deadline
November 2018		
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, 2018)
NFA Form PR	Registered CTAs	November 14 (for the quarter ending September 30, 2018)
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 2018)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding $350 million as of any month	November 15 (for October 2018)
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 2018)
Form PF	Large Hedge Fund Advisers	November 29 (for the quarter ending September 30, 2018)
CFTC Form CPO-PQR	Large CPOs	November 29 (for the quarter ending September 30, 2018)
NFA Form CPO-PQR	All registered CPOs, except Large CPOs	November 29 (for the quarter ending September 30, 2018)
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 2018)

December 2018		
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 17 (for November 2018). Note: Usually filed on the 15th calendar day of the following month, but if the 15th day is a holiday, Saturday or Sunday, the filing deadline is extended until the next business day.
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding $350 million as of any month	December 17 (for November 2018)
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 24 (for November 2018). Note: Usually filed on the 23rd calendar day of the following month, but if the 23rd day is a holiday, Saturday or Sunday, the filing deadline is extended until the next business day.
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 2018)
January 2019		
Form PF	Large Liquidity Fund Advisers	January 15 (for the quarter ending December 31, 2018)
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 15 (for December 2018)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding $350 million as of any month	January 15 (for December 2018)

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 22 (for the quarter ending December 31, 2018) (Martin Luther King, Jr. Day is on January 21, 2019)
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 2018)
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, 2018)
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 2018)
February 2019		
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, 2018)
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.e.*, Qualified Institutional Investors and/or passive investors)	February 14 (for 2018)
Form 13H Annual Amendment	Large traders of Regulation NMS securities	February 14 (for 2018)
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, 2018)

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 2019)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding $350 million as of any month	February 15 (for January 2019)
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 25 (for January 2019)
	March 2019	
Form PF	Large Hedge Fund Advisers	March 1 (for the quarter ending December 31, 2018)
CFTC Form CPO-PQR	Large CPOs	March 1 (for the quarter ending December 31, 2018)
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 2018)
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 2019)
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 2019)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding $350 million as of any month	March 15 (for February 2019)
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 25 (for February 2019)

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 2019)
CRS Information Reports	Financial institutions in "Participating Jurisdictions" (which currently do not include the US)	Consult local advisers
FATCA Information Report	Participating FFIs (except for FFIs in Model 1 IGA jurisdictions) FFIs in Model 1 IGA jurisdictions	Consult local advisers
	April 2019	
Form ADV Part 1 Annual Update	Registered investment advisers and exempt reporting advisers	April 1 (for an investment adviser with a December 31 fiscal year-end)
NFA Commodity Pool Annual Financial Statements Filing	Registered CPOs	April 1 (for a pool with a December 31 fiscal year-end)
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 15 (for the quarter ending March 31, 2019)
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 15 (for March 2019)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding $350 million as of any month	April 15 (for March 2019)
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 22 (for the quarter ending March 31, 2019)

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 23 (for March 2019)
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 Private Fund Investors	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, 2019)
Delivery of quarterly 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 2019)
Form ADV Part 2A Annual Update	Registered investment advisers	April 30 (for an investment adviser with a December 31 fiscal year-end)
Form PF	Registered investment advisers with at least $150 million in RAUM attributable to private funds, including Large Private Equity Fund Advisers	April 30 (for an investment adviser with a December 31 fiscal year-end)
May 2019		
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, 2019)
NFA Form PR	All registered CTAs	May 15 (for the quarter ending March 31, 2019)
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 2019)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding $350 million as of any month	May 15 (for April 2019)

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 2019)
Form PF	Large Hedge Fund Advisers	May 30 (for the quarter ending March 31, 2019)
CFTC Form CPO-PQR	Large CPOs	May 30 (for the quarter ending March 31, 2019)
NFA Form CPO-PQR	All registered CPOs, except Large CPOs	May 30 (for the quarter ending March 31, 2019)
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 2019)
June 2019		
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 17 (for May 2019). Note: Usually filed on the 15th calendar day of the following month, but if the 15th day is a holiday, Saturday or Sunday, the filing deadline is extended until the next business day.
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding $350 million as of any month	June 17 (for May 2019)
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 24 (for May 2019)
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 1 (for May 2019)

July 2019		
Delivery of Annual Audited Financial Statements to Private Fund Investors	Registered investment advisers (with respect to fund-of-funds)	July 1 (for a fund-of-funds with a December 31 fiscal year-end)
Form PF	Large Liquidity Fund Advisers	July 15 (for the quarter ending June 30, 2019)
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 15 (for June 2019)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding $350 million as of any month	July 15 (for June 2019)
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 22 (for the quarter ending June 30, 2019). Note: Usually filed on the 20th calendar day following the last day of March, June, September and December, but if the 20th day is a holiday, Saturday, or Sunday, the filing deadline is extended until the next business day.
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 23 (for June 2019)
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, 2019)
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 2019)

<u>August 2019</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, 2019)
NFA Form PR	All registered CTAs	August 14 (for the quarter ending June 30, 2019)
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 2019)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding $350 million as of any month	August 15 (for July 2019)
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 2019)
Form PF	Large Hedge Fund Advisers	August 29 (for the quarter ending June 30, 2019)
CFTC Form CPO-PQR	Large CPOs	August 29 (for the quarter ending June 30, 2019)
NFA Form CPO-PQR	All registered CPOs, except Large CPOs	August 29 (for the quarter ending June 30, 2019)
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 2019)
<u>September 2019</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 16 (for August 2019). Usually filed on the 15th calendar day of the following month, but if the 15th day is a holiday, Saturday or Sunday, the filing deadline is extended until the next business day.

TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding $350 million as of any month	September 16 (for August 2019)
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 23 (for August 2019)
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 2019)
October 2019		
Form PF	Large Liquidity Fund Advisers	October 15 (for the quarter ending September 30, 2019)
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 15 (for September 2019)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding $350 million as of any month	October 15 (for September 2019)
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 21 (for the quarter ending September 30, 2019). Note: Usually filed on the 20th calendar day following the last day of March, June, September and December, but if the 20th day is a holiday, Saturday, or Sunday, the filing deadline is extended until the next business day.
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 2019)

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, 2019)
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 2019)
<u>November 2019</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, 2019)
NFA Form PR	All registered CTAs	November 14 (for the quarter ending September 30, 2019)
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 2019)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding $350 million as of any month	November 15 (for October 2019)
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 25 (for October 2019) Note: Usually filed on the 23rd calendar day of the following month, but if the 23rd day is a holiday, Saturday or Sunday, the filing deadline is extended until the next business day.
Form PF	Large Hedge Fund Advisers	November 29 (for the quarter ending September 30, 2019)
CFTC Form CPO-PQR	Large CPOs	November 29 (for the quarter ending September 30, 2019)
NFA Form CPO-PQR	All registered CPOs, except Large CPOs	November 29 (for the quarter ending September 30, 2019)
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 2019)

Other Floating Deadlines		
Form D	Private funds conducting an offering under Regulation D	Initial Filing: Within 15 days of the initial sale of securities Annual Amendment: Anniversary date of the previous Form D filing Interim Amendment: As soon as practicable after certain changes in information Note: Additional state blue sky filing requirements may apply
Schedule 13D	Beneficial owners of at least 5% of a class of outstanding equity securities of a U.S. public company	Initial Filing: Within 10 days of crossing the 5% threshold Amendment: Promptly after any material change in beneficial ownership percentage
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.e.*, Qualified Institutional Investors and/or passive investors)	Initial Filing: Generally, within 45 days of year-end (if a QII or passive 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 increases or decreases 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
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 $84.4 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 for tax purposes	Due date (including any applicable extension) of the partnership's U.S. federal income tax return
Form 8832 Filing	Entities that filed an IRS Form 8832 with respect to 2018	Due date (including any applicable extension) of that entity's 2018 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 (*e.g.*, 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 2018 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 2018 U.S. federal income tax return

CbCR – Form 8975	U.S. tax resident parent entity of a MNE that has revenues of $850 million or more during the taxable year	Due date (including any applicable extension) of that entity's 2018 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: 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 2018 U.S. federal income tax return