

## 2019 Proskauer Annual Review and 2020 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 2020.

### 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.

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## SEC Examination Update

The U.S. Securities and Exchange Commission (SEC) Office of Compliance Inspections and Examinations (OCIE) was very active this year on many fronts, including within its private fund unit. Although early in his tenure SEC Chairman Clayton indicated that his priority was on market activities directly affecting retail investors (“main street investors”), the SEC’s private fund compliance and enforcement infrastructure was already established, and its activities continue apparently unabated.

The four-week government shutdown in January 2019 reduced exam activity last year, but we expect the numbers to trend upward in 2020. [Out of over 13,200 SEC-registered investment advisers \(about 35% of which advise private funds\), approximately 17% were examined during FY 2018, up from 15% in 2017.](#)

Which advisers are most likely to be examined? Because OCIE is focusing on conducting more (and more targeted) exams, the chances of undergoing an exam have remained high. The selection is data-driven and risk-based, so if OCIE’s data-crunchers believe that a manager exhibits characteristics falling within the priorities below, then the chances of an exam will increase. OCIE is still highly focused on examining firms that have never been examined or have not recently been examined, especially if the firm has substantially grown or expanded into new products. OCIE is particularly focused on advisers that manage different strategies or types of products, for example, private fund advisers that also advise a registered investment company or business development company.

For private funds, we expect a number of key areas to be the focus of exams in 2020. These conclusions are drawn from statements by senior staff at OCIE, the SEC’s disclosed exam priorities, and our experience with numerous recent exams.

- **Disclosure of Fees and Expenses** – This is a perennial focus. OCIE will examine practices or business models that may create increased risks of inadequately disclosed fees, expenses or other charges.
- **Conflicts of Interest** – Disclosure and management of conflicts is another perennial focus. In particular, OCIE is likely to examine: (1) fund arrangements with or services provided by affiliated entities or service providers; (2) fund transactions where the adviser or any affiliated parties have an interest; (3) side-by-side management arrangements, particularly where the same individuals advise multiple strategies or where the funds have similar strategies; and (4) allocation of expenses between or among the adviser and various funds or co-investors.
- **Portfolio Management and Trading** – OCIE will review firms’ practices for executing investment transactions on behalf of clients, fairly allocating investment opportunities among clients, ensuring consistency of investments with the objectives obtained from clients (e.g., avoiding “style drift”), and accurate disclosures.
- **Material, Non-Public Information (MNPI)** – OCIE is very focused on whether fund managers’ Section 204A procedures are tailored to specific business risks. We expect

additional focus on how managers address communications with portfolio companies when nonpublic transactions are being considered. For employees who sit on company boards, OCIE staff is likely to question how the fund addresses potential MNPI risks and information flow between the board and the adviser.

- **Performance Presentations** – Examiners will continue to focus on use of fund credit lines, whether they have been adequately disclosed, and the effect those credit lines may have on performance or reported IRR.
- **Digital Assets** – OCIE’s monitoring of the digital asset space will continue, as examiners seek to identify market participants offering, selling, trading, and managing these products or considering or actively seeking to offer these products.
- **Cybersecurity** – OCIE staff members have stated that for private fund advisers, addressing cyber risks can go to the heart of the fiduciary responsibilities to a fund or its investors, given the amount of sensitive information firms maintain regarding investors, portfolio companies and employees. From OCIE’s perspective, simply having policies and procedures is not enough - those procedures and underlying systems should be regularly assessed and tested.
- **Leveraged Loans** – We expect credit fund advisers to draw more scrutiny from OCIE. In September 2019 [testimony before the House Committee on Financial Services](#), the SEC stated that it intended to monitor “leveraged lending (including funds and products that invest in leveraged loans).” This top-down focus will likely be felt during exams in the coming year.

## OCIE 2019 Examination Priorities

The areas above roughly correspond with OCIE’s [2019 examination priorities](#), announced in December 2018. At a high level, those priorities covered six thematic areas: (i) compliance and risk at registrants responsible for critical market infrastructure; (ii) matters of importance to retail investors; (iii) the Financial Industry Regulatory Authority, Inc. (“FINRA”) and the Municipal Securities Rulemaking Board; (iv) digital assets; (v) cybersecurity; and (vi) anti-money laundering programs. While the staff’s attention to digital assets represented a new area of focus for 2019, the remainder of the topics are carried over from the [2018 examination priorities](#). The 2019 [report](#) noted that examinations in fiscal year 2018 led to more than 160 enforcement referrals and resulted in firms returning more than \$35 million to investors.

The 2019 examination priorities reflected a continued focus on a number of issues identified in prior years, with a continuing emphasis on both reviewing industry-wide risks and ensuring investor protections in the retail market. The following stated areas should be of interest to fund managers:

- Disclosure of Fees and Expenses ;
- Conflicts of Interest;
- Portfolio Management and Trading;

- Digital Assets; and
- Cybersecurity.

The 2019 examination priorities remain a helpful roadmap that advisers should use to anticipate and prepare for SEC exams. Registered advisers are well-advised to devote sufficient time and resources to maintain robust policies and procedures which, at a minimum, address the areas noted in the 2019 announcement to the extent applicable.

## **OCIE Issues Additional Topic-Specific Risk Alerts**

### ***Observations from Investment Adviser Examinations Relating to Electronic Messaging***

On December 14, 2018, OCIE released a [risk alert](#) encouraging investment advisers to review their risks, practices, policies, and procedures regarding electronic messaging and to consider any improvements to their compliance programs that would help them comply with applicable regulatory requirements. OCIE conducted this initiative, because it noticed an increasing use of various types of electronic messaging by adviser personnel for business-related communications.

OCIE's examination initiative focused on compliance with rule 204-2 (the Books and Records Rule) of the U.S. Investment Advisers Act of 1940, as amended (the Advisers Act), and whether policies and procedures were adopted and enforced as required by Advisers Act rule 206(4)-7 (the Compliance Rule). During the course of the initiative, the staff observed a range of practices with respect to electronic communications, including advisers that did not conduct any testing or monitoring to ensure compliance with firm policies and procedures. The staff's [risk alert](#) identified a number of examples of best practices for policies and procedures, employee testing and attestations, supervisory review (and monitoring/surveillance) and control over devices. For example, policies should permit only those forms of electronic communication for business purposes that the adviser determines can be captured and maintained in compliance with the books and records requirements, and should prohibit business use of technologies that can be readily misused by allowing automatic destruction of messages, anonymous communication, or prohibiting third-party viewing or back-up.

### ***Investment Adviser and Broker-Dealer Compliance Issues Related to Regulation S-P – Privacy Notices and Safeguard Policies***

On April 16, 2019, OCIE issued a [risk alert](#) based on compliance issues identified in recent examinations of investment advisers and broker-dealers relating to Regulation S-P. This alert is discussed in detail in the Cybersecurity and Privacy Law section of this Annual Review.

### ***Safeguarding Customer Records and Information in Network Storage – Use of Third Party Security Features***

On May 23, 2019, OCIE issued a [risk alert](#) highlighting risks associated with the storage of electronic customer records and information in the cloud and on other types of network storage solutions.

OCIE identified security risks associated with the storage of electronic customer records and information by broker-dealers and investment advisers in various network storage solutions, including those leveraging cloud-based storage. Although the majority of these network storage solutions offered encryption, password protection, and other security features designed to prevent unauthorized access, examiners observed that firms did not always use the available security features. Weak or misconfigured security settings on a network storage device could result in unauthorized access to information stored on the device.

During examinations, OCIE staff identified the following concerns that may raise compliance issues under Regulations S-P and S-ID:

- In some cases, firms did not adequately configure the security settings on their network storage solution to protect against unauthorized access. In addition, some firms did not have policies and procedures addressing the security configuration of their network storage solution. Often, misconfigured settings resulted from a lack of effective oversight when the storage solution was initially implemented.
- In some cases, firms did not ensure, through policies, procedures, contractual provisions, or otherwise, that the security settings on vendor-provided network storage solutions were configured in accordance with the firm's standards.
- In some cases, firms' policies and procedures did not identify the different types of data stored electronically by the firm and the appropriate controls for each type of data.

OCIE's [risk alert](#) provided a number of examples of effective practices regarding configuration of management programs, data classification procedures, and vendor management programs.

### *Investment Adviser Principal and Agency Cross Trading Compliance Issues*

On September 4, 2019, OCIE released a [risk alert](#) on certain principal and agency cross trading compliance issues identified in deficiency letters in connection with investment adviser exams completed during the past three years.

Section 206(3) of the Advisers Act requires an investment adviser entering into a principal trade with a client (i.e., buying a security from, or selling a security to, a client) to obtain the consent of the client to the transaction on a transaction-by-transaction basis (i.e., blanket disclosure and consent are not permitted). With respect to private funds, the staff of the SEC's Division of Investment Management has stated that the principal trading restrictions of Section 206(3) do not apply to a transaction between a client account and a pooled investment vehicle in which the investment adviser and/or its controlling persons, in the aggregate, have an ownership stake of 25 percent or less of the fund.

Section 206(3) of the Advisers Act also prohibits an investment adviser, directly or indirectly, while acting as broker for a person other than the advisory client, from knowingly effecting any sale or purchase of any security for the account of that client (i.e., engaging in "agency cross

transactions”) without disclosing to that client that the adviser, or an affiliate of the adviser, is acting as broker and obtaining the consent of the client to the sale or purchase.<sup>1</sup>

### Common Deficiencies Identified

With respect to principal trades, the risk alert noted that the OCIE staff had observed instances where investment advisers either did not recognize that they were engaging in principal trades (e.g., an affiliate of the adviser held a greater than 25% beneficial ownership interest in a party to the transaction), or failed to either provide sufficient disclosure or obtain the required consent from clients prior to the execution or settlement of the transactions.

In connection with agency cross transactions, the risk alert referenced situations where investment advisers either (i) engaged in agency cross transactions, despite disclosures to the contrary made to advisory clients, or (ii) were unable to produce any documentation that the adviser had complied with the written consent, confirmation, or disclosure requirements of Advisers Act Rule 206(3)-2.

Finally, OCIE staff noted instances where investment advisers either (i) did not have adequate compliance policies and procedures relating to Section 206(3) even though the advisers engaged in principal trades and agency cross transactions, or (ii) failed to follow established policies and procedures regarding principal trades and agency cross transactions.

### Key Takeaways

Investment advisers to private funds should pay close attention when contemplating transactions between a private fund and another of the investment adviser’s clients (e.g., another private fund or managed account), in particular where the investment adviser and/or affiliates collectively hold a greater than 25% beneficial ownership stake in one of the parties to the transaction. These situations can often arise in the early stages of a fund’s life, when ownership by affiliates can represent a higher percentage. Also, if investments are “warehoused” by another vehicle beneficially owned by an affiliate of the adviser prior to fund launch, then a later transfer of the investment to the fund may be a principal transaction requiring prior consent.

With respect to agency cross transactions, investment advisers should be careful not to receive any special or one-time fees or other compensation when reallocating investments between or among private funds managed by the adviser. Such fees may also raise an obligation to register as a broker-dealer under the U.S. Securities Exchange Act of 1934, as amended (the Exchange Act), and applicable state laws.

Recent SEC settlements with private fund managers have reflected the SEC’s view that where a private fund’s general partner is affiliated with the fund’s investment adviser, any consent provided by the general partner may be viewed as insufficient as a result of what the SEC considers to be an inherent conflict of interest. Conversely, if a private fund’s governance documents provide for a limited partner advisory committee (LPAC) or similar body that is

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<sup>1</sup> Advisers Act Rule 206(3)-2 permits certain agency cross transactions without requiring the adviser to provide transaction-by-transaction disclosure and consent, provided that certain conditions in the rule are satisfied.

properly authorized to provide consent on behalf of the fund, then the consent of the LPAC is usually sufficient, provided that the adviser makes a full and fair disclosure of the material facts. Absent the presence of an LPAC, advisers may be required to obtain consent directly from a private fund's investors, usually by reference to the applicable thresholds required for amendment of the private fund's governing documents.

Finally, registered investment advisers should review their written compliance policies and procedures adopted pursuant to Advisers Act Rule 206(4)-7(a) to ensure that reasonable methods are in place for the identification and management of potential transactions that may raise disclosure and consent obligations under Section 206(3).

## SEC Enforcement

During this past year, the SEC's Division of Enforcement faced a number of headwinds, limiting the number of enforcement actions across the board and, in particular, those involving private funds. First, Enforcement continued to face staffing shortages. While the hiring freeze was finally lifted after about two years and Enforcement was able to hire a small number of new attorneys, the limited hiring was not nearly enough to make up for several years of attrition. The Asset Management Unit, the specialized unit within Enforcement that focuses on investment advisers and their funds, remains smaller today than it was three years ago. Second, the SEC and Enforcement, along with most of the federal government, was largely idle during a four-week government shutdown. Finally, Enforcement has had to contend with a number of adverse legal precedents.

Notwithstanding all of the hurdles that the SEC has faced over the past year, Enforcement somehow remained active and aggressive, as evidenced by the number of actions the SEC brought against private fund advisers.

On November 6, 2019, the Enforcement Division announced its [enforcement results for FY 2019](#), accompanied by a report from the Co-Directors of its Division of Enforcement. While the total number of actions increased slightly from 2018, the percentage of cases involving investment advisers or investment companies increased more dramatically, growing from 22% in 2018 to 36% in 2019, with a significant portion of the increase attributable to the SEC's Share Class Selection Disclosure Initiative. Investment advisor cases accounted for 191 standalone actions in the past year. Insider trading cases decreased slightly from 10% of the actions filed in 2018 (51 actions) to 6% of the 2019 actions (30 actions). Total disgorgement and penalties were also up, reaching \$4.35 billion notwithstanding the impact of [Kokesh v. SEC](#), a Supreme Court decision holding that Commission claims for disgorgement are subject to [a five-year statute of limitations](#). The increase in actions, though small, was notable in light of this year's month-long government shutdown and the SEC hiring freeze, which extended through the first several months of FY 2019. The freeze, which may have been [the single biggest factor](#) impacting the current Enforcement program, was lifted on April 1, 2019. The 862 total actions and the 526 stand-alone actions brought by the SEC represent the second highest totals ever.

The results also indicate that individual accountability continues to be a priority for the agency's enforcement staff. With 69% of the Commission's standalone actions (excluding Share Class Initiative actions, which, as part of the Initiative, did not include charges against individuals)

including charges against individuals, Co-Directors of the Enforcement Division asserted that the Division “[remained focused on individual accountability](#) by pursuing charges, where appropriate, against executives at all levels of the corporate hierarchy.” Further, the SEC also continues to highlight its work protecting retail or “Main Street” investors. Based on our interactions with senior SEC staff, this focus on protecting Main Street extends to funds that manage pension and retirement fund investments.

Yearly data from 2014 through 2019 is summarized in the table below:

<b>Fiscal Year</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>
<b>Independent/Standalone Actions</b>	413	507	548	446	490	526
<b>Follow-on Administrative Proceedings (i.e., SEC Proceedings initiated following conviction or injunction in District Court)</b>	232	168	195	196	210	210
<b>Delinquent Filings</b>	110	132	125	112	121	126
<b>Total Actions</b>	755	807	868	754	821	862
<b>Disgorgement and Penalties Ordered (in billions)</b>	\$4.16	\$4.19	\$4.08	\$3.79	\$3.95	\$4.35

The bottom line for private fund advisers – expect more of the same from the SEC. The SEC will almost certainly continue to face some of the same headwinds next year. But as it did this past year, the SEC is likely to overcome those challenges in large part. While the SEC is unlikely to bring the same number of actions as it did three or four years ago, it will almost certainly continue to bring a significant number of actions against private fund advisers. In light of the Interpretive Guidance regarding the fiduciary duties of investment advisers, fund advisers should expect to see a continued focus by Enforcement on actions involving breaches of fiduciary duties and conflicts of interest. In addition, fund advisers should also expect to see more actions involving fees and expenses, valuations, principal and agency cross-trades, and insider trading.

Particular SEC Enforcement areas of focus over the past year are noted below.

### **Private Equity – Fee and Expense Allocations**

The SEC has continued to focus on fee and expense allocations, bringing a series of actions against private equity fund advisers who improperly allocate expenses or charge management fees based on overvalued assets.

In September, [the SEC settled charges against ECP Manager, LP](#), a private equity fund sponsor that allegedly collected management fees in contravention of the fund’s shareholders agreement.

While the fund's shareholders agreement prohibited the fund from taking management fees on invested capital contributions for investments that had been written down or written off, the order alleged that the Fund charged fees based on the full value of a series of convertible warrants that it had written down to zero. ECP settled the allegations for violations of the antifraud provisions of the Advisers Act. Please see our October 2, 2019 [post](#) for more information.

## Valuation

In addition to its focus on fees and expense allocation, the SEC has and will continue to focus on valuation as a key initiative.

In an interesting twist, in June of last year, [the SEC settled an action against Deer Park Road Management Company LP](#), based on allegations that the adviser had *undervalued* certain mortgage-backed securities. The allegations focused on the fact that Deer Park had been one of the most consistently performing hedge funds in the country, and that the undervaluation of these assets may have allowed it to artificially smooth its returns. The order alleged that the valuation policies and procedures were not reasonably designed because they lacked procedures detailing how to use available market inputs, and that the adviser did not take reasonable steps to implement the policies that were in place. Consequently, Deer Park agreed to violations of the compliance provisions of the Advisers Act. Notably, there was no disgorgement assessed. Please see our June 25, 2019 [post](#) for more information.

In a more classic valuation case, [the SEC brought charges against a fund manager](#), alleging that it over valued assets in order to collect fees. The complaint alleged that the adviser directed two managed funds to invest in subsidiaries of privately-held companies and continued to mark these investments up based on certain third-party valuations. The complaint also alleged that the adviser then recorded unrealized gains on these investments, and charged substantial fees based on those gains. The SEC's complaint, which is being contested, charged the fund manager with violations of the antifraud provisions of the Advisers Act.

In a similar vein, the [SEC recently settled an administrative proceeding](#) against a portfolio manager for a fund for mispricing private fund investments, which resulted in a large personal bonus to that portfolio manager. According to the SEC's order, from June 2016 to April 2017, the portfolio manager allegedly manipulated the inputs he used to value interest rate swaps and swap options to create the false impression that his investments were profitable. The SEC's order alleges that this artificially inflated the fund's reported returns and caused the fund to overpay fees, which led to the portfolio manager receiving a \$600,000 bonus. The portfolio manager agreed to aiding, abetting, and causing the adviser's violations of the antifraud provisions of the Advisers Act. The U.S. Commodity Futures Trading Commission (the "CFTC") also entered a consent order against the portfolio manager for violating the U.S. Commodity Exchange Act of 1936 (the "Commodity Exchange Act").

## Conflicts in Portfolio Transaction

The SEC also continues to focus on conflicted transactions, [recently settling charges against Talimco LLC](#) for allegedly manipulating the auction of a commercial real estate asset on behalf

of one client for the benefit of another. The order alleged that while selling a commercial real estate asset on behalf of a collateralized debt obligation client, the adviser was aiming to acquire the asset for another client, namely, a private fund. Rather than seek out bonafide bidders, Talimco rigged the auction to allow the private fund to buy the asset at an artificially low price, which it then sold for a substantial profit. Talimco settled by agreeing to a violation of the antifraud provisions of the Advisers Act.

## Trading Violations

Keeping with its announced focus on trading issues, the SEC Enforcement staff has brought several actions regarding trading violations, especially with respect to proprietary or personal accounts also managed by the adviser.

In August, the [SEC settled charges with Laurel Wealth Advisors](#) based on a multi-year cherry-picking scheme that resulted in \$56,075 in net same-day profits to the one of Laurel Wealth's representatives and \$60,821 in net same-day losses to the adviser's clients. Laurel Wealth agreed to violations of the compliance and antifraud provisions of the Advisers Act. The representative—who was the principal actor—agreed to violations of the fraud provisions of the Exchange Act.

Several days later, the [SEC announced a similar settled order against Financial Sherpa, Inc.](#), which also focused on cherry-picking. The SEC alleged that selective options trade allocations resulted in a net positive one-day return of over 45% for the Financial Sherpa's principal, whereas the individual clients had a net negative one-day return of 45%. Financial Sherpa agreed to violations of the fraud provisions of the Exchange Act and the antifraud provisions of the Advisers Act.

## Undisclosed fees

Enforcement staff have been highly focused on undisclosed fees charged to clients. In a series of cases over the past year, primarily against wealth managers, they have charged firms with fraud and other violations based on fees that were not adequately disclosed to clients. For instance, the following undisclosed fees have led to enforcement actions:

- A fund-of-funds manager's [undisclosed fee sharing agreement with an underlying fund](#) that resulted in an undisclosed conflict of interest;
- An undisclosed [7% commission charge](#) for alternative investments where there was an alternative share class (without embedded commissions) available;
- An [undisclosed 5% commission](#) that an adviser received when his clients invested in certain promissory notes;
- More than [\\$14 million in undisclosed incubator fees](#) charged to a portfolio of start-up companies by an adviser to five private venture capital funds;
- Receipt of [brokerage commissions for acquisitions of pre-IPO shares](#) the manager obtained for private funds without adequate disclosure;

- An [undisclosed revenue sharing agreement](#) for mutual fund share class investments that resulted in over \$100 million being paid to the adviser;
- [Undisclosed conflicts of interest](#) that resulted in investments in, and fees paid to, companies that were affiliates of the adviser; and
- [Approximately \\$254,000 in undisclosed fees](#) that were generated in exchange for recommending investments in certain private real estate funds.

## Custody Rule

For private funds that rely on the audited financials alternative to the Custody Rule, a failure to distribute audited financial statements to investors within 120 days of year end is a potential violation of the Custody Rule. In September, the [SEC charged hedge fund advisory firm ED Capital Management and its principal](#) with violations of the Custody Rule (among other violations). In that case, the manager was unable to obtain unqualified opinions from the audit firm it engaged, and was thus unable to deliver GAAP-compliant audited financial statements to its investors, thus violating the Custody Rule. Compounding the error, the manager incorrectly stated in its Forms ADV that it had distributed audited financial statements prepared in accordance with GAAP, leading to willful violations of Section 207 of the Advisers Act.

The SEC has also focused on whether the public accountant engaged for the audit is truly independent from the fund. If the accounting firm provides additional consulting services to a fund's adviser or an affiliate, that can call that auditor's independence into question, potentially jeopardizing compliance with the audited financials alternative. The SEC [recently settled an order with RSM US LLP](#) for violating the auditor independence rules, although it did not file enforcement actions against the fund advisers involved. The SEC alleged that RSM repeatedly represented that it was "independent" in its clients' audit reports while providing non-audit services to affiliates of the RSM's audit clients. The non-audit services included corporate secretarial services, payment facilitation, payroll outsourcing, loaned staff, financial information system design or implementation, bookkeeping, internal audit outsourcing, and investment adviser services. The auditor agreed to violations of the auditor independence rules and improper professional conduct.

## Cryptocurrency and ICOs

This past year, the SEC continued its focus on cryptocurrencies and related issues. Consistent with that focus, the SEC brought a number of cases involving unregistered initial coin offerings ("ICOs"). For more information, please see: [Company Settles Unregistered ICO Charges After Self-Reporting to SEC and Two Celebrities Charged With Unlawfully Touting Coin Offerings](#).

The SEC also brought a pair of settlement orders with respect to registration requirements for a fund and broker dealer operating in the crypto and digital assets space – 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. For more information, please see: [SEC Extends Registration Requirements for Investment Companies and Broker Dealers to ICOs and other Digital Assets](#)

## A Reminder: Private Companies Can Be Charged Under the Securities Laws

Private companies are also subject to SEC scrutiny. In April of this year, the SEC [announced a settlement of fraud claims against the founder of Jumio Inc.](#), a private mobile payments company, for misstating the company's financial results and using those results to sell his company shares on the secondary market. The order alleged a variety of misconduct by the founder, such as entering into round-trip transactions designed to inflate revenue. The founder ultimately agreed to settle the charges for a \$640,000 civil penalty, more than \$16 million in disgorgement and prejudgment interest, and a permanent bar from being an officer or director of a publicly traded company. Please see our April 11, 2019 [post](#) for more information.

The SEC also [reached a settlement with Prosper Funding LLC](#), a marketplace lender that offers and sells securities linked to the performance of its consumer credit loans. The order alleged that Prosper excluded certain non-performing charged-off loans from its calculation of annualized net returns that it reported to investors. Consequently, Prosper allegedly miscalculated, and materially overstated, the annualized net returns to retail and other investors, and failed to identify and correct this error despite being aware of internal concerns and customer complaints about the annualized net return calculation. Prosper agreed to non-scienter fraud charges under the U.S. Securities Act of 1933, as amended (the "Securities Act").

There have also been some court decisions of note affecting the Enforcement program:

### *Lucia: Constitutionality of ALJ Appointments*

Despite the forgoing actions, Enforcement has had to continue to navigate the fallout of the Supreme Court's decision in *Lucia v. SEC*, 138 S. Ct. 2044 (2018), holding that the SEC's Administrative Law Judges ("ALJs") had been appointed in violation of the appointments clause of the U.S. Constitution.

The *Lucia* decision and its aftermath have been particularly vexing for the SEC. While *Lucia* resolved some questions about the legality of the SEC's administrative proceedings, it left unanswered other equally important questions, most notably whether the removal protections afforded to ALJs are also unconstitutional. Because of that remaining uncertainty, the SEC has brought far fewer litigated actions in its administrative proceedings and instead has filed more actions in federal district court. This has presented significant challenges for the SEC when it has had to litigate cases involving non-fraud, technical, regulatory violations – complex cases where investor harm is not readily discernable; the SEC has had limited success when it has tried to present those types of cases to juries and federal court judges.

### *Lorenzo: Scheme Liability Theories*

In March, the Supreme Court held in *Lorenzo v. SEC* that persons who do not "make" material misstatements or omissions but who disseminate them with fraudulent intent, can be held liable for fraud under the so-called "scheme liability" provisions (Rule 10b-5 subsections (a) and (c)). After analyzing the Supreme Court's 2011 *Janus* decision, holding that only the "maker" of a misleading statement could be held liable under Rule 10b-5(b), this decision put to rest any lingering question about whether *Janus* prevented authorities from pursuing similar claims under

a “scheme” liability theory. In our view, this decision has been viewed by the Enforcement staff as supporting a broader use of “scheme” theories in various contexts.

Please see our March 27, 2019 [client alert](#) for more information.

#### *Robare: Negligent Conduct Not Enough under Section 207*

In May, the DC Circuit released an opinion addressing the SEC’s administrative findings against a registered investment adviser, The Robare Group for failure to disclose conflicts of interest. First, the court affirmed the SEC’s finding that such negligence-based conduct was a violation of Section 206(2) of the Advisers Act, holding that as a fiduciary to its clients, the adviser was required to make full and fair disclosure of all material facts, including conflicts of interest. But second, it held that the SEC could not find violations under Section 207 of the Advisers Act for “willfully” omitting material facts from a Form ADV based on the same *negligent* conduct. Please see our May 13, 2019 [post](#) for more information.

Finally, there were two other significant developments during the past year that could impact the SEC’s Enforcement program going forward.

#### *Statutes of Limitations Post-Kokesh*

In 2017, the U.S. Supreme Court ruled in *Kokesh v. SEC*, 137 S. Ct. 1635 (2017) that the SEC’s disgorgement remedy constitutes a “penalty,” and is therefore subject to the five-year statute of limitations in 28 U.S.C. § 2462. The Division of Enforcement’s Annual Report for fiscal year 2018 noted that “the Court’s ruling in *Kokesh* may cause the Commission to forgo up to approximately \$900 million in disgorgement, of which a substantial amount likely could have been returned to retail investors.”

On March 14, 2019, U.S. Senators John Kennedy (R-La.) and Mark Warner (D-Va.) took the initial step in attempting to reverse the impact of *Kokesh* by introducing the “[Securities Fraud Enforcement and Investor Compensation Act](#).” The proposed legislation would authorize the SEC to seek disgorgement of ill-gotten gains (which some have raised questions about after *Kokesh*), and codify the 5-year statute of limitations recognized by the *Kokesh* decision for disgorgement claims by the SEC. More significantly, the proposed legislation would authorize the SEC to seek restitution equal to the amount of investor losses. Historically, the SEC has only sought disgorgement (the amount of a respondents ill-gotten gains), and not restitution (the amount of investor harm). Often those amounts are the same, but there are cases where restitution based on investor harm greatly exceeds disgorgement based on ill-gotten gains (for example, in a fraudulent investment scheme where the respondent only keeps part of the proceeds but the full amount of the investment is lost, disgorgement will be the amount of proceeds retained by the respondent whereas restitution will equal the full amount of proceeds lost by investors). The proposed legislation would provide for a 10-year statute of limitations for the SEC to seek restitution and other equitable remedies like injunctions or officer and director bars.

## Waivers from Disqualification in Settled Actions

In July the SEC issued a “[Statement Regarding Offers of Settlement](#)” announcing important changes to how the SEC will consider future requests for waivers from disqualifications in settlements. Some of these disqualification can have severe consequences. For example, an issuer subject to certain SEC cease-and-desist orders (even one issued as part of a settlement) can be automatically disqualified from using the safe harbor provided by Regulation D under the Securities Act to conduct an unregistered offering of securities. A party subject to certain federal court injunctions may no longer act as an investment adviser to an investment company, absent a waiver. The new policy effectively allows a settling party to condition its offer of settlement on whether the SEC grants a requested waiver – if the waiver is not granted, the respondent now is able to retract its offer of settlement. Please see our July 8, 2019 [post](#) for more information.

## SEC Policy and Rulemaking

### Proposed Revisions to Advisers Act Advertising and Cash Solicitation Rules

On November 4, 2019, the SEC issued a [release](#) proposing to revise the rules pertaining to investment adviser advertisements and payments to solicitors under the Advisers Act. The SEC also proposed related amendments to Form ADV and Advisers Act Rule 204-2 (the books and records rule). The discussion below highlights several of the proposed revisions most relevant to advisers to private funds.

#### *Proposed Revisions to Investment Adviser Advertisements under Rule 206(4)-1*

The SEC proposes to eliminate some of the specific restrictions contained in existing Rule 206(4)-1, which was adopted in 1961, and instead replace them with more principles-based provisions. In particular, the proposed would implement a number of changes of particular relevance to managers of private funds, including:

- ***Anti-fraud prohibition.*** The language in the general anti-fraud prohibitions would be expanded to include making untrue statements or material omissions of fact, making unsubstantiated claims, making misleading implications about a material fact about the investment adviser, implying any potential benefits without discussing associated material risks or limitations, referring to the performance of specific investments in a manner that is not “fair and balanced,” or being otherwise misleading.
- ***Past specific investments:*** The revised rule would permit references to past specific investments and recommendations in advertisements, provided that the information is presented in a manner that is “fair and balanced”. The release also provides some examples of presentations of past specific performance results that would not be considered fair and balanced.
- ***Testimonials, endorsements and ratings:*** The revised rule would permit the use of testimonials, endorsements and third-party ratings in advertisements, subject to certain specified disclosures, including whether the person giving any testimonial or

endorsement is a client, and whether any compensation has been paid by or on behalf of the adviser.

- **Gross performance results:** Gross performance results could be included in advertisements, provided the adviser also provides net performance, or provides (or offers to promptly provide) a description of applicable fees and expenses. However, in advertisements targeted to “retail investors” (i.e., investors who are not “qualified purchasers”) net performance must be presented alongside any presentation of performance. In all cases, presentation of performance must be presented in a “fair and balanced manner.”
- **Extracted performance results:** An adviser could use “extracted” performance, representing the actual performance results of a subset representing certain categories or types of investments, provided the adviser also provides (or offers to promptly provide) the performance of all investments held in the relevant fund(s) or account(s).
- **Related performance results:** An adviser could use “related” performance of other funds or accounts managed using the same strategy, subject to certain conditions, including the requirement that the performance results for all related portfolios are included, subject to certain exceptions.
- **Hypothetical performance results:** An adviser could use various types of “hypothetical” performance results (including model results, back-tested results, or target returns), provided the adviser adopts and implements policies and procedures reasonably designed to ensure that the performance is relevant to the financial situation and investment objectives of the intended recipients, and the adviser provides certain specified disclosures and information related to the hypothetical performance.
- **Internal approval of advertisements:** All advertisements would have to be reviewed and approved in writing by a “designated employee” (generally legal or compliance personnel of the adviser) before dissemination.

#### *Proposed Revisions to Cash Payments for Client Solicitations under Rule 206(4)-3*

The proposed rule would adopt several key changes to the solicitation rule, Rule 206(4)-3, including:

- **Private funds:** The revised rule would apply to any arrangements between an adviser and anyone other than the adviser or its employees who is engaged to solicit investors and prospective investors in a private fund that the adviser manages (i.e., placement agents).
- **All forms of compensation:** The revised rule would expand the solicitation rule to apply regardless of the form of compensation for client or investor referrals, including directed brokerage.
- **No written acknowledgment:** An adviser would have to make certain disclosures required under the rule, but would no longer have to obtain a signed written

acknowledgment of receipt of the required disclosure statement from each prospective client or investor.

- **Brochure delivery.** The revised rule would eliminate the requirement that the solicitor deliver the adviser's brochure to a prospective client.
- **New disqualification requirements:** The proposed rule would expand the list of disciplinary events for which persons would be disqualified from acting as a solicitor, and extend the rule's definition of ineligible solicitor to certain persons associated with a firm that is an ineligible solicitor.

#### *Proposed Revisions to Books and Records Requirements under Rule 204-2 and Form ADV*

The proposed release contains a number of proposed revisions to the Advisers Act's recordkeeping requirements that relate to the proposed change to both the advertising and cash solicitation rules.

The proposed release would also add a new Item 5.L to the Form ADV, Part 1A in which a registered adviser would have to respond to a series of five questions in connection with the adviser's advertising activities.

#### *Review of SEC Guidance*

The SEC stated that, in connection with its amendments, it is considering withdrawing previously-issued no-action letters if it adopts the proposed amendments.

The discussion of many of the proposals contained in the SEC release provides interesting guidance on a number of issues, including (i) when information appearing in the press or media should be considered to be an advertisement provided by or on behalf of an adviser; (ii) the use of the performance track record of an employee generated while employed at a prior firm; and (iii) when directed brokerage would be deemed to be compensation for purposes of the solicitation rule.

#### *Next Steps*

At 507 pages in length, the proposing release will likely generate a substantial number of comments from across the investment management industry. The public comment period will remain open for 60 days following publication of the proposal in the [Federal Register](#).

### **Guidance on Investment Adviser Standard of Conduct**

On June 5, 2019, the SEC released its [Interpretation Regarding Standard of Conduct for Investment Advisers](#), which the agency had [previously proposed](#) on April 18, 2018 to reaffirm and, in some cases, clarify the SEC's views of the fiduciary duty that investment advisers owe to their clients under the Advisers Act. The interpretation reflects how the SEC and its staff have historically applied, reviewed and enforced the law in this area. By highlighting principles relevant to the fiduciary duty, the SEC sought to provide investment advisers with greater clarity about advisers' legal obligations.

As stated in the interpretation, an investment adviser's fiduciary duty under the Advisers Act comprises a duty of care and a duty of loyalty. The duty of care includes, among other things: (i) the duty to provide advice that is in the best interest of the client; (ii) the duty to seek best execution of a client's transactions where the adviser has the responsibility to select broker-dealers to execute client trades, and (iii) the duty to provide advice and monitoring over the course of the relationship.

To meet its duty of loyalty, the interpretation provides that an adviser is required to make full and fair disclosure to its clients of all material facts relating to the advisory relationship. Material facts relating to the advisory relationship include the capacity in which the adviser is acting with respect to the advice provided. In addition, the interpretation stated that an adviser must eliminate or at least expose through full and fair disclosure all conflicts of interest which might incline an investment adviser, consciously or unconsciously, to render advice which was not disinterested.

In order for disclosure to be full and fair, the interpretation provides that such disclosure should be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent. The interpretation offered that whether the disclosure is full and fair will depend upon, among other things, the nature of the client, the scope of the services, and the material fact or conflict. However, the interpretation noted that full and fair disclosure for an institutional client (including the specificity, level of detail, and explanation of terminology) can differ, in some cases significantly, from full and fair disclosure for a retail client because institutional clients generally have a greater capacity and more resources than retail clients to analyze and understand complex conflicts and their ramifications.

Additionally, the interpretation noted that when allocating investment opportunities between or among eligible clients, an adviser may face conflicts of interest, either between its own interests and those of a client or among different clients. If so, the adviser must eliminate or at least expose through full and fair disclosure the conflicts associated with its allocation policies, including how the adviser will allocate investment opportunities, such that a client can provide informed consent. When allocating investment opportunities, an adviser is permitted to consider the nature and objectives of the client and the scope of the relationship. An adviser need not have *pro rata* allocation policies, or any particular method of allocation, but, as with other conflicts and material facts, the adviser's allocation practices must not prevent it from providing advice that is in the best interest of its clients.

Finally, the interpretation provides that disclosure that an adviser "may" have a particular conflict, without more, is not adequate when the conflict actually exists. For example, the SEC stated that it would consider the use of "may" inappropriate when the conflict exists with respect to some (but not all) types or classes of clients, advice, or transactions without additional disclosure specifying the types or classes of clients, advice, or transactions with respect to which the conflict exists. In addition, the use of "may" would be inappropriate if it simply precedes a list of all possible or potential conflicts regardless of likelihood and obfuscates actual conflicts to the point that a client cannot provide informed consent. On the other hand, the interpretation offered that the word "may" could be appropriately used to disclose to a client a potential conflict that does not currently exist, but might reasonably present itself in the future.

## SEC Seeks Comments on Exempt Offering Rules

On June 18, 2019, the SEC released a [Concept Release on Harmonization of Securities Offering Exemptions](#) to solicit comment on several exemptions from registration under the Securities Act that facilitate capital raising.

The concept release sought input on whether changes should be made to improve the consistency, accessibility, and effectiveness of the SEC's exemptions for both companies and investors, including identifying potential overlap or gaps within the framework. It also considered, among other things, whether:

- The limitations on who can invest in certain exempt offerings, or the amount they can invest, provide an appropriate level of investor protection or pose an undue obstacle to capital formation or investor access to investment opportunities;
- The SEC should take steps to facilitate a company's ability to transition from one offering to another or to a registered offering;
- The SEC should expand companies' ability to raise capital through pooled investment funds;
- Retail investors should be allowed greater exposure to growth-stage companies through pooled investment funds such as interval funds and other closed-end funds; and
- The SEC should revise its exemptions governing the secondary trading of securities initially issued in exempt offerings.

Particular to offerings involving private funds in the United States, the concept release sought input on:

- Whether there should be any changes to improve, harmonize, or streamline any of the capital raising exemptions, including Rule 506 of Regulation D;
- Whether the limitations on who can invest in certain exempt offerings, or the amount they can invest, provide an appropriate level of investor protection (i.e., whether the current levels of investor protection are insufficient, appropriate, or excessive) or pose an undue obstacle to capital formation or investor access to investment opportunities, including a discussion of the persons and companies that fall within the "accredited investor" definition;
- Whether the SEC should take steps to facilitate capital formation in exempt offerings through pooled investment funds, including interval funds and other closed-end funds, and whether retail investors should be allowed greater exposure to growth-stage companies through pooled investment funds in light of the potential advantages and risks of investing through such funds; and

- Whether the SEC should revise its rules governing exemptions for resales of securities to facilitate capital formation and to promote investor protection by improving secondary market liquidity.

As of the closing of the comment period on September 24, 2019, the SEC had received nearly a hundred [comment letters](#) in response to the concept release.

### **SEC's Division of Investment Management Issues Letter Regarding Custody and Digital Assets**

On March 12, 2019, the Deputy Director and Chief Counsel of the SEC's Division of Investment Management released a letter in response to the Investment Adviser Association addressing [Non-Delivery-Versus-Payment \(DVP\) Custodial Practices and Digital Assets](#).

A footnote in the [adopting release](#) for the 2003 amendments to the Adviser Act's Custody Rule described a securities trade settled on a DVP basis as one involving a "transfer [of] funds (or securities) out of a client's account only upon corresponding transfer of securities (or funds) into the account." The SEC's staff's guidance in the area of non-DVP custodial practices follows the Division of Investment Management's [Guidance Update 2017-01](#), wherein the staff stated that traditional DVP arrangements did not constitute "custody" under the Advisers Act. Following that Guidance Update, investment advisers and other market participants raised issues regarding the regulatory status of investment adviser and custodial trading practices that are processed or settled on a non-DVP basis.

Of particular relevance to private fund advisers, the staff of the SEC's Division of Investment Management sought industry input on the following issues:

- What types of instruments trade on a non-DVP basis? How do these instruments trade?
- Are there particular types of securities transactions settled on a non-DVP basis that present greater or lesser risk of misappropriation or loss?
- What role do custodians play in the settlement process of non-DVP trading? What role do they play in mitigating risks of misappropriation or loss arising from such trading?
- To what extent do non-DVP assets appear on client account statements from qualified custodians? To what extent does an investment adviser have any influence over, or input into, whether and how such assets appear on account statements? Are there any assets that trade on a non-DVP basis that would not appear on a qualified custodian's account statements?
- To what extent could evolving technologies, such as blockchain/distributed ledger technology (DLT), provide enhanced or diminished client protection in the context of Non-DVP trading?

Regarding advisers' custody of their clients' digital assets, the staff of the SEC's Division of Investment Management sought industry input on the following issues:

- What challenges do investment advisers face in complying with the Custody Rule with respect to digital assets? What considerations specific to the custody of digital assets should the staff evaluate when considering any amendments to the Custody Rule? For example, are there disclosures or records other than account statements that would similarly address the investor protection concerns underlying the Custody Rule's requirement to deliver account statements?
- To what extent are investment advisers construing digital assets as “funds”, “securities”, or neither, for purposes of the Custody Rule? What considerations are advisers applying to reach this conclusion?
- To what extent are investment advisers including digital assets in calculating regulatory assets under management for purposes of meeting the thresholds for registering with the Commission? What considerations are included within this analysis?
- How should concerns about misappropriation of digital assets be addressed, and what are the most effective ways in which technology can be leveraged to address such concerns? How can client losses due to misappropriation of digital assets most effectively be remedied?
- To what extent do investment advisers construe digital assets as “securities” for purposes of determining whether they meet the definition of an “investment adviser” under section 202(a)(11) of the Advisers Act? What considerations are included in such an analysis?
- To what extent can DLT be used more broadly for purposes of evidencing ownership of securities? Can DLT be useful for custody and recordkeeping purposes for other types of assets, and not just digital asset securities? What, if any, concerns are there about the use of DLT with respect to custody and recordkeeping?

## **U.S. Federal Regulators Adopt Amendments to the Volcker Rule**

On September 18, 2019, the SEC, CFTC and other federal regulators issued a [set of final rules](#) adopting amendments to the regulations implementing section 13 of the Bank Holding Company Act. Section 13 contains certain restrictions on the ability of a banking entity and nonbank financial company supervised by the Federal Reserve Board to engage in proprietary trading and have certain interests in, or relationships with, any private fund relying on an exemption from the definition of an investment company found in either Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (Covered Funds).

The agencies delayed any significant revisions to the definition of a “covered fund.” However, the release suggested that a subsequent release will address outstanding issues on this topic. The agencies did include a relatively narrow expansion of the ability of banking entities to acquire covered fund positions as part of hedging fund-linked products and in connection with their market making and underwriting activities.

The existing regulations implementing section 13 of the Bank Holding Company Act include an exemption for non-U.S. banking entities and their investments in covered funds outside the United States, so long as no ownership interest is “offered for sale or sold to a resident of the

United States” and any acquisition, retention or sponsorship is conducted “solely outside of the United States” (the “SOTUS” exemption). On February 27, 2015, the agencies’ staff issued [frequently asked question #13](#) to clarify that the marketing restriction only applied to the activities of a foreign bank and not of unaffiliated third-party sponsors. This relief was codified by the agencies via the new amendments.

Finally, regarding non-U.S. private funds that are not covered funds where no ownership interest is offered for sale or sold to a resident of the United States and any acquisition, retention or sponsorship is conducted solely outside of the United States (so-called Foreign Excluded Funds), the agencies noted that on July 17, 2019, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, released a [policy statement](#) regarding treatment of certain foreign funds under the rules implementing Section 13 of the Bank Holding Company Act, wherein those agencies indicated that they “would not propose to take action during the two-year period ending July 21, 2021, against a foreign banking entity based on attribution of the activities and investments of a qualifying foreign excluded fund to the foreign banking entity, or against a qualifying foreign excluded fund as a banking entity, in each case where the foreign banking entity’s acquisition or retention of any ownership interest in, or sponsorship of, the qualifying foreign excluded fund would meet the requirements for permitted covered fund activities and investments solely outside the United States, as provided in section 13(d)(1)(I) of the BHC Act and section \_\_.13(b) of the Agencies’ implementing rules, as if the qualifying foreign excluded fund were a covered fund.”

The effective date for the amendments is January 1, 2020, and banking entities must comply with the final amendments by January 1, 2021.

## CFTC/NFA Updates

### NFA Adopts Swaps Proficiency Requirements

On March 25, 2019, the National Futures Association (NFA) issued [Notice to Members I-19-09](#) addressing (i) recent amendments to [NFA Bylaw 301](#) and [NFA Compliance Rule 2-24](#), and (ii) the adoption of a new Interpretive Notice entitled [NFA Bylaw 301 and Compliance Rule 2-24: Proficiency Requirements for Swap APs](#) to implement new Swaps Proficiency Requirements.

NFA Bylaw 301(l) requires certain NFA member firms engaged in CFTC regulated swaps activities and their registered associated persons (APs) to be approved by the NFA as a swap firm or swap AP, respectively. By way of background, interest rate swaps, currency swaps, commodity swaps, including energy, metals and agricultural swaps, and broad-based index swaps, such as index credit default swaps, are all swaps.

The NFA amended NFA Bylaw 301(l) to specify that any individual seeking approval as a futures commission merchant (FCM), introducing broker (IB), commodity pool operator (CPO) or commodity trading advisor (CTA) member swap firm or as a swap AP of an FCM, IB, CPO or CTA member firm must pass NFA’s Swaps Proficiency Requirements. The NFA’s Swaps Proficiency Requirements are comprised of two tracks. The Long Track consists of eight modules (swaps products and applications, regulation of the swaps market, onboarding, transactional disclosures, swap dealer anti-fraud and ethical practices, trade

execution/clearing/margin, risk management and supervision) and will take approximately eight hours to complete. The Short Track consists of four modules (swaps products and applications, regulation of the swaps market, supervision and intermediary compliance, anti-fraud and other requirements) and will take approximately four hours to complete.

The NFA also amended NFA Compliance Rule 2-24 to prohibit a swap dealer (SD) member firm from having any person associated with it who is acting as an AP that has not satisfied NFA's Swaps Proficiency Requirements.

The Interpretive Notice excludes certain individuals who limit their swap related activities to counterparties that are non-U.S. persons and/or non-U.S. branch offices of a U.S. SD from the NFA's Swaps Proficiency Requirements.

These new requirements will become effective on January 31, 2020.

### **NFA Issues Guidance on ISSPs and CPO Internal Controls Systems**

The NFA has amended its existing guidance to its members on Information Systems Security Programs (ISSPs), and has adopted a new Interpretive Notice related to CPO internal controls systems. Both became effective on April 1, 2019.

#### *ISSPs*

The new [ISSP guidance](#), which applies to all NFA members, provides additional clarity on training requirements and the level of management which must approve an ISSP.

Specifically, NFA members are required to identify the topics covered during ISSP training and are required to train employees when hired, at least annually thereafter, and more frequently if circumstances warrant.

ISSPs must now be approved by a member's CEO or another senior level officer with primary responsibility for information systems security (e.g., the Chief Technology Officer (CTO) or Chief Information Security Officer (CISO)). The amendment further clarifies that, although an NFA member firm can participate in a consolidated group ISSP, each member still has an independent obligation to ensure that all written policies and procedures relating to the ISSP are appropriate to its information security risks, and can be produced upon request to the NFA and the CFTC.

Also included in the amended ISSP guidance is a new requirement that NFA members notify the NFA of cybersecurity incidents related to their commodity interest business that result in a loss of customer or counterparty funds or loss of a member firm's capital, or where a member notifies its customers or counterparties of an incident pursuant to state or federal law.

#### *CPO Internal Controls System*

The NFA has adopted an [Interpretive Notice](#) which requires CPOs to develop an internal controls system designed to deter errors and fraudulent activity, protect customer funds, and produce financial reports that are timely, accurate and reliable. The Interpretive Notice specifically

focuses on the creation of a strong controls environment and management's commitment to integrity and ethical values. At a minimum, this means that a CPO must adopt and implement:

- written policies and procedures reasonably designed to ensure that the CPO's operations are in compliance with applicable NFA rules and CFTC regulations; and
- written policies and procedures that fully explain the CPO's internal controls framework.

While the Notice acknowledges that internal controls systems will vary based on a CPO's size and the complexity of its operations, it states that every CPO should conduct a risk assessment to identify its most critical risks and develop and implement controls to address those risks. The Notice highlights the importance of adequate controls with respect to subscriptions, redemptions and transfers, risk management, and investment and valuation of pool assets. The Notice also stresses that there should be a separation of duties, when possible, to ensure that no single employee is in a position to carry out or conceal errors or fraud or have control over any two phases of a transaction or operation.

### **CFTC Divisions Announce Examination Priorities**

On February 12, 2019, the CFTC announced [2019 Examination Priorities](#) for registrants of the Division of Market Oversight (DMO), Division of Swap Dealer & Intermediary Oversight (DSIO), and Division of Clearing & Risk (DCR). This marks the first time that the CFTC has published Examination Priorities for its divisions. The examination priorities focused primarily on the operation of derivatives markets and clearing organizations and the protection of customer funds held by FCMs.

### **CFTC Charges Hedge Fund with Violating Wheat Futures Speculative Position Limits**

On July 2, 2019, the CFTC issued an [Order](#) filing and settling charges against Elephas Investment Management Ltd. (Elephas), a Hong Kong-based hedge fund, for violating wheat futures speculative position limits. The Order required Elephas to pay a \$160,000 civil monetary penalty, and noted that Elephas made an additional payment of \$166,590 pursuant to a disciplinary action by the CME Group (formerly the Chicago Mercantile Exchange & Chicago Board of Trade).

Of particular interest, Elephas violated the position limit not because of its acquisition of a new position in excess of the applicable limit, but rather because its existing position became subject at the end of a month to the lower "spot" limit for the relevant commodity, rather than the higher futures position limit. The order thereby emphasizes (1) that violations of position limits do not require any finding of an intention to violate the rule; (2) the importance of establishing adequate systems to monitor changes in applicable position limits, and (3) that position limits apply to traders located anywhere in the world (on an aggregated basis with respect to all accounts that they manage), and are not limited to firms registered with the CFTC or NFA.

## Alternative Data

In a ruling that is being hailed as a victory for web scrapers and the open nature of publicly available website data, the Ninth Circuit, on September 9, 2019, issued its long-awaited opinion in [\*hiQ Labs, Inc. v. LinkedIn Corp.\*](#), No. 17-16783 (9<sup>th</sup> Cir. Sept. 9, 2019). The crucial question before the court was whether once hiQ Labs, Inc. (“hiQ”) received LinkedIn Corp.’s (“LinkedIn”) cease-and-desist letter demanding it stop scraping public LinkedIn profiles, any further scraping of such data was “without authorization” within the meaning of the federal Computer Fraud and Abuse Act (CFAA). The appeals court affirmed the lower court’s order granting a preliminary injunction barring the professional networking platform LinkedIn from blocking hiQ, a data analytics company, from accessing and scraping publicly available LinkedIn member profiles to create competing business analytic products. Most notably, the Ninth Circuit held that hiQ had shown a likelihood of success on the merits in its claim that when a computer network generally permits public access to its data, a user’s accessing that publicly available data will not constitute access “without authorization” under the CFAA.

In light of this ruling, data scrapers, content aggregators and advocates of a more open internet will certainly be emboldened, but we reiterate something we advised back in our 2017 [Client Alert](#) about the lower court’s hiQ decision: while the Ninth Circuit’s decision suggests that the CFAA is not an available remedy to protect against unwanted scraping of public website data that is “presumptively open to all,” entities engaged in scraping should remain careful. The road ahead, while perhaps less bumpy than before, still contains rough patches. Indeed, the Ninth Circuit cautioned that its opinion was issued only at the preliminary injunction stage and that the court did not “resolve the companies’ legal dispute definitively, nor do we address all the claims and defenses they have pleaded in the district court.”

### Overview of the *hiQ* Dispute

Since the California district court [ruling](#) in August 2017, LinkedIn’s appeal and [Opening Brief](#) in October 2017 and hiQ’s subsequent [Answering Brief](#) and LinkedIn’s [Reply Brief](#), and the [oral argument](#) in March 2018, it’s been a long wait for the Ninth Circuit’s decision in this case. Before we dive deeper into the ruling, a brief summary of the lower court proceedings is necessary.

The *hiQ* dispute involves LinkedIn’s challenge to hiQ’s scraping of public profile data to create a competing business analytics product. After receiving a cease-and-desist letter from LinkedIn that demanded hiQ stop its scraping activity and stated, principally, that hiQ’s further access would be a violation of the federal CFAA, hiQ filed a declaratory judgment seeking a preliminary injunction barring LinkedIn from blocking hiQ’s access to LinkedIn public profiles. Significantly, LinkedIn had sent the cease-and-desist letter to hiQ after years of tolerating hiQ’s access and use of its data; in fact, hiQ’s business model of employee data analysis at the time of the litigation was wholly dependent on crunching LinkedIn data that users elected to publish publicly. The key question concerning the applicability of the CFAA in this case was whether, by continuing to access public LinkedIn profiles after LinkedIn explicitly revoked permission to do so, hiQ had “accessed a computer without authorization” within the meaning of the CFAA.

The lower court [issued](#) a preliminary injunction, finding that the balance of equities favored *hiQ*, and distinguished the Ninth Circuit [Power Ventures](#) precedent that had held that a commercial entity that accesses a website after permission has been explicitly revoked can, under certain circumstances, be civilly liable under the CFAA. The lower court expressed “serious doubt” as to whether LinkedIn’s revocation of permission to access the public portions of its site renders *hiQ*’s access “without authorization” within the meaning of the CFAA. In the lower court’s view, the CFAA was intended instead to deal with “hacking” or “trespass” onto private, often password-protected mainframe computers, and the district court was “reluctant” to expand its scope absent convincing authority.

On appeal, the parties offered dueling visions of what the law surrounding the CFAA and scraping should be:

- *LinkedIn*: “[A]uthorization from LinkedIn—the server’s owner—is ‘needed’ to avoid CFAA liability, regardless of whether those servers also host data that LinkedIn generally makes available on its website. *hiQ* lacked that required ‘authorization’ once LinkedIn sent *hiQ* its cease-and-desist letter and implemented additional technological barriers restricting bot access.”
- *hiQ*: “LinkedIn does not grant permission to access its public content because those pages are, by definition, open for all to see and use. *hiQ*, like any other Internet user, simply requests LinkedIn’s public pages, and LinkedIn’s servers automatically provide them. There is no ‘authorization’ for LinkedIn to revoke. Reading the statute in accordance with the language’s ordinary significance, ‘without authorization’ refers to circumstances where authorization is a prerequisite to access.”

### **The CFAA Issue on Appeal**

In the decision, the Ninth Circuit held that *hiQ* made an adequate showing at this stage to support an injunction prohibiting LinkedIn from selectively blocking *hiQ*’s access to public member profiles based on, among other things, the merits of its tortious interference with contract claim. While a full discussion of the merits of that claim are beyond the scope of this Annual Review, the court was compelled to consider LinkedIn’s defense that *hiQ* could not succeed on its tortious interference with contract and related state claims because its access to LinkedIn’s site was “unauthorized” under the CFAA.

The pivotal CFAA question is whether once *hiQ* received LinkedIn’s cease-and-desist letter, any further scraping and use of LinkedIn’s data was “without authorization” within the meaning of the CFAA and thus a violation of the statute. If so, *hiQ* would have no legal right of access to LinkedIn’s data and so could not succeed on any of its state law claims.

Liability under the CFAA arises when a person who “intentionally accesses a computer without authorization ... and thereby obtains ... information from any protected computer.” 18 U.S.C. § 1030(a)(2)(C). “Without authorization” is not defined, but in the quintessential case, the CFAA is invoked to remedy incidences of computer hacking or when an employee accesses a corporate network after having had his or her permission rescinded.

In the scraping context, as seen by this highly-contested dispute, CFAA “without authorization” liability presents nuanced issues. In short, the appeals court was asked to decide whether the CFAA’s “without authorization” provision is limited to computer information for which access permission, such as password authentication, is generally required.

Looking at the legislative history and precedent, the Ninth Circuit stated that the CFAA was enacted to prevent computer hacking, and that it should be best understood as “an anti-intrusion statute and not as a misappropriation statute.” Thus, the court concluded that the CFAA’s “without authorization” provision is “inapt” with regard to access to public LinkedIn profiles and that *hiQ* raised a serious question as to whether the CFAA’s “without authorization” provision should only apply to computer information protected by access controls (e.g., password authentication). The Ninth Circuit distinguished its [\*Power Ventures\* precedent](#), which held that that a violation of the terms of use of a website, without more, cannot be the basis for liability under the CFAA but that a social media aggregation site had accessed Facebook’s computers “without authorization” after receiving an individualized cease-and-desist letter. While *Power Ventures* involved the gathering of social media user profile data protected by a username and password authentication system, the data *hiQ* was scraping was available to anyone with a web browser.

## Unanswered Questions and Looking Ahead

Screen or web scraping is an issue that has been controversial since the early days of e-commerce. Content aggregators and data users are always thinking of new and productive uses for data readily accessible from websites, with scraping as an obvious technical measure to access that data. Many advocate that content on publicly-available websites is implicitly free to harvest and exploit, while web services hosting valuable user-generated content or other data typically wish to exercise control over which parties can access and use it for commercial purposes. The CFAA has been one of the most potent legal tools used by website owners to challenge scraping activities. While the law surrounding screen scraping remains uncertain, the Ninth Circuit clarified whether scraping data from a public-facing website likely violates the CFAA “unauthorized access” provision, even if a website operator revokes a data scraper’s access via a cease-and-desist letter.

In considering the balance of equities surrounding the lower court’s grant of a preliminary injunction, the court enunciated multiple pro-scraping sentiments, echoing the lower court’s concern that allowing large internet platforms to selectively restrict access to publicly available website data would not necessarily be in the public interest.

While the *hiQ* decision is certainly a scraping-positive decision, it leaves many unanswered questions. *hiQ*, while advocating an open lane for scraping public website data, is not a complete green light for scraping in general. The Ninth Circuit held that the CFAA is likely not a viable claim for limiting the scraping of publicly available web data, yet other questions and issues are lurking:

- The calculus in any particular CFAA-scraping dispute will depend on the nature of the data at issue, as evidenced by the varying holdings in the Ninth Circuit’s *Power Ventures* decision, which involved password-protected social media profiles, and *hiQ*,

which involved “public” LinkedIn member data. Indeed, the *hiQ* court, in weighing whether the injunction was in the public interest, noted the nature of LinkedIn’s user-generated data and implicitly differentiated it from proprietary or private data.

- While the crux of the decision involved the CFAA issue, LinkedIn had advanced other claims, including breach of contract, unjust enrichment and trespass to chattels. The court did not consider these claims on appeal, and noted that website operators concerned about unwanted data scraping may have causes of action beyond the CFAA, such as copyright infringement, misappropriation, breach of contract, or privacy-related claims. As we’ve seen in other cases involving scraping or unwanted access, such claims may be viable.
- In today’s e-commerce environment, many online marketplaces scrape publicly available price data from competitors and other retailers to glean dynamic pricing and benchmarking analytics. The *hiQ* holding would appear to limit the availability of a CFAA cause of action for such activities, though, as previously discussed, other potential state causes of action remain and entities are still encouraged to follow certain risk management practices when engaged in scraping.
- While the Ninth Circuit’s decisions regarding technology law are often considered persuasive authority, other jurisdictions outside of the Ninth Circuit are not bound by its decisions. Thus, the reach of the *hiQ* court’s interpretation of CFAA liability for scraping public websites is yet to be determined (and it is possible that the entire Ninth Circuit will hear the case en banc).
- What will be the practical result of the *hiQ* holding? LinkedIn and other platforms will always remain wary of “free riders” that wish to use their databases for commercial purposes. But will the decision impel LinkedIn and other similar platforms to put such data behind an authentication wall? As the court noted, many LinkedIn users intend their profiles to be accessed by other members or the public and such a radical change of access could undermine its own business model: “Of course, LinkedIn could satisfy its ‘free rider’ concern by eliminating the public access option, albeit at a cost to the preferences of many users and, possibly, to its own bottom line.”
- Websites may still enact protective measure against malicious automated activity that threatens the integrity of their networks. The Ninth Circuit noted, in dicta, that the injunction does not preclude LinkedIn from continuing to engage in “technological self-help against bad actors.”

## Insider Trading

The past 12 months have seen a resolution of the debate that the Second Circuit started in 2014 about the nature of the “personal benefit” needed to create liability for insider trading. The law is now clear in the Second Circuit that a tipper’s intent to benefit a tippee by providing material, nonpublic information (“MNPI”) can suffice to establish the personal benefit required for tipper and tippee liability, regardless of the parties’ relationship.

The year also saw a number of other noteworthy events, including (i) a ruling requiring a retrial of a defendant who had pled guilty without establishing that he had *known* that a tipper had provided MNPI to him in exchange for a personal benefit, (ii) a decision suggesting that insider-trading liability should turn on the *purpose* for which confidential information was used or disclosed, (iii) yet another reminder that criminal securities-fraud liability can be established even without proof of personal benefits and fiduciary breaches, (iv) a decision addressing when information becomes sufficiently “public” for trading purposes, (v) a reminder from the SEC about Regulation FD’s prohibition on selective disclosure of MNPI, (vi) the retrial of Sean Stewart, (vii) a Second Circuit ruling that forfeiture penalties for insider trading can include the appreciated value of trading funds, (viii) the CFTC’s continued interest in insider trading, (ix) a decision on private civil liability for insider trading, (x) legislative efforts to address insider trading, and (xi) an update on the insider-trading charges against Representative Christopher Collins.

### **The End of the Line for the “Close Personal Relationship” Requirement for Tippee Liability**

Our annual updates over the past several years have traced the apparently short-lived revolution in insider-trading law triggered 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 undermined *Newman*, and insider-trading law now has ended up more or less where it was in 2014, before *Newman*. The Supreme Court’s June 2019 denial of Martoma’s *certiorari* petition appears to mark the end of this debate – at least for now.

The debate centered on the nature of the “personal benefit” that a tipper of MNPI must obtain to create tipper and tippee liability for trading based on that information. Insider-trading liability arises under the Securities Exchange Act of 1934 (the “Exchange Act”) only if securities are bought or sold on the basis of MNPI 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.

In 2014, the Second Circuit 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). Two years later, the Supreme Court decided *Salman v. United States*, 137 S. Ct. 420 (2016), which rejected *Newman*’s holding that a tipper must receive an objective, consequential personal benefit representing an actual or potential pecuniary gain.

In the wake of *Salman*, the Second Circuit returned to the other part of the *Newman* decision: the “meaningfully close personal relationship” requirement. The court held in *United States v. Martoma*, 894 F.3d 64 (2d Cir. 2018), that “there are many ways to establish a personal benefit,” such as 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.” 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 Supreme Court denied Martoma’s *certiorari* petition in June 2019, and the short-lived era of *Newman* now appears to be over, at least in the Second Circuit. Under the *Martoma* decision, a tipper’s intent to benefit a tippee can suffice to establish the personal benefit required for tipper and tippee liability, regardless of the parties’ relationship.

The Second Circuit followed *Martoma* in *United States v. Klein*, 913 F.3d 73 (2d Cir. 2019), when it affirmed the conviction of a nontrading tipper who had allegedly tipped his friend and financial advisor about a potential transaction that the tipper’s law firm was handling. The Second Circuit held that the requisite “personal benefit” to the tipper “can be established in a number of ways, including by illustrating the nature of the relationship between the tipper and the tippee *or* the tipper’s receipt of something of value” (emphasis added). “The critical question regards the tipper’s purpose: did the tipper share the material non-public information with the tippee intending that the tippee use the information to improperly trade in securities?” The court concluded that a reasonable jury could have found that the tipper had conveyed the information to the tippee so that the tippee could trade on it.

A federal court in Illinois also followed the *Martoma* decision in refusing to dismiss an indictment against remote tippees. The court held in *United States v. Beshey*, 2019 WL 277730 (N.D. Ill. Jan. 22, 2019), that “personal benefit to an insider [tipper] may be inferred when the insider tips a close friend.”

### **Retrial of Richard Lee**

While the *Martoma* saga appears to have ended, another long-running insider-trading matter was temporarily revived. A federal judge ruled in June that a retrial was required for Richard Lee, a former hedge-fund portfolio manager who had pled guilty in 2013 to securities fraud and conspiracy to commit securities fraud. *United States v. Lee*, No. 13 CR 539 (PGG) (S.D.N.Y. June 21, 2019).

Lee had pled guilty to obtaining and trading on information from tippers at public companies and investment firms. He had stated in his factual allocution that he had known, or had had reason to believe, that other persons had breached a fiduciary duty or duty of confidentiality in providing the information to him.

In 2017, however, Lee moved to withdraw his guilty plea, contending that it was insufficient in the wake of *Newman* based on developments in insider-trading law concerning the personal-benefit requirement. Lee’s motion focused on an aspect of *Newman* that was not undermined by *Salman* and *Martoma*: the requirement that a tippee *know* that the tipper disclosed MNPI in exchange for a personal benefit (however that benefit might be defined under *Salman* and *Martoma*).

The court held that Lee’s plea proceeding had not addressed Lee’s knowledge of any personal benefit that the tippers had received from divulging the confidential information. The plea

proceeding had not explored “(1) who the corporate insiders were; (2) whether Lee knew who they were; (3) to whom the corporate insiders disclosed material non-public information, or (4) the nature of the relationship between the tippers and those to whom they disclosed material non-public information.” The court therefore held Lee’s guilty plea to be factually insufficient in the absence of any information in the record “that speaks directly or indirectly to Lee’s knowledge of any personal benefit the corporate insiders received as a result of divulging confidential information.”

The Government ended up dismissing the case on November 7, 2019, before the scheduled December retrial.

As we have noted in our prior updates, *Newman*’s most enduring holding was not its effort to narrow the definition of “personal benefit,” but its insistence that a tippee must *know* that the tipper received a personal benefit of some sort. The *Lee* court observed that, “[p]rior to *Newman*, it was not clear that a breach of fiduciary duty [by the tipper] by definition includes a personal benefit to the tipper. *Newman* clarifies this point, which the Supreme Court later confirmed in *Salman*.” Because of this clarification of the law, the court saw “no reason to believe that Lee – in using the phrase ‘breach of fiduciary duty’ during his 2013 allocution – understood that phrase to include the liability components later explicated in *Newman* and *Salman*.”

Particularly in situations involving remote tippees, this holding – that a tippee must *know* that the tipper received a personal benefit in exchange for tipping MNPI – can be a powerful defense, and a deterrent to the prosecution. But this aspect of *Newman* and *Lee* is a *defense*. For compliance purposes, we urge our clients to avoid getting into situations where they need defenses. The better way to protect oneself and preserve one’s reputation is to avoid trading on MNPI in the first place.

### **Should Insider-Trading Liability Turn on the *Purpose* for Which Confidential Information Was Used or Disclosed?**

Having watched the debate about the Second Circuit’s *Newman* decision, and having contributed to that debate by criticizing the *Newman* decision while sitting by designation as an appellate judge on the Ninth Circuit, Southern District of New York Judge Jed Rakoff recently expressed some frustration over all the theorizing about insider trading. He observed that it “is a straightforward concept that some courts have managed to complicate.” In Judge Rakoff’s view, liability should turn on the *purpose* for which the confidential information was used or disclosed. The user or discloser can be liable if he or she acted “for personal advantage,” but not if he or she acted for “a corporate or otherwise permissible purpose.” *United States v. Pinto-Thomaz*, 352 F. Supp. 3d 287 (S.D.N.Y. 2018).

Judge Rakoff opined that “insider trading is a variation of the species of fraud known as embezzlement,” in which someone else’s property – MNPI – is taken and either used by the embezzler for his or her own benefit or passed on to a third party who knows that the property was stolen, but nevertheless uses it to buy or sell securities. Thus, “if the embezzler, instead of trading on the information himself, passes on the information to someone who knows it is misappropriated information but still intends to use it in connection with the purchase or sale of

securities, that ‘tippee’ is likewise liable, just as any knowing receiver of stolen goods would be. It is just that simple – or, conceptually, should be.”

Judge Rakoff surveyed the case law starting with *Dirks v. SEC*, 463 U.S. 646 (1983), and concluded that the Supreme Court did not mean to suggest that “‘personal benefit’ consisted of any particular type of benefit, but only that it was a benefit grounded in using company information for *personal advantage*, as opposed to a *corporate or otherwise permissible purpose* (such as whistleblowing)” – as was the situation in *Dirks*. “While use of the term ‘personal purpose’ or ‘personal advantage,’ rather than ‘personal benefit,’ could perhaps have averted subsequent confusion, *Dirks* was quite clear as to the wide breadth of its understanding of a personal benefit.”

Judge Rakoff’s articulation of a purpose test – personal purpose vs. corporate purpose – does appear to simplify the analysis and would avoid some of the philosophical gymnastics that have enlivened insider-trading law (such as whether wine, live lobsters, steak dinners, massage parlors, or college friendships can constitute the requisite “personal benefit”). But will it work?

The Government had proposed such a test in *Salman*, when it urged the Supreme Court to adopt a broad distinction between disclosure for corporate purposes and disclosure for noncorporate purposes – and to hold that any disclosure for a noncorporate purpose satisfies *Dirks*. But the Court did not bite. It unanimously applied the *Dirks* standard and affirmed *Salman*’s conviction.

The fact that the Court did not reconsider the *Dirks* test in *Salman* does not necessarily mean that the Court disagreed with the standard that the Government had proposed. Perhaps the Court simply saw no need to rethink *Dirks* in order to decide the case before it. Perhaps the desirability of a unanimous decision outweighed any potential inclination to tinker with longstanding precedent. Other possibilities also exist. And, of course, the Court did not overtly *reject* the Government’s proposal.

But any court tempted by Judge Rakoff’s corporate-purpose test might need to grapple with the Supreme Court’s sidestepping that argument in *Salman* and the Court’s unanimous reiteration of the *Dirks* standard. We will see how other courts react to the *Pinto-Thomaz* decision in the future.

### **Securities-Fraud Liability Even Without Personal Benefits and Fiduciary Breaches**

As we noted in our prior annual update, 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 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 – does not require consideration of either fiduciary breaches or personal benefits, and its intent requirement differs from § 10(b)’s. Prosecutors are continuing to rely on § 1348 in insider-trading cases, as the recent decision in *United States v. Ying*, 2018 WL 6322308 (N.D. Ga. Dec. 4, 2018), illustrates.

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.

In the *Ying* case, the United States brought insider-trading charges under both § 10(b) and § 1348 against Equifax’s Chief Information Officer, who was accused of having sold company stock before news of Equifax’s data breach became public. Ying sought to dismiss the indictment on various grounds, including multiplicity: he contended that the Government had charged him with the same offense in two separate counts, under §§ 10(b) and 1348.

The court rejected the claim, holding that the counts under the two statutes were not multiplicitous. The § 10(b) count required proof that the defendant had acted willfully, but a violation of § 1348 does not require proof of willfulness.

The *Ying* case and other decisions under § 1348 illustrate that, for compliance purposes, the focus should be on whether prospective traders know that they have MNPI – rather than on whether the provider of that information received a personal benefit for providing it.

### **When Does Information Become Sufficiently “Public” for Trading?**

The *Lee* case discussed above also addressed the question of when new information becomes sufficiently “public” so that it can safely be used for securities trading. As previously noted above, Lee was a hedge-fund portfolio manager who had pled guilty to trading on tips of MNPI, but he later sought to withdraw his guilty plea, arguing that, among other points, the information he had obtained from his tipper was actually public.

Lee contended that data suggested that many investors had known about the alleged MNPI and that the issuer’s stock price had risen during pre-market activity and had continued to rise during the morning while Lee was trading. The court rejected that argument, holding that “[i]nformation is not ‘fully impounded’ into the price of a stock if the price is rising as one is trading . . . . At best, the information is in the process of being ‘impounded’ into the share price by virtue of the trades that are contemporaneously occurring.”

The court also held that the fact that one research firm had informed its clients about the nonpublic information did not make the information sufficiently public. As the court noted, “[i]t is not enough that multiple institutional investors had received [the research firm’s] tip that a [corporate] transaction was imminent, . . . , even where some of these investors had traded on this information.” Information “becomes public when disclosed to achieve a broad dissemination to the investing public generally and without favoring any special person or group, or when, although known only by a few persons, their trading on it has caused the information to be fully impounded into the price of the particular stock.” In light of the facts that (i) Lee had not presented evidence “as to how many or which [research-firm] clients received this information, or when they received it,” (ii) the research firm had disclosed the information only to “a special group – [its] clients,” and (iii) the issuer’s “share price continued to rise while Lee was trading, demonstrating that the information he had obtained was not fully impounded into the share price,” the evidence did not show that the information at issue was public when Lee received it and began to trade.

## Reg FD's Prohibition on Selective Disclosure Is Not Dead

The SEC sent a forceful reminder about the rules prohibiting selective disclosure of MNPI when it instituted cease-and-desist proceedings against a company that had selectively disclosed such information. The company at issue settled the proceedings without admitting or denying liability. *In the Matter of TherapeuticsMD, Inc.*, Admin. Proc. File No. 3-19362 (Aug. 20, 2019).

The company had held several meetings with the Food and Drug Administration (the “FDA”) in its effort to obtain approval of a new drug. After one of those meetings, a corporate executive emailed the six sell-side research analysts that covered the company and provided positive reports on the most recent meeting with the FDA. Several follow-up phone calls with the analysts also took place. The company’s stock price subsequently rose, but the company did not publicly disclose the substance of the FDA meeting at that time.

The following month, after another meeting with the FDA, the company released an 8-K and a press release updating the public on the regulatory approval status. The stock price declined, and the company then held a pre-scheduled conference call with the sell-side analysts. The company provided additional information to the analysts, which then published research notes that included the information from the company. The stock price rebounded. However, the company did not publicly disclose the information that it had given to the analysts.

The SEC concluded that the company’s disclosures to the analysts – without disclosure to the public at large – had violated § 13(a) of the Exchange Act and Regulation FD, which prohibits public companies from selectively disclosing material information to persons outside the company, including institutional investors, securities analysts, and other securities professionals. “Information is nonpublic if it has not been disseminated in a manner making it available to investors generally.”

The analysts’ issuance of research reports on what they had been told did not constitute public disclosure of the information. According to the SEC: “Because [the company] failed to simultaneously publicly disseminate the material information in accordance with Regulation FD, the investing public was placed at a disadvantage relative to the analysts and their subscribers who were privy to the selective disclosures.” The SEC’s statement echoes that of the *Lee* court, quoted above.

Regulation FD, of course, is the issuer’s obligation, not the analysts’ or the hedge funds’ responsibility. However, the recipient of information disclosed in violation of Regulation FD could become enmeshed in insider-trading issues if the recipient knows (or perhaps should have known) that the discloser breached a duty under Regulation FD. The discloser would presumably need to have obtained a personal benefit if the recipient is to be held liable, but one can imagine situations where the discloser knows the recipient and intends to confer a favor on him or her. And in any event, we generally advise our clients not to make trading decisions based on whether they have correctly gauged that the tipper did or did not receive a personal benefit. Accordingly, even recipients of corporate information need to be alert that they are not receiving and trading on selective disclosures that could violate Regulation FD.

## Conviction with and Without the Silver Platter: the Retrial of Sean Stewart

One of the year's most closely watched insider-trading events was the retrial of Sean Stewart, the former investment banker who allegedly had tipped his father about five impending corporate transactions about which Stewart had learned through his work. The father had then shared the information with a former colleague and potential business partner, who traded on the tips and allegedly split the proceeds with the father. Both the father and the tippee pled guilty, but the son did not – and he was tried for insider trading because of the alleged tips to his father. *U.S. v. Stewart*, No. 1:15-cr-00287 (S.D.N.Y.).

A critical piece of evidence in the case was the father's statement to his former colleague (who by that point was cooperating with the Government and taping the conversation) that Stewart had told his father: "I can't believe it. I handed you this on a silver platter and you didn't invest in this." The Government portrayed this testimony as proof that Stewart had provided the information to his father intending that the father would trade on it.

After the father was arrested, however, he made statements in an FBI interview that arguably undercut the inference that Stewart had intended him to trade on MNPI. According to the father, "Sean said, 'Uh y'know, all these deals – if you were trading – you could have made like millions of dollars[,] and I said, 'Sean nobody's going to trade and make millions of dollars on this stuff.' That wasn't his intention." When the FBI asked the father why Stewart had given him the information, the father replied: "I think he was just proud of the fact that he was doing deals and y'know almost like [']hey, this deal is going to go way up[,] not intending that somebody was going to trade on it." And when the FBI asked the father "[w]hy did [Sean] get mad at you and say, 'I served this up to you on a silver platter and you didn't invest in it,'" the father replied that "I think that – that day, [Sean] was clearly drinking" because he was going through a divorce.

The District Court excluded the father's statements to the FBI, and Stewart was convicted of insider trading. The Second Circuit reversed, holding that the District Court had erroneously excluded the father's post-arrest statements and that the error was not harmless. *United States v. Stewart*, 907 F.3d 677 (2d Cir. 2018).

The Second Circuit observed that, "[t]o find Sean guilty, the jury had to conclude that Sean intended that his father would trade, thus personally benefitting from the misappropriation of his employer's material, nonpublic information." The exclusion of the father's post-arrest statements deprived the jury of information that, if believed, "might have supported inferences that Sean did not know, expect, or intend that his father would invest based upon their discussions."

Stewart was retried in September 2019. The District Judge (Judge Rakoff again, who had not presided over the first trial) barred the Government from introducing the "silver platter" statement, holding that it was inadmissible because it had not been made in furtherance of an alleged conspiracy between Stewart and his father and did not qualify for admission under a hearsay exception. The recording of the conversation between the father and his former colleague as presented during the retrial showed the colleague asking the father whether Stewart had conveyed MNPI "out of the kindness of his heart," and the father replied: "No, it's just, you

know, it's just stuff he mentions as he goes around, you know, 'Oh, I am working on this, I am working on that.'”

But even without the silver platter, the result was the same: the jury convicted Stewart of insider trading after only about 65 minutes of deliberation. Press reports quoted one juror as saying that the “most damning” evidence was the result of a FINRA inquiry and the trades from tips that only Stewart allegedly could have provided. The FINRA inquiry had focused on allegedly suspicious trading of one issuer’s securities, and FINRA had produced a list of traders, including Stewart’s father. When Stewart’s employer asked Stewart about the list, he initially had denied recognizing any of the names on it.

### **Forfeiture Penalties for Insider Trading Can Include Appreciation on Trading Funds**

The Second Circuit held in July 2019 that forfeiture penalties for insider trading can include the appreciated value of illegally obtained trading funds. *United States v. Afriyie*, 929 F.3d 63 (2d Cir. 2019).

The *Afriyie* case involved an investment analyst who had researched potential investments for his firm. In violation of his firm’s policies, the analyst had traded on alleged MNPI about a potential acquisition. The analyst was convicted of insider trading and wire fraud, and the Second Circuit affirmed the convictions.

On appeal, the analyst challenged the forfeiture calculation, which had been applied to the “proceeds” acquired through the illegal trading, including the appreciated value of those funds. The Second Circuit affirmed, holding that “forfeiture may extend to the appreciation of funds acquired through illegal transactions in an insider-trading scheme.” Under 18 U.S.C. § 981(a)(1)(C), a convicted defendant must forfeit not only the property that “constitutes . . . proceeds,” but also property that is “derived from proceeds traceable” to the offense. The latter clause covered the appreciated value of the illegally obtained funds.

### **CFTC’s Continued Interest in Insider Trading**

Our 2018 update mentioned the Commodity Futures Trading Commission’s ramp-up of surveillance of insider trading and its creation of an Insider Trading and Information Protection Task Force. The CFTC’s interest in combatting insider trading continued with its enforcement action against EOX Holdings and one of its brokers. *CFTC v. EOX Holding LLC*, No. 1:18-cv-8890 (S.D.N.Y.), filed on September 28, 2018.

The *EOX* complaint alleges that the broker breached a duty of trust and confidence to EOX’s customers by tipping a friend about confidential information concerning other customers and by trading the friend’s discretionary account on the basis of that confidential customer information. The claim is based on CFTC Rule 180.1, which prohibits misappropriation of confidential information – in this case, the customers’ information. Prior CFTC actions under Rule 180.1 had involved alleged breaches of duty to the employer, through use of the employer’s confidential information. The Rule is similar to the SEC’s Rule 10b-5, and the CFTC appears to be guided by precedent under Rule 10b-5 involving insider trading and the misappropriation theory.

The CFTC also charged EOX with failure to supervise the broker, as required under CFTC Rule 166.3, by failing to establish, implement, and enforce policies to detect or prevent misuse of confidential customer information, failing to review the broker's discretionary trading and dealings with his friend, and failing to establish, implement, or enforce policies governing EOX brokers' handling of customer orders, preparation and retention of records, and protection of confidential customer information. The CFTC had not previously charged an entity for failing to implement and enforce appropriate controls to prevent misappropriation of confidential information.

The defendants moved to dismiss the case, but a ruling appears to have been delayed by a forum fight about the appropriate venue. The case was transferred to the Southern District of Texas on July 31, 2019, where it is now pending as Case No. 4:19-cv-2901.

### **Private Civil Liability for Insider Trading**

Although we generally think in terms of the risk of governmental action for insider trading, private civil liability can also exist. Section 20A of the Exchange Act allows persons who buy or sell securities contemporaneously with those who sell or buy those securities based on MNPI to sue the insider-traders for damages (which shall not exceed the traders' profit gained or loss avoided on the transaction). This issue has arisen in the ongoing *Valeant* securities litigation, in which the court recently denied a motion to dismiss a § 20A claim filed by contemporaneous traders. *In re Valeant Pharms. Int'l Sec. Litig.*, Civ. No. 15-7658 (D.N.J. June 30, 2019).

The *Valeant* case involved sales of Valeant stock by a hedge fund whose affiliated persons had served as members of Valeant's Board of Directors. The fund allegedly had a policy that limited concentration in any investment to less than 20% of the fund's holdings. The fund's Valeant holdings had exceeded the 20% mark, and, at some point, the fund sold off some of its Valeant shares at a time when Valeant allegedly had been involved in undisclosed improper business dealings and accounting practices that eventually led to a restatement and the termination of an allegedly improper marketing arrangement. An institutional investor that bought shares on the same day that the fund sold sued the fund, claiming that the fund's sale had been based on MNPI because of the fund's representative on Valeant's Board.

The court denied the fund's motion to dismiss the § 20A claim, holding that the purchaser had sufficiently pled that the fund, through the director, had known of and had access to MNPI at the time of the sale. The court held that, for pleading purposes, the fund's invocation of its concentration policy did not require dismissal of the claim because the fund had not previously followed its policy and had not sold down its Valeant position earlier.

### **Legislation on Insider Trading? Perhaps This Time?**

Since the Second Circuit's 2014 decision in *Newman* triggered a debate about the personal-benefit requirement, several bills have been introduced in Congress to define insider trading. The most recent effort is H.R. 2534, which the House Financial Services Committee passed in May 2019.

H.R. 2534 would prohibit the purchase or sale of securities while the trader is in possession of MNPI if the purchaser or seller "knows, or recklessly disregards, that such information has been

obtained wrongfully, or that such purchase or sale would constitute a wrongful use of such information.” Trading would be considered wrongful if the information was obtained (i) through theft, bribery, misrepresentation, or espionage, (ii) in violation of any federal law “protecting computer data or the intellectual property or privacy of computer users,” (iii) through “conversion, misappropriation, or other unauthorized and deceptive taking of such information,” or (iv) in breach of any fiduciary duty, confidentiality, contract, “or any other personal or other relationship of trust and confidence.”

The bill thus would appear to codify aspects of insider-trading law as we know it. However, unlike current insider-trading law, the bill does *not* require that the discloser of the information have received a personal benefit in exchange for providing information in breach of a breach of duty. To the contrary, the bill makes clear that the knowledge component does *not* require the trader to know “the specific means by which the information was obtained or communicated, or whether any personal benefit was paid or promised by or to any person in the chain of communication, so long as the person trading while in possession of such information . . . was aware, consciously avoided being aware, or recklessly disregarded that such information was wrongfully obtained or communicated.”

The bill further states that, except as provided under Exchange Act § 20(a)’s control-person liability provision, no person shall be liable “solely by reason of the fact that such person controls or employs a person who has violated this section, if such controlling person or employer did not participate in, profit from, or directly or indirectly induce the acts constituting the violation of this section.” This provision could provide protection to a fund whose employee has gone rogue, as long as the fund itself did not profit from or directly or indirectly induce the alleged misconduct.

The bill would also require the SEC to determine within 180 days after enactment whether “automatic trading transactions” should be exempted, and it provides an interim exemption for such transactions. The bill defines “automatic trading transactions” as those that “occur[] automatically” or are “made pursuant to an advance election.”

In January 2019, the full House passed a separate, bipartisan bill (115H6320) calling for the SEC to study whether Rule 10b5-1 should be amended to (i) limit issuers’ and insiders’ ability to adopt trading plans only during trading windows, (ii) limit issuers’ and insiders’ ability to adopt multiple trading plans, (iii) establish “a mandatory delay between the adoption of a trading plan and the execution of the first trade pursuant to such a plan,” (iv) limit the frequency with which trading plans can be modified or canceled, (v) require issuers and insiders to file trading plans and any amendments, terminations, and transactions with the SEC, or (vi) require boards of issuers that have adopted trading plans to adopt policies covering trading-plan practices, periodically monitor transactions under the plans, and ensure that “issuer policies discuss trading plan use in the context of guidelines or requirements on equity hedging, holding, and ownership.”

And in September 2019, parallel bills were proposed in the House (H.R. 4335) and the Senate (S. 2488) to plug the so-called “8-K trading gap.” The bills would require the SEC, within one year after the proposed legislation’s enactment, to issue rules requiring issuers to establish policies, controls, and procedures to prevent executive officers and directors from trading the

issuers' securities between (i) either the date a reportable event occurs (for Form 8-K §§ 1-6) or the date the issuer determines to report that event (for Form 8-K §§ 7-8) and (ii) the date the issuer files a Form 8-K or furnishes it to the SEC. The SEC may exempt "automatic" transactions, such as those made pursuant to advance election or trading plans, but not if the trading plans were adopted during the pre-8-K periods described in the preceding sentence.

No further action appears to have been taken so far on any of these bills.

### **Update on Representative Christopher Collins**

Our 2018 update discussed the indictment of Representative Christopher Collins (Rep. – NY) on insider-trading charges. Collins was a director and large shareholder of an Australian pharmaceutical company. While attending a Congressional picnic at the White House, he received an email from the company's CEO informing the directors that the company's only significant product had failed a drug trial. Within the next several minutes, Collins allegedly made six "missed" calls to his son and finally connected on a seventh try. The indictment charged that, during the seventh call, Collins told his son about the drug-trial failure. The son then allegedly tipped his then-fiancée, her father and mother, and a friend. The tippees sold their shares before the news of the drug trial became public.

Collins resigned from Congress on September 30, 2019, and pled guilty to the insider-trading charges on October 1, 2019. His son pled guilty two days later.

### **Private Fund Litigation**

Uncertainty surrounding notable unicorns, fluctuating market and credit cycles, and a philosophical change in how the industry views and utilizes litigation will impact litigation risks for advisers (and their funds) in 2020. Here are several areas that should be on the top of every adviser's list as we look forward.

#### **Unicorns: The Ripple Effect**

Many have been speculating for years that some unicorns have been substantially overvalued, supported by recent events surrounding IPOs of notable unicorns. Valuation issues and related risks for private investment funds will continue to be difficult to ignore as investors' expectations for liquidity and performance increase in 2020. When faced with a potential market downturn in the coming years, the success (or not) of certain high-profile unicorn exits will have a ripple effect. Disappointing outcomes may cause investors and employee shareholders to pursue litigation. In addition to private litigation claims, the SEC and the U.S. Department of Justice (the "DOJ") have made clear that private companies are not exempt from the federal securities laws and they will step in when a unicorn's actions amount to fraud or other regulatory violations. Funds – and particularly those with a heavy concentration in unicorns (or directors on unicorn boards) – should be paying careful attention to these inquiries, and in the meantime should be reviewing their insurance coverage program.

## Litigation Funding Fuels Potential Disputes

Litigation funders, whose business strategy is to invest in claims by covering the expenses of litigation in exchange for a share in the recovery, are raising capital at an unprecedented pace. Fund sponsors evaluating potential claims should explore the potential benefits of litigation financing concerning their portfolio company investments. Those potential benefits can include: (i) providing the sponsor with a cash infusion from the proceeds of the sale of the interest in the litigation(s); (ii) transferring some downside risk of an unsuccessful litigation to a third party; (iii) improving the balance sheet of a portfolio company by reducing litigation expenses; and (iv) allowing the sponsor to pursue potentially meritorious litigation(s) without having to expend capital on litigation expenses.

Limited partners have not typically been in the business of initiating litigation – in part because their primary objective is to maximize the value of their investment and litigation is viewed as having certain costs with an uncertain return. At the same time, limited partners – unlike managers who can often rely on indemnification from the fund and other sources – must cover their own legal expenses. These factors have contributed to relatively low levels of litigation involving private funds. Enter litigation funders, which provide the potential to fuel a new wave of litigation affecting private funds, whether involving disputes at the portfolio company level, the fund, or even the adviser.

## ICOs – What Happens When the Music Stops

Regulatory actions involving blockchain-based technology—such as cryptocurrencies ICOs—has drawn the most attention over the past year. Although the SEC continues to pursue antifraud and registration violations involving ICOs, cryptocurrencies, and [related activities](#), the volatility of cryptocurrencies and ICO-related investments will continue to be a fertile ground for private disputes. While Section 29(b) of the Exchange Act and Section 12(a)(1) of the Securities Act both provide mechanisms to unwind securities transactions, such disputes can be quite costly if the proper precautions are not taken. Coupling these risks with increasing regulatory scrutiny, fund managers should carefully consider their investment choices and prepare for varying degrees of legal scrutiny between those choices.

## Private Credit Defaults and Workouts

Private credit lending remains on track to become a \$1 trillion industry by 2020, but may face headwinds during the next economic downturn. The landscape for deals has become more competitive, with higher leverage and deal terms that are looser or have deteriorated. In the 1980s and early 1990s, commercial banks assembled dedicated teams and developed sophisticated systems to work-out troubled commercial loans. It remains to be seen how private credit lenders would respond to a similar situation, but if necessary they would be doing so with substantial resources and many tools at their disposal.

## Portfolio Company Litigation on the Rise

Control over portfolio companies – through directorships or otherwise – has always been a source of litigation risk for advisers and their funds. That risk has only increased as plaintiffs seek to name fund advisers, as well as their funds and board-designees, as defendants in high-stakes litigation matters under veil-piercing theories. Aggressive plaintiffs’ lawyers view advisers as lucrative targets because of their deep pockets and desire to avoid litigation. And we continue to see a steady uptick in something that was once viewed as taboo in the industry – advisers and their funds suing other advisers and their funds in post-closing disputes. We expect this trend to continue in 2019 and beyond, given the institutionalization of the fund industry, increasing competition, and litigation funding.

The Third Circuit [recently issued an important decision](#) for private fund advisers who serve on corporate boards. In a precedential decision, the Third Circuit distinguished the role of nonvoting board observers from the function of formal corporate directors. And while the decision was issued in the context of liability for alleged violations of the securities laws, the Third Circuit suggested the analysis may apply more broadly to other situations involving board observers. A member of the private fund adviser who also sits on the company’s board of directors must navigate potential conflicts of interest between their duties to the company and to the private fund. Board observers, on the other hand, have access to important and timely information, and while they do not have voting rights, board observers, unlike directors, do not owe fiduciary duties. The Third Circuit’s decision – distinguishing board observers from formal directors for purposes of liability in at least some contexts – is another data point for private fund advisers to consider when weighing the pros and cons of appointing one of its members as a formal director or a nonvoting board observer. (For more information, please see our August 21, 2019 [post](#) on The Capital Commitment)

## Alter Ego Liability for Fund Managers in Portfolio Company Disputes

Limited liability is a hallmark of the standard corporate structure. Yet the legal doctrines of veil piercing and alter ego liability [can permit courts to “pierce” or bypass the corporate structure](#) in order to hold shareholders (i.e. the fund) and directors personally liable for a portfolio company’s actions or debts. A recent case in a North Dakota district court is a reminder to private equity funds and managers that, under certain conditions, they may be held liable under an alter ego theory for actions of a fund’s portfolio companies. The plaintiffs in [the underlying case](#) brought a veil-piercing claim against a private equity firm in a products liability action against related portfolio companies. Despite the fund sponsor’s position that it lacked unity of ownership and unity of interest with the portfolio companies, the court denied its motion for summary judgment and determined that under federal law, veil-piercing was a question for the jury to decide. (For more information, please see our September 16, 2019 [post](#) on The Capital Commitment).

## FINRA / Broker-Dealer Updates

Last June, the SEC adopted Regulation Best Interest, a new conduct standard for broker-dealers making recommendations to retail customers. At the same time, the SEC issued a release reaffirming and clarifying the fiduciary duty investment advisers owe to clients, including

institutional clients. For more information, see our client [alert](#) on Regulation BI and related interpretations.

An adviser's fiduciary duty includes a duty of care and a duty of loyalty. The duty of loyalty requires that an adviser not subordinate its clients' interests to its own. An adviser's duty of care requires the provision of advice in a client's best interest. It also includes the duty to seek best execution where an adviser has responsibility for broker selection. This means the adviser must seek to obtain executions where the client's total cost or proceeds in each transaction are the most favorable under the circumstances.

When assessing best execution, total cost or proceeds includes the *execution price* as well as the *commission, mark-up or mark-down* applied to a transaction. However, the adviser's obligation does not require it to ensure that the client receives the absolute lowest (highest) execution price in the case of a buy (sell) order or that it pays the lowest possible commission. The measure of performance is qualitative, not quantitative. The objective should be to maximize value for the client in terms of the full range and quality of a broker's services, including execution capabilities, value of research provided, financial responsibility and responsiveness to the adviser.

An investment adviser should have procedures in place to monitor compliance with its best execution obligation. Recently, OCIE issued a risk [alert](#) reiterating its expectation that advisers "periodically and systematically" evaluate the quality of executions provided by the broker-dealers they use to execute clients' orders. An adviser's procedures for evaluating the quality of executions should include modules for assessing both the execution prices and the commission costs.

The trade execution component should evaluate how the broker-dealers perform relative to the national best bid or offer (NBBO) and the liquidity available at the time of the trades. Regulation NMS requires broker-dealers to publish quarterly reports identifying the top venues to which they route customer orders in NMS securities and the material aspects of their relationships with those venues, including payment for order flow, profit sharing and other arrangements that might affect their routing decisions. On request, a broker-dealer also must provide a customer with a report that identifies the venues to which all of its orders were routed in the prior six months. These reports are intended to be used in conjunction with trade execution performance reports published by securities exchanges and other market centers under Regulation NMS. Together the broker-dealer and market center reports enable investors to evaluate the order routing practices of their brokerage firms and the performance of the venues to which their orders are routed.

Late last year, the SEC amended Regulation NMS to require broker-dealers to provide more enhanced information and individualized disclosures. Starting in January 2020, broker-dealers will be required to furnish to customers, on request, a report of the customer's orders submitted on a *not held* basis over the prior six months. (A not held order is one in which the broker-dealer is given time and price discretion.) This enhanced reporting will help advisers evaluate issues relevant to broker's performance in terms of execution quality, information leakage and conflicts of interest.

Advisers will have access to important additional trade execution detail. The expanded report must provide aggregate information for each venue to which the broker-dealer routed the customer's orders, including: (1) information on order routing (e.g. total shares and average order size); (2) execution (e.g. shares executed, fill rate, average size, average net execution rebate or fee, and shares executed at the midpoint, more favorable and less favorable side of the spread); (3) orders that provided liquidity (e.g. shares executed, average time between entry and execution and average rebate/fee); and (4) orders that removed liquidity. It also must include data on orders exposed through actionable indications of interest and the venues to which they were exposed. Investment advisers, especially advisers to hedge funds and separate accounts, should consider how best to incorporate the existing and new reports into their best execution reviews. The information on rebates also may be helpful in negotiating client commission charges.

The quality of brokerage and research services received is a relevant consideration for the commission component of an adviser's best execution analysis. Section 28(e) of the Exchange Act furnishes a safe harbor for investment advisers and other fiduciaries who pay more than the lowest commission charge (referred to as "paying up") for brokerage and research services provided all of its conditions are met.

Section 28(e) requires a money manager to make a good faith determination that the commissions paid are reasonable in relation to the value of the brokerage and research services received. The adviser may consider, among other things, the effective use of market, time and price discretion, anonymity, financial responsibility, operational effectiveness, trade monitoring services, proprietary and third party research reports, trading ideas, market color and similar products and services received from the broker. The Commission has provided guidance on the kinds of products and services that are eligible for protection. For more information, see [our client advisory on 28\(e\)](#). The safe harbor is applicable even where the adviser makes separate or side-by-side payments for research in order to comply with MiFID II or other arrangements that unbundle brokerage and research services. For more information, see [our client advisory on MiFID II](#). Advisers should have procedures to ensure compliance with the Section 28(e) safe harbor.

## **The Foreign Corrupt Practices Act**

### **Enforcement Activity**

The SEC and DOJ continue to aggressively enforce the Foreign Corrupt Practices Act (FCPA), the federal statute that prohibits companies from making payments to foreign government officials for government contracts and other business. There have been thirteen corporate FCPA enforcement actions that have been brought by the SEC and DOJ in the first three quarters of 2019. The enforcement actions have involved companies in the oil and gas, technology, telecommunications, retail, healthcare, and finance sectors. This level of enforcement activity is roughly in line with the enforcement activity over the last two years, although it is well-short of the record-high twenty-seven corporate enforcement actions in 2016. At the same time, the number of enforcement actions involving individuals is trending upward.

In 2016, we saw the first [significant enforcement action targeting the private fund industry](#) — activity that the government had been previewing for years. And, while we have not seen any public enforcement cases targeting fund managers since then, we have seen additional activity relating to financial institutions, which advisers to private funds should note. So far in 2019, for example, the government brought [enforcement actions](#) against two [investment banks](#) for FCPA violations related to the hiring of relatives of foreign government officials. These are part of a string of FCPA-related enforcement actions that have been brought against financial institutions in recent years. With more cases in the enforcement pipeline, 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.

### **SEC Chairman Criticizes Foreign Anticorruption Efforts**

Increased international cooperation has been a point of emphasis in anti-corruption enforcement in recent years. But, according to SEC Chairman Jay Clayton, he has not seen enough improvement from foreign enforcement authorities. Last month, in a [speech](#) to the Economic Club of New York, Clayton criticized his foreign counterparts for failing to adequately enforce the laws on the books in their own countries: “Corruption is corrosive. We see examples where corruption leads to poverty, exploitation and conflict. Yet, we must face the fact that, in many areas of the world, our work may not be having the desired effect. Why? In significant part, because many other countries, including those that have long had similar offshore anti-corruption laws on their books, do not enforce those laws,” Clayton said. He emphasized that, despite this, he does not intend to change the FCPA enforcement posture of the SEC. Instead, he indicated that this is going to be “front of ... mind” when he engages with his international counterparts on other matters where “common, cooperative enforcement strategies are essential.”

### **CFTC Signals New Focus on Foreign Corrupt Practices**

In addition to foreign regulators, the SEC and DOJ — the agencies charged by statute with enforcing the FCPA — will now have a new domestic regulator to coordinate with as well. On March 6, 2019, the CFTC issued an [Enforcement Advisory](#) on self-reporting and cooperation for violations of the Commodity Exchange Act involving foreign corrupt practices. In doing so, the CFTC signaled for the first time that it would be policing violations of the CEA carried out through foreign corrupt practices. In [remarks](#) at the American Bar Association’s National Institute on White Collar Crime, CFTC Director of Enforcement James M. McDonald explained that “companies and individuals engaging in foreign corrupt practices should recognize that this sort of misconduct might constitute fraud, manipulation, false reporting, or a number of other types of violations under the CEA, and thus be subject to enforcement actions brought by the CFTC.” For example, the CFTC could invoke its authority under the CEA if a fund were to use bribes or other corrupt means to secure business in connection with activities regulated by the CFTC, e.g., trading, advising, or dealing in swaps or derivatives; to manipulate benchmarks; to falsely report prices; or to otherwise alter the prices in commodity markets that drive U.S. derivatives prices. In light of the foregoing, fund managers that are registered CPOs should pay special attention to this new enforcement priority.

## Committee on Foreign Investment in the United States

Following the enactment of the Foreign Investment Risk Review Modernization Act (FIRRMA) in August 2018 and the implementation of the FIRRMA Pilot Program in November 2018, the Treasury Department issued long-anticipated proposed rules to implement FIRRMA on September 17, 2019. The rules are in a 30-day notice and comment period, and will become final no later than February 13, 2020. The new proposed rules implement, among other things, FIRRMA provisions on real estate transactions, clarify what counts as a covered investment, and propose new rules for foreign persons and excepted investors. Thomas Feddo, former deputy assistant secretary, was confirmed on September 12, 2019 as the Treasury Department's first Assistant Secretary for Investment Security. This position, created by FIRRMA, gives Committee on Foreign Investment in the United States (CFIUS) more influence and greater authority within the Treasury Department.

The proposed rules were issued in two parts: 31 CFR Part 800 – Provisions Pertaining to Certain Investments in the United States by Foreign Persons and 31 CFR Part 802 - Provisions Pertaining to Certain Transactions in the United States by Foreign Persons Involving Real Estate. CFIUS already had the authority to review any control transaction by a foreign person in respect of U.S. businesses to determine the potential impact on the national security of the United States. Under the Part 800 Rule, CFIUS's jurisdiction has been expanded to also cover certain non-controlling investments in U.S. business that (i) are involved with “critical technologies”; (ii) own, operate, manufacture or supply or provide services to “critical infrastructures” or (iii) collect or maintain “sensitive personal data”, in each case, if such investments afford foreign persons certain rights (as described below). Under the Part 802 Rule, CFIUS will also have the jurisdiction to review certain “covered real estate” transactions if the relevant real estate is in close proximity to U.S. military installations or sensitive U.S. government facilities, or within or part of an airport or a maritime port.

On the one hand, the proposed rules greatly expand CFIUS's jurisdiction to review a wide range of foreign investments in U.S. businesses and real estate. On the other hand, the proposed rules appear to show some restraint on the part of CFIUS by limiting the instances where mandatory CFIUS filings are required.

### **The Pilot Program (including mandatory filings) remain in place**

The proposed rules do not alter the interim “Pilot Program” rules (31 CFR Part 801) issued on October 11, 2018. Until further notice, or until the Pilot Program expires in February 2020 if not extended, investments subject to the Pilot Program will continue to be subject to potential mandatory CFIUS filings.

Under the Pilot Program, a mandatory filing regime was created for certain foreign investments in U.S. businesses that produce, design, test, manufacture, fabricate, or develop certain “critical technologies” if such transaction: (i) could result in a foreign person controlling such business; (ii) affords a foreign person with access to “material non-public technical information” regarding such business (information necessary to design, fabricate, develop, test, produce or manufacture critical technologies); (iii) affords a foreign person with membership or observer rights on the board of such business; or (iv) affords a foreign person the right to involvement in the

substantive decision-making of such business with respect to the relevant critical technology. Critical technologies generally includes: (a) defense services and articles controlled by the International Traffic in Arms Regulations; (b) items controlled by the Export Administration Regulations for reasons related to national security, chemical and biological weapons proliferation, nuclear nonproliferation, missile technology, regional stability, or surreptitious listening; (c) specially designed nuclear components, parts and technology; and (d) select agents and toxins, in each case, used in or developed for any of the twenty-seven sensitive industries enumerated under the Pilot Program rule (please see our [October 31, 2018 alert](#) for the complete list of industries), and also include certain “emerging and foundation technologies” controlled under the Export Control Reform Act. The rules defining “emerging and foundational technologies” are expected by year end, and are likely to include categories such as biotechnology, artificial intelligence, additive manufacturing (including 3-D printing), navigation and timing (including self-driving car technology), microprocessor technology, robotics and quantum computing. When the final list of “emerging and foundation technologies” is released, it will be immediately relevant, as they will automatically be incorporated into the definition of critical technologies.

Under the Pilot Program, indirect participation in such investments by a foreign person as a limited partner of a private investment fund generally does not trigger a mandatory CFIUS filing if: (i) the fund is exclusively managed by a general partner (or equivalent) that is not the foreign person; (ii) neither the foreign person nor the advisory board of the fund has certain control rights with respect to the fund, including, the ability to control investment decisions or participate in the substantive decision making of the fund regarding companies in which the fund is invested, or the ability to unilaterally select or remove the general partner (or equivalent); and (iii) the foreign person does not have access to “material non-public technical information” regarding the applicable company.

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), or the involvement of investment professionals who are not U.S. nationals in the investment activities of an investment fund could cause a mandatory CFIUS filing, remains a fact-specific analysis.

On Pilot Program enforcement, there have been no signs that CFIUS has imposed penalties for failure to comply with the mandatory filing requirement rules. CFIUS issued a set of FAQ’s in July 2019 clarifying that where a foreign person is making both an indirect investment in a pilot program U.S. business through an investment fund, as well as a direct investment in the pilot program U.S. business, CFIUS will consider the totality of the particular facts and circumstances of the transaction in determining whether a transaction is subject to its jurisdiction. This has been an important issue and question for many investors, as it is a model not infrequently seen, and one where additional clarification is necessary and welcome. While the issuance does not provide significant clarity on how to address the scenario, it does accept the premise that there may be cases where the dual-track investment does not necessarily trigger a Pilot Program filing requirement.

## **The proposed rules maintain CFIUS's jurisdiction to review control investments**

The proposed regulations maintain CFIUS's broad jurisdiction to review for national security reasons any investment in any U.S. business (referred to as, "covered control transactions" in the proposed rules) where a foreign person obtains "control" of the U.S. business. The term control is broadly defined (generally, the power to determine, direct or decide important matters of the business) and could be triggered even where the foreign investor holds a small minority stake in the business (if for example, the investor retains the right to dismiss senior executives, terminate significant contracts or select new business lines).

## **The proposed rules expand CFIUS's jurisdiction to review non-control investments in TID U.S. Businesses**

CFIUS's jurisdiction has been expanded to cover certain non-controlling equity investments in U.S. businesses that (i) are involved with "critical technologies"; (ii) own operate, manufacture or supply or provide services to "critical infrastructures" that are so vital to the United States that the incapacity or destruction of such systems or assets would have debilitating impact on national security or (iii) collect or maintain "sensitive personal data" that may be exploited in a manner that threatens to harm national security (a "TID U.S. Business"). Any such direct or indirect foreign investment in a TID U.S. Business (referred to as a "covered investment" in the proposed rules) is subject to CFIUS's jurisdiction, if such investment affords a foreign person:

- (i) access to "material non-public technical information";
- (ii) membership or observer rights on the board of such business; or
- (iii) rights to involvement, other than through voting shares, in the "substantive decision-making"<sup>2</sup> of such business.

### *Critical Technologies.*

The criteria for determining a "critical technology" U.S. business is unchanged from the Pilot Program, except that for purposes of potentially being a TID U.S. Business, there is no requirement that relevant business uses the "critical technology" in one of the enumerated twenty-seven sensitive pilot program industries.

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<sup>2</sup> "[S]ubstantive decision-making" under the proposed rules is defined as the process through which decisions regarding significant matters affecting an entity are undertaken. The proposed rules provide a non-exhaustive list of the types of significant matters that are covered: (1) involvement in decisions related to pricing, sales and contracts; (2) corporate strategy and business development; (3) research and development; (4) manufacturing locations; (5) access to critical technologies, material non-public technical information or sensitive personal data; (6) physical and cybersecurity protocols; (7) establishment or maintenance of architecture of information technology used in collection or maintaining sensitive personal data; (8) practices and policies regarding collection use or storage of sensitive personal data; and (9) strategic partnerships. The rules clarify that strictly administrative decisions do not constitute substantive decision-making.

### *Critical Infrastructure.*

A “critical infrastructure” investment is generally an investment in a U.S. business that owns, operates, manufactures or supplies or provides services (referred to as “functions related to critical infrastructure” in the proposed rules) to critical infrastructures, including, certain defense industrial base sectors, telecommunications, energy, transportation, financial services and public water and waste systems. The proposed rules provide an appendix (reproduced at the end of this Alert) that sets forth the combinations of the twenty-eight categories of “critical infrastructures” and “functions related to critical infrastructure” that potentially constitute a TID U.S. Businesses.

### *Sensitive Personal Data.*

A “sensitive personal data” investment is generally an investment in a U.S. businesses that maintains or collects “identifiable data” (generally, data that can be used to identify a person of a type falling within one of the ten categories set forth below) of more than one million people, or tailors its product to U.S. executive branch or military personnel. The applicable “identifiable data” categories generally include: (i) data that could be used to determine a person’s financial distress; (ii) data contained in a consumer report (unless limited data is obtained from a consumer reporting agency for purposes described in the Fair Credit Reporting Act); (iii) data contained in insurance applications; (iv) data that relates to a person’s physical, mental or psychological well-being (i.e. health information); (v) non-public electronic communications, including email messaging, or chat communications between or among users of a U.S. business’ products or services (if the U.S. business is providing communications platforms used by third parties); (vi) geolocation data; (vii) biometric enrollment data (e.g., facial, voice, retina and fingerprints); (viii) data stored and processed for generating state and federal identification cards; (ix) data concerning U.S. government personnel security clearance and (x) data in an application for U.S. government security clearance. Genetic information constitutes “sensitive personal data”, regardless of the amount of data collected or maintained, who the business targets or if it falls within one of the ten categories set forth above. The proposed regulations expressly exclude information that an employer may maintain with respect to its own employees.

### **Investment fund exception for “covered investments” in TID U.S. Businesses**

Similar to the Pilot Program, the proposed rules contain an exception for indirect “covered investments” of foreign persons in a TID U.S. Businesses through a private investment fund. The criteria for determining if this exception applies are the same criteria utilized by the Pilot Program investment fund exception (described above).

### **New mandatory filings only applies to a narrow category of transactions**

Under the proposed rules, a mandatory CFIUS filing is only required if a foreign person acquires a 25 percent or more of the voting interests in a TID U.S. Business and, in turn, a foreign government holds owns 49 percent or more of the voting interests in that foreign person (referred to as “substantial interest” in such TID U.S. Business in the proposed rules). As discussed above, the mandatory filing requirements of the Pilot Program relating to “critical technology” U.S. businesses remain in effect. Outside of these transactions, under the proposed rules, CFIUS filings would remain voluntary.

## **The proposed rules explain how FIRRMA applies to real estate**

Certain transactions involving real estate where the transaction could result in a foreign person controlling a U.S. business have always been subject to CFIUS's jurisdiction. Recognizing that real estate transactions implicate different concerns and different review procedures than M&A transactions, CFIUS opted to conduct a separate rule-making solely for real estate transactions that do not necessarily involve the acquisition of an operating business. Under the proposed rules, CFIUS will have jurisdiction over the purchase or lease by, or concession to, a foreign person of "covered real estate" if the foreign person obtains three or more of the following property rights: (i) the right to physical access; (ii) the right to exclude others; (iii) the right to improve or develop the property or (iv) the right to attach fixed or immovable objects. Covered real estate generally includes real estate that is physically within or functionally a part of an airport or a maritime port, or close to U.S. military installations and other sensitive government facilities. CFIUS appears to be concerned with, among other things, the ability of foreign persons to collect intelligence and the risk of exposing sensitive activities. For certain military facilities, real estate within a 100-mile radius will come under the new rule. The proposed rules provide for certain exceptions related to single housing units, retail trade and food services, commercial office space, the extension of a mortgage or similar financing for a foreign person to acquire "covered real estate" and real estate within urban areas of urbanized clusters. Though real estate acquisitions will not require mandatory filings, parties should be aware that gaining access or other property rights may trigger CFIUS jurisdiction and interest, depending on the facility and the nature and nationality of the buyer.

## **The "White List"**

The proposed rules will also introduce a list of "excepted foreign states" whose investors may be exempt from CFIUS's expanded non-control TID U.S. Business and real estate transaction jurisdiction. At least two-thirds of the voting members of CFIUS must agree to add a foreign state to this list. In general, countries on the list must maintain a robust process to analyze foreign investments for national security risks and facilitate coordination with the United States on matters relating to investment security. Given these requirements the list is expected to be quite narrow. In a stakeholder's meeting on September 27, 2019, Thomas Feddo, the newly appointed Assistant Secretary for Investment Security, said the list of "excepted foreign states" should be available by early 2020, and that the exemption would be available immediately – giving the designated countries a two-year grace period to implement satisfactory foreign investment review programs.

In order for a specific investor (referred to as an "excepted investor" in the proposed rules) to qualify for the exception, such investor generally would need to be (i) a foreign national of such foreign state; (ii) a foreign government of such foreign state or (iii) a foreign entity that is organized and has its principal place of business in the United States or such foreign state, all members of its board of directors (or similar body) must be citizens of the United States or such foreign state and all investors with equity interests of 5% or more in such entity must be citizens of the United States or such foreign state. If the above criteria cease to be true within three years from the completion date of the transaction, CFIUS may assert its jurisdiction over the previously exempted transaction. Under the proposed rules, a similar "excepted real estate

investor” exemption has been proposed with respect to real estate transactions, though Treasury has said that the list of excepted foreign states for real estate transactions may not be identical to the list of excepted foreign states for TID transactions.

## Enforcement

Notable developments with respect to transaction reviews and enforcement include the unwinding of the ownership of gay dating site Grindr by Chinese gaming company, Beijing Kunlun Tech; the unwinding of China’s iCarbonX acquisition of PatientsLikeMe; and the Pamplona forced divestiture of a minority stake in cybersecurity firm Cofense – acquired in 2018 by BlackRock and Pamplona. These represent transactions and investments that were not required to be reviewed by CFIUS, but where the committee nevertheless affirmatively took action. In the Grindr and PatientsLikeMe matters, the committee was concerned about the personal data of U.S. citizens – a potential harbinger of additional pilot programs to come by year end requiring mandatory notification for transactions involving such information.

Cybersecurity firm Cofense was acquired in 2018 by investment firms BlackRock and Pamplona, with Pamplona holding a minority stake. CFIUS contacted Pamplona, which is partly backed by a Russian billionaire on Treasury Dept.’s “oligarchs’ list”, shortly after the transaction and began investigating. Pamplona has agreed to divest its interest in Cofense. The committee also imposed its first ever fine (\$1 million) on unnamed parties for breaches of a 2016 mitigation agreement and “failure to establish requisite security policies and failure to provide adequate reports to CFIUS” according to the notice, demonstrating its active commitment to enforcement

## Conclusion

The proposed rules greatly expand CFIUS’s jurisdiction to review a wide-range of transactions involving foreign investment in U.S technology, infrastructure and data businesses, and the purchase or lease by, or a concession to, a foreign person of sensitive U.S. real estate. However, as discussed above, other than with respect certain foreign government investing in TID U.S. Businesses (and the Pilot Program mandatory filings remaining in effect), the proposed rules have not expanded the types of transactions requiring a mandatory CFIUS filing, and thus CFIUS filings are expected to largely remain voluntary. We will provide updates on any developments as the proposed rules proceed through the rule-making process and into their final forms. In the meantime, we expect CFIUS to continue to monitor and examine a wide range of foreign investment in U.S. businesses where national security concerns could be implicated.

Outside the U.S, other jurisdictions are adopting or otherwise enhancing their own CFIUS-like regimes to review foreign direct investment (“FDI”) in businesses deemed to involve sensitive or critical industries, technology, or infrastructure. For example, in November 2018, the EU Parliament established Regulation 2017/0224, which was adopted by the European Council on March 5, 2019. Rather than providing for an FDI review mechanism *per se*, instead the Regulation sets out the basic procedural requirements that EU Member States with an FDI system will need to follow with respect to transparency, timeframes, protection of confidential information, and judicial redress. In accordance with the Regulation, the European Commission will be able to issue an opinion to the applicable Member State(s) on FDI likely to affect or otherwise impact projects of wider-EU interests. However, it will be for the Member State(s) to

decide whether to approve the FDI. In addition to EU Member States, the United Kingdom published a white paper reviewing FDI proposals in response to the Chinese investment in the Hinkley Point nuclear project. While the UK does not have a specific FDI regime, it is likely that, post-Brexit, any such regime will be implemented by the UK Government to review closely FDI in sectors posing national security risks such as advance technologies and national infrastructure projects.

Beyond Europe, other jurisdictions have launched or are in the process of launching their own FDI regimes. While the regimes vary widely, especially in the Middle East and Asia-Pacific regions, countries such as Australia, Japan, China and Israel have their own specific regimes for FDI in relevant sectors. The wider global trend is towards a more restrictive or protectionist review platform and may create new regulatory hurdles for cross-border transactions.

## Anti-Money Laundering and Sanctions Enforcement

### Important New Guidance from the Office of Foreign Assets Control

In May 2019, Treasury's Office of Foreign Assets Control ("OFAC") released "[A Framework for OFAC Compliance Commitments](#)," suggesting for the first time that companies have an affirmative obligation to maintain an effective sanctions compliance program.<sup>3</sup> Advisors to private funds should note this development, as all U.S. persons are required to comply with OFAC sanctions.

While failing to implement a sanctions compliance program is not itself a violation of OFAC's regulations, maintaining a sanctions compliance program has always been a mitigating factor in the assessment of monetary penalties in OFAC enforcement actions. But Treasury's recent pronouncement represents a policy shift. It marks the first time that OFAC has provided explicit guidance on what it considers to be the essential components of a sanctions compliance program, signaling that firms must now comply with OFAC's expectations by taking affirmative steps to understand and effectively address their sanctions risks. A compliance program that falls short of the basic requirements outlined in OFAC's recent guidance may be viewed as a separate aggravating factor leading to increased monetary penalties in the event of a violation.

It is clear from the guidance that OFAC expects to see firms maintain more than just a check-the-box program. The guidance acknowledges that a firm's risk-based compliance program will depend on several factors, including the size and sophistication of firm, the products and services it offers, the nature of its customers and counterparties, and the geographic locations in which the firm operates. At the same time, OFAC identifies five essential components that every compliance program should incorporate: (1) support from senior management; (2) periodic risk assessments; (3) internal controls, including policies and procedures designed to identify, interdict, escalate, report, and maintain records related to activity that is prohibited by OFAC-administered sanctions programs; (4) periodic testing and auditing; and (5) periodic training for

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<sup>3</sup> For an in-depth discussion of OFAC's new compliance guidelines, see [Navigating the Complex Relationship Between Voluntary Self-Disclosure and Enforcement](#) by Seetha Ramachandran and Lucas Kowalczyk, in the International Comparative Legal Guide to Sanctions (2019).

all appropriate employees. In evaluating these criteria, OFAC appears focused on practical indicia that firms are committed to sanctions compliance, including how resources are allocated and the quality and experience of relevant personnel. Recent enforcement actions in the months following the guidance underscore OFAC's new emphasis on the importance of compliance programs.

In light of the new OFAC guidance, advisors to private funds should take a hard look at their current sanctions compliance programs. This is particularly important as funds continue to raise money offshore and pursue yield through foreign investments, and as the U.S. sanctions regime becomes more complex. In the last year alone, we have seen changes to the sanctions against Russia, Venezuela, and Iran, which have had a significant impact on private funds.

### **Cayman Anti-Money Laundering Developments**

Advisors to Cayman-based funds should confirm that they are in compliance with new Cayman [AML regulations](#) that went into effect last year. The new regulations altered the regulatory environment for Cayman-based funds, including those that are unregistered. One of the major changes in the Cayman AML regulations is a new requirement that Cayman funds designate natural persons employed at a managerial level to serve as AML officers. Specifically, Cayman funds are now required to designate an AML Compliance Officer, a Money Laundering Reporting Officer, and a Deputy Money Laundering Reporting Officer. The new Cayman AML regulations also significantly expand the kinds of AML procedures that funds are expected to maintain. The deadline for Cayman-based funds to comply with the new requirements was December 31, 2018.

### **SEC Examinations for Funds with an Affiliated Broker-Dealer**

AML issues should also be top of mind for funds that have an affiliated broker-dealer. In December 2018, OCIE announced its [2019 examination priorities](#). According to OCIE, it intends to “continue to prioritize examining broker-dealers for compliance with their AML obligations.” In particular, OCIE intends to focus on whether broker-dealers are filing suspicious activity reports with Treasury's Financial Crimes Enforcement Network, as appropriate, and whether they have implemented all elements of their AML programs. During examinations, OCIE also intends to focus on whether broker-dealers have conducted independent tests of their AML program on a timely basis. According to OCIE, “[t]he goal of these examinations is to ensure that broker-dealers have policies and procedures in place that are reasonably designed to identify suspicious activity and illegal money laundering activities.” In a recent decision, *SEC v. Alpine Securities Corp.*, the Southern District of New York suggested that the SEC's books-and-records authority under Exchange Act rule 17a-8, allows the SEC to bring enforcement actions based on the reporting of potentially suspicious transactions under the Bank Secrecy Act, expanding the SEC's jurisdiction over AML cases.

## Cybersecurity and Privacy Law

### OCIE Releases Risk Alert for Investment Advisers and Broker-Dealers, Under Regulation S-P

On April 16, 2019, OCIE issued a Risk Alert providing guidance to investment advisers and brokers and dealers (“registrants”) relating to Regulation S-P, the key SEC rule regarding privacy notices and safeguarding policies of registrants. This Risk Alert further examines issues raised in the SEC-published reference guide, [Questions Advisors Should Ask While Establishing or Reviewing Their Compliance Programs](#), as well as prior OCIE-published Risk Alerts. The most recent Risk Alert highlights common shortcomings and weak spots in registrants’ privacy policies and procedures.

Regulation S-P requires that all registrants adopt written policies and procedures that are reasonably designed to (a) ensure the security and confidentiality of consumer records and information; (b) protect against any anticipated threats or hazards to the security or integrity of customer records and information, and (c) protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer.

OCIE found that registrants either did not have written policies and procedures that complied with this rule, or that the policies in place merely reiterated the text of the rule without creating administrative, technical, or physical procedures to actually implement the rule. The primary deficiencies OCIE noted were:

- Personal devices used to store and maintain customer information despite a lack of clear policies and procedures on how the devices should be configured to protect this information;
- Electronic communications of personally identifiable information, for example a lack of policies and procedures designed to prevent employees from sending unencrypted emails containing the information;
- Unsecure networks, as policies and procedures did not prevent employees from sending personally identifiable information to unsecured networks;
- Outside vendors not required to comply with registrants’ formal policies and procedures despite access to personally identifiable information;
- Unmaintained inventories of personally identifiable information, leaving registrants potentially unaware and unable to safeguard the categories of information maintained;
- Unsecure physical locations where customer personally identifiable information was stored;
- Customer login credentials being shared with more employees than allowed under relevant policies and procedures; and

- Departed employees retaining access rights to restricted customer information post departure.

Regulation S-P also mandates that registrants provide clear and conspicuous notice to customers of their privacy policies and practices both during the initial establishment of the customer relationship, and on an ongoing basis for the duration of the relationship. This notice must detail the customer's right to opt out of certain disclosures of nonpublic personal information about the customer to third parties unaffiliated with the registrant.

OCIE observed that registrants frequently failed to provide these notices to customers, and when they did, the notices did not necessarily reflect the firms' policies and procedures, nor did they include the opt out right.

Investment advisors registered with the SEC, and broker-dealers should review their written policies and procedures to ensure compliance in both form and practice.

### **The SHIELD Act**

On July 25, 2019, New York Governor Andrew Cuomo signed into law the Stop Hacks and Improve Electronic Data Security Act (the "SHIELD Act" or the "Act"). The Act amends New York State's current data breach notification law, covering breaches of certain personally identifiable computerized data ("Private Information"). The Act also imposes substantive data security requirements on business that own or lease the private information of New York residents, regardless of whether the businesses otherwise conduct business in New York. Both portions of the Act include potential civil penalties for noncompliance. The SHIELD Act's breach notification provisions took effect on October 23, 2019, while the Act's new data security requirements will take effect on March 21, 2020.

Generally, the SHIELD Act expands the definition of Private Information that, if breached, could trigger a notification requirement. In particular, under the Act, identifiers now also include biometric information (such as fingerprint, voice print, retina or iris image, or other unique physical representation or digital representation of biometric data used to authenticate or ascertain the individual's identity), and a user name or e-mail address, in combination with a password or security question and answer, that would permit access to an online account. N.Y. Gen. Bus. Law § 899-aa(1)(b).

The SHIELD Act expands the definition of "breach of the security system" to include any unauthorized access to Private Information, such as viewing, but not obtaining copies of, the Private Information. *Id.* § 899-aa(1)(c). Previously, the State's data security law only considered the unauthorized acquisition of personal information to be a breach.

The SHIELD Act also expands jurisdiction to encompass any person or business that owns or licenses computerized data which includes Private Information, regardless of whether the person or business otherwise conducts business in New York, as long as the affected individual is a resident of New York. *Id.* § 899-aa(2).

However, the SHIELD Act also adds an important new exception to breach notification, based on a "harm to the individual" standard. Under the new rule, a business may be exempt from the

breach notification requirements, if “exposure of Private Information was an inadvertent disclosure and the individual or business reasonably determines such exposure will not likely result in misuse of such information, or financial harm to the affected persons or emotional harm in the case of unknown disclosure of online credentials.” *Id.* § 899-aa(2)(a). Certain documentation requirements apply.

The SHIELD Act substantially expands the current law and requires any person or business that is not subject to (and, notably, in compliance with) certain other data security laws, and which owns or licenses computerized Private Information of a resident of New York, “to develop, implement and maintain reasonable safeguards to protect the security, confidentiality and integrity of the Private Information including, but not limited to, disposal of data.” N.Y. Gen. Bus. Law § 899-bb(2). The new law provides, among other things, that a person or business shall be deemed to meet this standard if it implements a data security program that includes:

- Reasonable administrative safeguards, such as the following: (a) the designation of one or more employees to coordinate the security program; (b) identification of reasonably foreseeable internal and external risks; (c) assessment of the sufficiency of safeguards in place to control identified risks; (d) training and managing employees in the security program practices and procedures; (e) the selection of service providers capable of maintaining appropriate safeguards, and requiring those safeguards by contract; and (f) adjusting the security program in light of business changes or new circumstances. *Id.* § 899-bb(2)(b)(ii)(A).
- Reasonable technical safeguards, such as where the business: (a) assesses risks in network and software design; (b) assesses risks in information processing, transmission and storage; (c) detects, prevents and responds to attacks or system failures; and (d) regularly tests and monitors the effectiveness of key controls, systems and procedures. *Id.* § 899-bb(2)(b)(ii)(B).
- Reasonable physical safeguards, such as where the business: (a) assesses risks of information storage and disposal; (b) detects, prevents and responds to intrusions; (c) protects against unauthorized access to or use of Private Information during or after the collection, transportation and destruction of disposal of the information; and (d) disposes of Private Information within a reasonable amount of time after it is no longer needed for business purposes by erasing electronic media so that the information cannot be read or reconstructed. *Id.* § 899-bb(2)(b)(ii)(C).

The SHIELD Act toughens the potential civil penalties for breach of notification law violations, increasing them to up to twenty dollars per instance of failed notification (capped at \$250,000), and imposes new civil penalties (up to \$5,000 per violation, with no cap) for certain failures to comply with the new data security standards.

More specifically, the SHIELD Act does not authorize a private right of action, but does authorize the Attorney General to bring an action and obtain civil penalties. N.Y. Gen. Bus. Law § 899-aa(6)(a); N.Y. Gen. Bus. Law § 899-bb(2)(d)-(e). For knowing and reckless violations of the data breach notification requirements, a court may impose penalties of the greater of \$5,000 or up to \$20 per instance of failed notification, with a cap of \$250,000. N.Y. Gen. Bus.

Law § 899-aa(6)(a). For violations of the new data security standards, a court, looking to New York’s consumer fraud statute, may impose penalties of up to \$5,000 “per violation.” This penalty provision does not include an upper limit, and it is also unclear what would count as a single violation under the law. N.Y. Gen. Bus. Law. §§ 899-bb(2)(d) and 350-d.

## **The California Consumer Privacy Act**

The California Consumer Privacy Act of 2018 (the “CCPA”) was signed into law on June 28, 2018, and will go into effect beginning January 1, 2020. The Act seeks to give California consumers the right to learn about and control certain aspects of how a business handles consumers’ personal information, by requiring businesses to implement measures designed to enable consumers to exercise this right.

The following sets out the general provisions of the CCPA, as well as a high-level overview of several amendments to the CCPA that seek to clarify the law’s scope and requirements in advance of its January 1, 2020 effective date.

### **Background**

The CCPA gives “consumers” (defined as natural persons who are California residents) four basic rights with respect to their personal information:

- The right to know, through a general privacy policy and with more specifics available upon request, what personal information a business has collected about them, where it was sourced from, what it is being used for, whether it is being disclosed or sold, and to whom it is being disclosed or sold;
- The right to “opt-out” of allowing a business to sell their personal information to third parties;
- The right to have businesses delete their personal information, with some exceptions; and
- The right to receive equal service and pricing from a business, even if they exercise their privacy rights under the CCPA.

The CCPA’s provisions are designed to implement these rights. For example, the CCPA requires companies to make certain disclosures to consumers via their privacy policies, or otherwise at the time the personal data is collected. Businesses must proactively disclose the existence and nature of consumers’ rights under the CCPA, the categories of personal information they collect, the purpose for which that personal information is collected, and the categories of personal information that it sold or disclosed in the preceding 12 months. In terms of compliance, these provisions will require companies to determine what personal data they are collecting from individuals and for what purposes, and to update their privacy policies every 12 months to make the disclosures the CCPA requires.

Companies that sell consumer data to third parties will need to disclose that practice and give consumers the ability to opt out of the sale by supplying a link titled “Do Not Sell My Personal Information” on the business’s home page. This is known as the right to “opt out.”

Consumers also have the right to request certain information from businesses, including, for example, the sources from which a business collected the consumer's personal information, the specific pieces of personal information it collected about the consumer, and the third parties with which it shared that information. The CCPA requires businesses to provide at least two means for consumers to submit requests for disclosure including, at minimum, a toll-free telephone number and website. Additionally, businesses will have to disclose the requested information free of charge within 45 days of the receipt of a consumer's request, subject to possible extensions of the time frame. Companies therefore will need to determine how they can monitor their data sharing practices and marshal the requested information within a short period of time pursuant to a data subject's request.

The CCPA also forbids business from discriminating against consumers for exercising their privacy rights under the CCPA.

### **What qualifies as “personal information” under the CCPA?**

For purposes of the CCPA, “personal information” is defined as “information that identifies, relates to, describes, is capable of being associated with, or could reasonably be linked, directly or indirectly, with a particular consumer or household.” The CCPA provides a non-exhaustive list of examples that includes some expansive examples. For example, personal information includes “commercial information” (including “records of personal property, products or services purchased, obtained, or considered, or other purchasing or consuming histories or tendencies”), and “internet or other electronic, visual, thermal, olfactory, or similar information.” Personal information does not include information that lawfully is made available from federal, state, or local government records that is used for a purpose that is used for a purpose that is compatible with the purpose for which such data is so maintained.

While various California laws define “personal information” in different ways, they generally recognize that “personal information” is information that can be used to identify a particular individual. The CCPA's definition is worded more broadly, and includes information that is identifiable to a household, not necessarily a consumer. Additionally, the CCPA defines personal information quite broadly. For example, the definition of personal information includes unique personal identifiers, which is defined broadly to include device identifiers, other online tracking technologies and “probabilistic identifiers” (identifiers based on personal information that “more probably than not” identify a consumer or device). On the other hand, the CCPA does not apply to de-identified personal data, as long as the de-identification measures meet the CCPA's very strict standards. Companies developing their compliance strategy should give careful consideration to the types of personal information they collect, and cast a wide net in terms of thinking about data that may fall within the CCPA's definition.

### **Who has to comply with the CCPA?**

The CCPA will apply to for-profit businesses that collect and control California residents' personal information, do business in the State of California, and: (a) have annual gross revenues in excess of \$25 million; or (b) receive or disclose the personal information of 50,000 or more California residents, households or devices on an annual basis; or (c) derive 50 percent or more

of their annual revenues from selling California residents' personal information. The CCPA also draws in corporate affiliates of such businesses that share their branding.

Companies may be exempted from the CCPA “if every aspect of . . . commercial conduct takes place wholly outside of California,” meaning that: (1) the business collected the information from the consumer in question while he or she was outside California; (2) no part of any sale of his or her personal information occurred in California, and (3) no personal information collected while the consumer was in California is sold. Realistically though, many companies will remain subject to CCPA Act by virtue of having “consumers” (California residents) among their customers, as described below.

### **Who is protected by the CCPA?**

The CCPA requires that the protections listed above be made available to “consumers,” who are defined as California residents for tax purposes. However, California’s large population and economic presence means that many (if not most) companies serve California consumers – even if those companies have no physical presence in the State. Additionally, few companies are likely to cabin all of the CCPA’s requirements to California residents, as it is difficult to offer a different website experience to residents of a specific state. Realistically, this makes it likely that companies with California-based customers—which is most U.S. companies that have an online presence—will need to comply with the CCPA, and will need to update their privacy policies and websites in order to do so.

### **How will the CCPA be enforced?**

The CCPA can be enforced by the California Attorney General, subject to a thirty-day cure period. The civil penalty for intentional violations of the CCPA is up to \$7,500 per violation.

The CCPA also provides a private right of action that allows consumers to seek, either individually or as a class, statutory or actual damages and injunctive and other relief, if their sensitive personal information (more narrowly defined than under the rest of the CCPA) is subject to unauthorized access and exfiltration, theft or disclosure as a result of a business’s failure to implement and maintain required reasonable security procedures.

A consumer who wishes to bring an action under the CCPA will need to meet certain requirements before proceeding with a claim. A consumer seeking statutory damages must provide the defendant business with thirty days’ notice of intent to sue before filing an action. (Consumers seeking actual damages do not need to supply such notice). If the business provides the consumer with an “express written statement” demonstrating that the violation has been cured, and that no further violation will occur, within thirty days of receiving the consumer’s notice, then the consumer cannot proceed with an action for statutory damages. A consumer who files an action must provide notice to the Attorney General within 30 days after filing. The Attorney General may (1) respond by notifying the consumer that the Attorney General will prosecute the action instead; (2) respond by notifying the consumer that he or she must not proceed with the action, or (3) not respond at all within 30 days, thereby allowing the consumer to proceed with the action.

## Recent Legislative Interpretations

Since the CCPA's enactment in June 2018, California legislators have scrambled to clarify the law's scope and requirements in advance of its January 1, 2020 effective date. On September 13, 2019, the last day of the California legislative session before the CCPA goes into effect, the legislature passed five amendments that will be presented to the California Governor for signature. Below is a high level overview of key aspects of the five bills amending the CCPA that await the Governor's signature, two proposed amendments that were ordered to the inactive file without passage, and an additional bill awaiting the Governor's signature that would require data brokers to register with the Attorney General of California.

### Bills Advancing to the Governor for Signature

*Assembly Bill 25: Employment Information* – Generally exempts from the scope of the CCPA, until January 1, 2021, personal information collected by a business in certain limited employment-related contexts.

*Assembly Bill 874: Definitions – Personal Information and Publically Available Information* – Narrows the definition of “personal information” by expanding the scope of the “publicly available information” exemption

*Assembly Bill 1146: Vehicle Information* – Removed consumers' opt-out rights where personal information is shared between a new motor vehicle dealer and the vehicle's manufacturer for purposes of a vehicle repair covered by a warranty or recall.

*Assembly Bill 1355*

- Until January 1, 2021, exempts from many CCPA's requirements personal information collected as part of certain business-to-business transactions or communications.
- Narrows the scope of “personal information” that is subject to CCPA requirements by excluding de-identified or aggregate consumer information.
- Allows business to authenticate consumers based on what is reasonable in light of the nature of the personal information requested and allows businesses to require consumers to submit access requests through existing accounts.
- Makes certain clarifying amendments, such as clarifying that businesses do not need to collect personal information for compliance purposes if they do not normally do so.
- Corrects certain drafting errors.

*Assembly Bill 1564: Methods for Consumers to Submit Requests for Disclosures*

- Creates an exception for certain online-only businesses to the general rule that businesses must offer at least two methods for consumers to submit requests for CCPA disclosures.

- Such online-only businesses need only provide consumers with an email address for submitting requests for CCPA disclosures.

## **Bills Ordered to the Inactive File**

### *Assembly Bill 846: Loyalty Programs*

This bill would have specified that the CCPA should not be construed as prohibiting businesses from offering customer loyalty programs, provided that they are not “unjust, unreasonably, coercive, or usurious in nature.” This bill was ordered to the inactive file, although it is possible that this bill will return in the next legislative session. The inactive file is a holding area for bills that are ready for floor consideration, and bills from the inactive file may be sent to the floor for consideration at a later time.

### *Assembly Bill 1281: Facial Recognition Technology Disclosure*

Businesses that use facial recognition technology do not need to disclose their usage on posted signs, for now. On September 10, 2019, this bill, which would have required businesses to post such signs, was ordered to the inactive file.

## **Data Broker Registration Bill**

On a related note, the California legislature also passed a bill governing data brokers. Assembly Bill 1202 requires data brokers to register with the Attorney General of California. Data brokers are defined in the bill as businesses that knowingly collect and sell to third parties the personal information of a consumer with which it does not have a direct relationship. This bill would incorporate the broad definition of “sale” from the CCPA, broadening the scope of the law, if enacted.

## **U.S. Tax**

The U.S. Internal Revenue Service (the “IRS”) and the U.S. Department of Treasury (the “Treasury”) have continued working to implement and provide guidance in connection with the major tax reform legislation enacted in December of 2017. The following summary covers the most recent updates to select provisions affecting advisers and the private funds industry, as well as recent tax policy proposals.

### *Selected Provisions*

#### **Limitation on Business Interest Deductions**

As currently in effect, section 163(j) of the Internal Revenue Code of 1986, as amended (the “Code”) limits the deductibility of business interest to 30% of adjusted taxable income (“ATI”), 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.

On November 26, 2018, the IRS and the Treasury issued [proposed regulations](#) (the “Proposed 163(j) Regulations”) under section 163(j). The Proposed 163(j) Regulations provide additional guidance on the statute, including guidance on: (i) the application of the provision to partnerships and S corporations, (ii) the definition of “interest”, (iii) the statutory definition of ATI, and (iv) ordering rules and guidance on the interaction between section 163(j) and other provisions.

Notably, partnerships or S corporations that are “traders” or otherwise are engaged in a trade or business in which some partners or shareholders do not materially participate (e.g., limited partners of a trader hedge fund) will be subject to section 163(j). To the extent that the business interest expense of such a partnership or S corporation is not subject to the section 163(j) limitation, it will still be limited by section 163(d) at the owner level. With respect to partnerships, to the extent that the business interest expense is subject to the section 163(j) limitation and becomes a carryover item of the limited partners, the interest expense will be treated as investment interest expense subject to section 163(d) in the hands of the limited partners.

This result will create an incentive for general partners and individual investors in trading funds that utilize leverage to either (i) hold their interests in those funds through a controlled foreign corporation (“CFC”) and make a section 962 election with respect to the CFC (which election is only available to a U.S. Shareholder (as defined below) that is an individual) , or (ii) invest in those funds through a foreign feeder that is treated as a passive foreign investment company (“PFIC”) and make a “qualifying electing fund” (“QEF”) election to report their share of the PFIC’s income on an annual basis. Because the earnings and profits of a CFC and PFIC are reduced by interest expense that is disallowed under section 163(j), and because an investor in a CFC or PFIC reports only its share of the CFC’s or PFIC’s earnings and profits, investing through a CFC or PFIC will effectively preserve the investor’s interest expense deduction.

For a further discussion of the Proposed 163(j) Regulations, please see our [December 5, 2018 blog post](#).

### **Changes to the Determination of Controlled Foreign Corporation Status**

Under the current rules, 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 tax reform, 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 30 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 tested every day of the year.

Prior to tax reform, section 958(b)(4) of the 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.

On October 1, 2019, the IRS and the Treasury released a revenue procedure, [Rev. Proc. 2019-40](#) (the “Rev. Proc.”), and [proposed regulations](#) relating to the repeal of the inbound attribution limitation.

The proposed regulations “turn off” certain special rules that arise solely as a result of the repeal of the inbound attribution limitation. However, the proposed regulations do not (i) prevent foreign corporations from being treated as CFCs as a result of the repeal of section 958(b)(4), (ii) limit the subpart F or GILTI income required to be reported as a result of the repeal of section 958(b)(4), and (iii) reinstate the portfolio interest exemption for foreign corporations affected by the repeal of section 958(b)(4).

The Rev. Proc. provides certain safe harbors for a U.S. Shareholder of a “foreign-controlled CFC”, which is a foreign corporation that would not be a CFC if the determination were made without applying the downward attribution rule so as to consider a U.S. person as owning stock which is owned by a foreign person (i.e., the foreign corporation would not be a CFC but for the repeal of the attribution limitation). The Rev. Proc. also provides safe harbors for certain persons to use alternative information to determine their taxable income with respect to foreign corporations that are CFCs solely as a result of the repeal of section 958(b)(4) if they are unable to obtain information to report these amounts with greater accuracy.

Under the Rev. Proc., the IRS will accept a U.S. person’s determination that a foreign corporation does not meet the section 957 ownership requirements and, therefore, that the foreign corporation is not a CFC with respect to the U.S. person if the U.S. person does not have actual knowledge, statements received, and/or reliable publicly available information sufficient for the U.S. person to determine that the section 957 ownership requirements are met. For this purpose, actual knowledge, statements received, and/or reliable publicly available information as of a given date shall be treated as true for all subsequent dates, unless subsequent information rebuts the original information. If the U.S. person directly owns stock of, or an interest in, a foreign entity (“top-tier entity”), to apply the safe harbor, the U.S. person must inquire of the top-tier entity whether it meets the section 957 ownership requirements, whether, how, and to what extent such top-tier entity directly or indirectly owns stock of one or more foreign corporations, and whether, how, and to what extent such top-tier entity owns directly or indirectly stock of, or an interest in, one or more domestic entities.

### **Global Intangible Low-Taxed Income (“GILTI”) and Subpart F Final and Proposed Regulations**

Introduced as part of tax reform, 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.

### *Regulations Concerning Domestic Partnerships*

On June 14, 2019, the IRS and the Treasury issued [final regulations](#) concerning GILTI (the “Final GILTI Regulations”) and [proposed regulations](#) concerning the treatment of domestic partnerships for purposes of determining the subpart F income of a partner (the “Proposed Subpart F Regulations”).

Departing from the approach taken by proposed GILTI regulations, under the Final GILTI Regulations, the provisions of the statute concerning domestic partnerships are interpreted to adopt an aggregate approach for purposes of determining the amount of GILTI income included in the partners’ gross income. That is, a domestic partnership will not be treated as owning stock of a CFC for purposes of determining income inclusions under the GILTI Rules. Instead, stock ownership will be determined at the partner level, and each partner will be treated as owning the stock of a CFC in proportion to such partner’s interest in the partnership. Only a partner whose ownership of a CFC reaches the 10% threshold will be required to include its pro-rata share of GILTI in its gross income.

Although domestic partnerships have generally been treated as entities under the subpart F regime, the Proposed Subpart F Regulations adopt the same approach as the Final GILTI Regulations for purposes of determining income inclusions under the subpart F rules. Under the Proposed Subpart F Regulations, for purposes of determining income inclusions under subpart F, partners in a domestic partnership would be treated as owning stock of the CFC in proportion to their respective interests in the partnership. The Proposed Subpart F Regulations provide that taxpayers may choose to apply them for tax years of a foreign corporation beginning after December 31, 2017, and for tax years of a domestic partnership in which or with which such tax years of the foreign corporation end, provided that such taxpayers and the United States persons related to them (within the meaning of section 267 or 707 of the Code) consistently apply the relevant rule with respect to all foreign corporations.

Note that the Final GILTI Regulations and Proposed Subpart F Regulations do not change the treatment of domestic partnerships as separate entities for purposes of determining whether a foreign corporation is a CFC or for other purposes of the Code, such as section 1248, which provides that gain from the sale of a CFC may be recharacterized as dividend income, which generally is taxed at ordinary income rates (unless the CFC is treated as a “qualified foreign corporation” for purposes of the qualified dividend income rules).

### **Treatment of Offshore Insurance Companies as PFICs and Other Changes to the PFIC Rules**

On July 10, 2019, the Treasury and the IRS issued [proposed regulations](#) (the “Proposed PFIC Regulations”) clarifying certain PFIC rules, including rules related to foreign insurance companies. A foreign insurance company is treated as a PFIC unless it is a qualifying foreign corporation (a “QIC”), which means a foreign corporation (i) that would be taxed as an insurance

company were it a U.S. corporation, and (ii) 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 Status," offshore insurance companies are now more likely to be classified as CFCs.

The Proposed PFIC Regulations include guidance regarding whether the income of a foreign corporation is excluded from passive income because the income is derived in the active conduct of an insurance business by a QIC and proposed rules for determining whether a foreign corporation is a QIC. Additionally, the Proposed PFIC Regulations address the treatment of income and assets of (i) certain look-through subsidiaries and look-through partnerships held by the QIC, and (ii) certain domestic insurance corporations owned by a tested foreign corporation as active for purposes of section 1297(a), except for purposes of the attribution rule and determining whether a tested foreign corporation is a PFIC.

The Proposed PFIC Regulations also provide guidance with respect to a number of other PFIC issues that are not specifically addressed in the current regulations, such as (i) the application of ownership attribution rules for purposes of determining whether the PFIC rules apply to a partner in a partnership when the partnership owns PFIC stock through a non-PFIC foreign corporation, and (ii) further clarification on certain complexities in respect of the "income test" and the "asset test". The Proposed PFIC Regulations clarify that, for purposes of determining whether a partner in a partnership is treated as owning a portion of PFIC stock owned indirectly by the partnership through a non-PFIC foreign corporation, the partner will be considered to own 50% or more in value of the stock of the non-PFIC foreign corporation through the partnership only if the partner directly or indirectly owns 50% or more of the ownership interests in the partnership. The goal of this approach is for the attribution rules to apply consistently whether a U.S. person owns stock of a non-PFIC foreign corporation through a partnership or directly.

The Proposed PFIC Regulations seek to resolve some of the complexities that arise in the determination of the ownership of a PFIC and in the application of the "income test", a test that generally classifies a foreign corporation as a PFIC if 75% or more of the foreign corporation's gross income for a year is passive, and the "asset test", a test that generally classifies a foreign corporation as a PFIC if 50% or more of the foreign corporation's for a year produce passive income, in cases in which certain look-through rules apply to such foreign corporation. The Proposed PFIC Regulations would, for purposes of the income test, treat the income from any partnership at least 25% owned by a "tested" foreign corporation as if the tested foreign corporation directly received its distributive share of any item of income of such partnership. Whether such income qualifies for the exceptions to passive income or the exceptions to foreign personal holding company would be tested at the partnership level, taking into account only the activities of the partnership. A different approach would apply to the treatment of partners when a tested foreign corporation owns, directly or indirectly, less than 25% of the value of the partnership. The tested foreign corporation's distributive share of the partnership's income would be treated as passive income.

Similarly, for purposes of the asset test, a tested foreign corporation would be treated as holding directly its proportionate share of the assets held by a 25% or more owned partnership. By contrast, a partner's interest in a 25%-owned partnership would be treated as a passive asset. Generally, a corporation's proportionate share of a partnership asset would be treated as producing passive income, or being held to produce passive income, to the extent the asset produced, or was held to produce, passive income in the partnership's hands, taking into account only the partnership's activities.

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

On December 7, 2018, the IRS issued [Notice 2018-97](#), which provides initial guidance on section 83(i). This provision permits certain employees who receive stock options or stock-settled restricted stock units as compensation for the performance of services to 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 and the corporation meets the definition of "eligible corporation."

Under the statute, the section 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 income 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 employer), (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.

Section 83(i) requires an eligible corporation to provide a notice to qualified employees who received qualified stock at the time (or a reasonable period before) the income with respect to such stock would be includible in the qualified employee's income. Notice 2018-97 provides guidance on certain aspects of the definition of an eligible corporation and establishes that the determination as to whether a corporation qualifies as an eligible corporation must be made on a calendar year basis. Additionally, Notice 2018-97 addresses the timing of employment tax withholding if a section 83(i) election is in effect. Section 83(i) does not change the timing of income inclusion for purposes of withholding Federal Insurance Contributions Act ("FICA") taxes and Federal Unemployment Tax Act ("FUTA") tax. Notice 2018-97 confirms that qualified stock under section 83(i) is considered wages for income tax withholding purposes. The stock deferred pursuant to the section 83(i) election is treated as wages at the end of the deferral period in an amount equal to the amount included in income under section 83 for the taxable year that includes such date. Federal income tax must be withheld at the highest rate under section 1 (currently 37%), without regard to an employee's Form W-4 elections. Such withholding is collected as though the income from the deferral stock is a taxable fringe benefit. In response to concerns that corporations that do not wish to offer section 83(i) arrangements to their employees may inadvertently create conditions to permit such an arrangement, Notice 2018-97 confirms

that whether to make grants of qualified stock is within the control of the corporation. Corporations may specify in stock grant documentation that the stock received will not be eligible for an election under section 83(i).

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

Enacted as part of the 2017 tax reform legislation, section 1446(f) generally requires a transferee, in connection with a disposition of a partnership interest by a non-U.S. person, to withhold and remit 10 percent of the “amount realized” by the transferor, if any portion of any gain realized by the transferor would be treated as effectively connected with the conduct of a trade or business in the United States under the substantive sourcing rule of section 864(c)(8).

On May 13, 2019, the IRS and the Treasury published [proposed regulations](#) providing guidance on the rules imposing withholding and reporting requirements under the Code on dispositions of certain partnership interests by non-U.S. persons (the “Proposed 1446(f) Regulations”). Prior to issuing the Proposed 1446(f) Regulations, the IRS issued [Notice 2018-08](#) and [Notice 2018-29](#) to provide interim guidance with respect to these withholding and information reporting requirements. For a discussion this previous guidance, please see our [related blog post](#) here.

The Proposed 1446(f) Regulations adopt many of the rules set forth in Notice 2018-29, with certain modifications, and include some taxpayer friendly provisions, such as (i) providing flexibility in determining the date on which qualifications for exceptions to withholdings may be applicable; (ii) extending the period of time to 22 months for which a Schedule K-1 is valid to determine a transferring partner’s share of partnership liabilities (up from 10 months under Notice 2018-29); (iii) allowing non-U.S. partnerships to reduce or avoid withholding if there are U.S. partners in the partnership; (iv) providing guidance as to the application of nonrecognition provisions of the Code as an exception from withholding; (v) allowing transferors to claim treaty benefits as a partial or total exception to withholding; and (vi) setting forth new procedures for purposes of determining the amount to withhold, including through certification of maximum tax liability and certification of shares of partnership liabilities.

Some provisions may complicate sales of partnership interests by adding additional compliance burdens or by narrowing certain of the exceptions to withholding provided under Notice 2018-29, such as: (i) requiring transferees to certify withholding to a partnership and supply supporting documentation; (ii) resuming secondary withholding obligations for partnerships, which may be liable for a transferee’s failure to withhold; (iii) lowering the minimal effectively connected taxable income (“ECTI”) threshold from 25 percent to 10 percent in the exceptions to withholding both based on the effectively connected gain upon a deemed sale and the transferor’s historic allocable share of ECTI; (iv) providing that transferors with zero ECTI generally may not provide a certification under the “less than 10 percent historic ECTI” exception; and (v) providing that only a withholding partnership can claim a refund for any over-withholding by the partnership.

The 1446(f) regulations will be effective 60 days after the regulations are finalized. As of October 23, 2019, IRS officials could not provide a definitive estimate of when final regulations would be issued. However, under the IRS and Treasury’s priority guidance plan, the general

rules is they should be issued before June 30, 2020. For further discussion, including details regarding exceptions from withholding under the Proposed 1446(f) Regulations, please see our [May 22, 2019 blog post](#).

## **Tax Treatment of Partnership Audits**

Effective for audits of tax years that begin after December 31, 2017, the Bipartisan Budget Act of 2015 significantly altered the U.S. tax rules applicable to audits of partnerships (including LLCs taxed as partnerships). One change from these new audit rules is that the position of “tax matters partner” has been replaced with that of a “partnership representative.” The designated partnership representative acts on behalf of the partnership and deals with the IRS during an audit of the partnership. While the partnership representative need not be a partner or member of the relevant partnership or LLC, 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. A partnership generally designates a partnership representative by indicating the partnership representative – and a designated individual, if applicable – on the partnership’s tax return.

If the IRS determines that a partnership representative designation is not in effect, it will notify the partnership of that determination. The partnership will then have 30 days from the IRS’ mailing of that notification – not from receipt of the IRS notification – to adequately designate a partnership representative and provide all necessary information about the partnership representative, unless the designation is ineffective by reason of multiple revocations.

## **Proposed Regulations Regarding Qualified Foreign Pension Funds**

On June 7, 2019, the Treasury and the IRS released [proposed regulations](#) under Sections 897, 1445 and 1446 (the “Proposed QFPF Regulations”) regarding the exception for qualified foreign pension funds (“QFPFs”) from taxation under the Foreign Investment in Real Property Tax Act (“FIRPTA”) provisions of the Code.

The Proposed QFPF Regulations are taxpayer favorable because they broadly construe which entities may constitute QFPFs and the requirements that must be met under Section 897(l) in an effort to include a wide range of plans that are in substance foreign pension funds but that might not qualify under a strict interpretation of the statute. These regulations should encourage further investment in U.S. real property by foreign pension plans by providing greater clarity regarding whether a plan meets the requirements to be treated as a QFPF. Rules for certifying an exemption from FIRPTA withholding and plans to revise IRS Form W-8EXP are also provided in the Proposed QFPF Regulations.

To read a discussion of the Proposed QPFP Regulations please see our [July 3, 2019 blog post](#).

## **Qualified Opportunity Zone Program**

On April 17, 2019, IRS and the Treasury issued a second set of [proposed regulations](#) (the “Proposed QOZ Regulations”) regarding the qualified opportunity zone program, which was enacted as part of tax reform. The qualified opportunity zone program is designed to encourage investment in distressed communities designated as qualified opportunity zones (“QOZ”), by providing tax incentives for equity investments in “qualified opportunity funds” (“QOF”) that, in turn, invest directly or indirectly in the QOZs.

Generally, the program provides three potential benefits to taxpayers who invest in a QOF. 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 a QOF 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 QOF, 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 QOF 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 QOF 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 QOF for 10 years, it can sell its interest in the QOF without being subject to tax attributable to appreciation in the value of the taxpayer’s interest in the QOF.

Please see our [October 23, 2018 blog post](#) on the proposed QOZ regulations for further background discussion of the QOZ program and analysis of the first set of proposed regulations issued in October 2018 (the “Initial Proposed Regulations”).

The Proposed QOZ Regulations are very taxpayer friendly, and address some, but not all, of the questions that were left unanswered by the Initial Proposed Regulations. Although the Proposed QOZ Regulations generally are proposed to be effective on or after the date of the publication of final regulations, taxpayers and QOFs may generally rely on them so long as the taxpayer and/or the QOF applies the Proposed QOZ Regulations consistently and in their entirety. However, taxpayers may not rely on the rules that permit a QOF partnership, S corporation, or REIT whose owners have held their QOF interests for at least 10 years to sell assets without its owners recognizing capital gains on the sale, until the Proposed QOZ Regulations are finalized.

For an in-depth discussion of the Proposed QOZ Regulations, please see our [April 30, 2019 blog post](#).

## **871(m) Regulations**

On September 17, 2015, the IRS and the Treasury 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 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](#) extending the phase-in application of section 871(m) to certain transactions.

[Notice 2018-72](#) 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.

On October 23, 2019, an IRS official stated that the IRS is working to finalize temporary regulations on section 871(m) before they sunset, and those regulations will provide an extension of the transition period. Details on how long the additional extension would be or when the regulations are expected to be released were not provided.

### **Proposed Section 385 Regulations**

Since their release in October 2016, the final and temporary regulations under section 385 of the Code (the “385 Regulations”) have been controversial. The intent of section 385 and the 385 Regulations generally was to prevent erosion of the U.S. tax base through placement of debt owed by a U.S. corporation to a foreign affiliate, which was a typical post-inversion planning technique. [As issued in 2016](#), the 385 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.

On November 4, 2019, the IRS [finalized proposed regulations](#) removing certain final and temporary 385 Regulations that had set forth minimum documentation requirements in order for certain financial arrangements among expanded groups to be treated as debt for U.S. federal income tax purposes. However, the IRS noted that it continues to consider the issues addressed by the removed regulations and may propose modified regulations that would simplify and streamline the requirements to minimize taxpayer burdens while ensuring the collection of information needed for tax administration purposes.

Concurrently, the IRS issued [notice](#) of its intention to issue proposed regulations (the “Proposed 385 Regulations”) which would be a substantially modified version of temporary 385 Regulations that expired in October 2019. Like the temporary 385 Regulations, the Proposed 385 Regulations would treat as stock certain debt that is issued by a corporation to a controlling shareholder in a distribution or in another related-party transaction that achieves an economically similar result. Unlike the temporary 385 Regulations, the Proposed 385 Regulations would not treat a debt instrument as funding a distribution or economically similar transaction solely because of its temporal proximity to a distribution. Even with the addition of other anti-avoidance provisions, such as the interest limitation of section 163(j), anti-hybrid rules, and the Base Erosion and Anti-abuse Tax (“BEAT”) to the Code, this suggests the IRS believes that

rules for the issues addressed in the temporary regulations remain necessary in at least some situations.

## **Proposed FATCA Regulations Offer Significant Compliance and Withholding Burden Relief**

On December 13, 2018, the IRS and the Treasury issued [proposed regulations](#) (the “Proposed FATCA Regulations”) addressing various aspects of the withholding and information reporting regime commonly referred to as FATCA. The Proposed FATCA Regulations provide significant relief from potential withholding and compliance burdens that U.S. and non-U.S. financial institutions would otherwise be subject to under FATCA. The preamble to the Proposed FATCA Regulations announces that taxpayers may generally rely on the Proposed Regulations pending issuance of final regulations.

### *Elimination of Withholding on Payments of Gross Proceeds*

FATCA’s main tool to achieve the goal of preventing U.S. taxpayers from holding unreported assets and income offshore is a 30% withholding tax imposed on certain U.S.-source payments (referred to as “withholdable payments”) made to a foreign financial institution (an “FFI”) that does not agree to provide the U.S. government with certain information. Withholding on payments of gross proceeds from the sale or other disposition of property of a type which can produce interest or dividends from U.S. sources (such as a sale of stock or a debt instrument of a U.S. issuer) was scheduled to come into effect on January 1, 2019. Under the Proposed FATCA Regulations, the withholding obligation on these types of payments is eliminated entirely.

### *Further Suspension of Potential “Foreign Passthru Payment” Withholding*

FATCA provides that certain payments by an FFI to a non-compliant account holder at such FFI that are “attributable to” withholdable payments would be subject to withholding under FATCA (such payments, “foreign passthru payments”). As a result of the establishment of a robust network of bilateral intergovernmental agreements implementing the goals of FATCA, the IRS and the Treasury have determined, at least for now, that withholding on foreign passthru payments is not required. The Proposed FATCA Regulations provide that withholding on such payments will not be effective before the date that is two years after the publication of final regulations defining the term “foreign passthru payment.”

For further coverage on these proposed regulations, please see our [December 17, 2018 blog post](#).

## **Final Regulations on Partnership Liabilities under Section 752**

On October 10, 2019, the IRS issued [final regulations](#) on (i) partnership liabilities that are treated as recourse liabilities under section 752, (ii) the treatment of bottom dollar payments under section 752, and (iii) when certain obligations to restore a deficit balance in a partner’s capital account are disregarded under section 704 (the “752 Final Regulations”).

Concurrent with the issuance of the 752 Final Regulations, the IRS issued [final regulations](#) withdrawing 2016 temporary regulations under section 707 on disguised sales of property to or

by a partnership and reinstating the regulations previously in effect (the “707 Final Regulations”).

The 752 Final Regulations adopt earlier proposed and temporary regulations to define bottom dollar payment obligations to include any payment obligation under a guarantee or similar arrangement when the partner (or related person) is not liable, up to the full amount of the payment obligation in the event of non-payment by the partnership.

Under 752 Final Regulations, the definition of a bottom dollar payment obligation has been revised to specifically address capital contribution obligations and deficit restoration obligations. Under the revised definition, a bottom dollar payment obligation includes, with respect to a capital contribution obligation and a deficit restoration obligation, any payment obligation other than one in which the partner is or would be required to (i) make the full amount of the partner’s capital contribution, or (ii) restore the full amount of the partner’s deficit capital account.

The 752 Final Regulations generally require taxpayers to disclose bottom dollar payment obligations by filing *Form 8275, Disclosure Statement*, with the partnership return for the tax year in which a bottom dollar payment obligation is undertaken or modified. The 752 Final Regulations clarify that identifying the payment obligation for which disclosure is made includes stating whether the obligation is a guarantee, reimbursement, indemnity or deficit restoration obligation.

The 707 Final Regulations adopt regulations proposed in 2018, effectively returning to the rule in place before temporary regulations related to section 707 were issued. The proposed regulations and the 707 Final Regulations provide that, for purposes of allocating liabilities under the section 707 disguised sale rules, a partner’s share of a partnership liability includes the portion of the liability allocated to that partner under section 752 as a recourse liability.

The 707 Final Regulations apply to any transaction for which all transfers occur on or after October 4, 2019. A partnership and its partners may apply the 707 Final Regulations to any transaction for which all transfers occur on or after January 3, 2017 (the effective date of the 707 Temporary Regulations).

## **IRS Guidance for Transition from LIBOR**

On October 9, 2019, the IRS and Treasury released [proposed regulations](#) addressing market concerns regarding the U.S. tax effect of the expected transition from LIBOR and other interbank offered rates on debt instruments (e.g., loans, notes and bonds) and non-debt contracts (e.g., swaps and other derivatives). Please see our [October 15, 2019 blog post](#) for a discussion and analysis of the proposed regulations.

## **New Guidance on Virtual Currency**

On October 9, 2019, the IRS issued the first official guidance on the taxation of cryptocurrency transactions in more than five years. The guidance includes both a Revenue Ruling, [Rev. Rul. 2019-24](#), and answers to [Frequently Asked Questions on Virtual Currency Transactions](#) (the “FAQs,” together with Revenue Ruling 2019-24, the “Guidance”). The Guidance provides much sought information concerning the tax consequences of cryptocurrency “hard forks”, as well as

acceptable methods of determining tax basis for cryptocurrency transactions. The Guidance also reasserts the IRS's position, announced in [Notice 2014-21](#), that cryptocurrency is "property" for U.S. federal income tax purposes and provides information on how the rules generally applicable to transactions in property apply in the cryptocurrency context. For further coverage, including a discussion of questions that remain open, please see our October 17, 2019 [blog post](#).

## **Democratic Lawmakers Outline Tax Policy Proposals**

As the 2020 presidential election approaches, several Democratic lawmakers and presidential candidates have set forth tax policy proposals ranging from increasing income tax rates to imposing a wealth tax. For a chart summarizing the various proposals and further discussion, please see our [October 21, 2019 blog post](#).

## **ERISA**

The U.S. Department of Labor's ("DOL") "new" fiduciary rule – which briefly 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 – initially became effective on June 9, 2017, but was later vacated by a Fifth Circuit Court of Appeals decision on March 15, 2018. Accordingly, we are currently 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 DOL's Spring 2019 regulatory agenda (set forth [here](#)) listed a notice of proposed rulemaking for "Fiduciary Rule and Prohibited Transaction Exemptions" for December 2019, so the fiduciary rule saga may be continuing. What any proposed rule will look like (or when it will actually arrive) is anyone's guess at this point, but further muddying expectations is the fact that, effective October 1, 2019, the Employee Benefits Security Administration arm of the DOL was reorganized in a manner that might change the DOL's priorities/views on any new rule. Stay tuned . . .

## **State Regulation / Blue-Sky**

### **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, 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 with Rule 506, there is no pre-emption and, 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 for the offering as well as other aspects of the offering. If a filing is incomplete or late or a state finds any other issue with it, they are likely to require that the issuer make a rescission offer to the investors and possibly pay fines.

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.

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

### Harassment and Discrimination

#### *New York Sexual Harassment*

Effective October 9, 2018, New York State employers must adopt written sexual harassment prevention policies and institute annual anti-harassment training for employees. To satisfy the training requirements, employers may either: (1) adopt the State’s model training script, slides,

and/or case studies; or (2) provide other live training or interactive online/video training that meets or exceeds the law's minimum standards for training. Employers must train all employees – including exempt, non-exempt, part-time, seasonal and temporary employees – on or before October 9, 2019. And, according to the State's guidance, employers also need to train employees who “work[] a portion of their time in New York State, even if they're based in another state.”

In addition, employers in New York City must also comply with the Stop Sexual Harassment in NYC Act's training requirements, which went into effect on April 1, 2019. While there are many similarities between the State and City requirements – including the requirement that the training be interactive – the City law also requires that employees be trained on bystander intervention. And like the State's guidance, the City's guidance similarly extends an employer's training obligation to employees who are connected to New York City “in any way.” This includes (1) employees who work or will work in New York City; (2) employees who work a portion of their time in New York City; and (3) employees who are based elsewhere but who interact with other employees in New York City (even if they are not physically present in the City). Employers have until December 31, 2019, to comply with the City's training requirements.

### ***New York Harassment and Discrimination***

On July 12, 2019, Governor Andrew Cuomo signed into law an amendment to the New York State Human Rights Law (“NYSHRL”) that broadens the definition of “race” to include “traits historically associated with race, including but not limited to, hair texture and protective hairstyles.” The amendment renders it an unlawful practice to discriminate on the basis of such traits in employment, as well as housing and in public accommodations. This amendment prohibiting hairstyle discrimination is one of the first in the nation and follows California's decision to pass a similar measure.

Similarly, on August 9, 2019, Governor Cuomo signed an additional amendment to the NYSHRL that prohibits employers in New York State from imposing as a condition of obtaining or retaining employment any terms or conditions that would require a person to violate or forego a sincerely held practice of their religion. Such practices could include, for example, wearing “any attire, clothing, or [having] facial hair in accordance with the requirements of [the employee's] religion.” Employers may, however, still take advantage of the undue hardship defense if they are able to demonstrate that they have engaged in a bona fide discussion with the employee or applicant and are unable to reasonably accommodate the employee's or applicant's sincerely held religious observance without imposing an undue hardship on the employer's business. The amendment took effect on October 8, 2019.

On August 12, 2019, Governor Cuomo signed into law significant expansions to workplace anti-discrimination protections in New York State. The new legislation includes numerous measures regarding discrimination and harassment in all forms (not just sexual harassment) in the workplace. A few of the relevant provisions are discussed below:

- Effective **immediately**, New York employers will be required to provide employees, both at the time of hire and at every annual sexual harassment prevention training, with a

notice containing the employer's sexual harassment prevention policy and "the information presented at the employer's training program."

- Effective **October 11, 2019**:
  - A complainant will no longer need to show that alleged sexual or other workplace harassment is "severe or pervasive" in order to succeed on their claim under the NYSHRL, but rather need only show that they were subjected to "inferior terms, conditions or privileges of employment because of the individual's membership in one or more of [the] protected categories [in New York State]." However, it will be an affirmative defense for an employer to show that the conduct does not rise above the level of "petty slights or trivial inconveniences."
  - The *Faragher-Ellerth* defense will no longer apply to discrimination claims under the NYSHRL. This affirmative defense applies where an employee unreasonably fails to take advantage of an employer's internal complaint mechanisms with regard to the claims at issue. While the defense would still be available in response to federal discrimination claims, employers will not be able to raise the same defense to NYSHRL claims.
  - The existing prohibition on mandatory pre-suit arbitration of sexual harassment claims will be extended to any claims of unlawful discrimination.
  - However, as is the case with the current prohibition on mandatory arbitration of sexual harassment claims, the expanded prohibition applies only to the extent it is not inconsistent with federal law. Recently, the Southern District of New York held in *Latif v. Morgan Stanley Co.* (S.D.N.Y. June 26, 2019), that New York's prohibition on mandatory arbitration of sexual harassment claims is preempted by the Federal Arbitration Act in situations where both laws apply. It seems likely that the *Latif* analysis would similarly apply to this latest attempt to restrict mandatory arbitration.
- Effective **August 12, 2020**, individuals will have three years to report claims of sexual harassment to the New York State Division of Human Rights, rather than the current one year limitation on reporting.

For more information on the law's other expansions to anti-discrimination protections, please refer to our August 12, 2019 [post](#) on Proskauer's Law and the Workplace blog outlining all of the law's provisions and their effective dates.

### ***Connecticut Sexual Harassment***

On June 18, 2019, Connecticut Governor Ned Lamont signed into law the Time's Up Act, which amends existing state law to impose greater sexual harassment training and notice requirements on employers.

Currently, Connecticut law requires employers with 50 or more employees to provide two hours of sexual harassment training to all supervisory employees. Effective October 1, 2019, the Act expands this requirement such that employers with three or more employees must provide sexual harassment training to all employees by October 1, 2020. Employers with fewer than three employees will be required to provide such training only to supervisory employees.

Although there is still no annual training requirement, employers are required to provide periodic supplemental training that updates all supervisory and nonsupervisory employees on the content of such training and education not less than every ten years. Such training must include information concerning the federal and state statutory provisions concerning sexual harassment and remedies available to victims of sexual harassment. The Connecticut Commission on Human Rights and Opportunities (“CHRO”) will develop an online training video or other interactive training material that employers may use to comply with the Act’s requirements.

While existing employees need not receive training until October 1, 2020, new employees hired on October 1, 2019, or later must receive training within six months of hire. Also, employers who have already provided two hours of sexual harassment training to their employees since October 1, 2018, need not retrain such employees before the October 1, 2020 deadline. Failure to provide the required trainings will be considered a “discriminatory practice” and employers may be subject to fines up to \$1,000.

The Act also imposes new notice requirements, requiring employers to provide a notice regarding the illegality of sexual harassment and the remedies available to victims. Additionally, the Act empowers the CHRO to inspect an employer’s premises during work hours to ensure compliance with required trainings and notices.

Please see our July 2, 2019 [post](#) on Proskauer’s Law and the Workplace blog for more information.

### ***Sexual Orientation and Gender Identity as Protected Characteristics***

On October 8, 2019, the U.S Supreme Court heard oral argument relating to three cases that ask the Court to decide whether termination on the basis of sexual orientation or gender identity is prohibited by Title VII. Collectively, the plaintiffs argue that termination or other adverse employment actions on the basis of sexual orientation or gender identity constitute sex discrimination under Title VII. While some states’ anti-discrimination laws currently prohibit discrimination that occurs because of an employee’s sexual orientation or gender identity, a majority of states provide no such protections. Accordingly, in recent years, numerous cases have been brought arguing that Title VII protects employees from discrimination on these grounds. While some circuit courts have permitted Title VII suits to proceed based on gender identity discrimination or sexual orientation discrimination, federal courts have not uniformly embraced this expansive view of Title VII. Regardless of how the Supreme Court ultimately decides the case, the decision will inevitably impact the employment relationship.

Please see our [February 27, 2018](#), and [March 12, 2018](#), blog posts analyzing two of the Circuit Court decisions that are now before the Supreme Court.

## **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 or taken effect in Connecticut, Colorado, Illinois, New Jersey, New York, and Washington.

On January 6, 2020, the New York statewide salary history ban will go into effect. Specifically, the law amends the New York Labor law to prohibit employers from:

- Relying on the wage or salary history of an applicant in determining whether to offer employment to such individual or in determining the wages or salary for such individual;
- Orally or in writing, seeking, requesting, or requiring the wage or salary history from an applicant or current employee as a condition of being interviewed, or as a condition of continuing to be considered for an offer of employment, or as a condition of employment or promotion;
- Orally or in writing, seeking, requesting, or requiring the wage or salary history of an applicant or current employee from a current or former employer, current or former employee, or agent of the applicant or current employee's current or former employer;
- Refusing to interview, hire, promote, otherwise employ, or otherwise retaliating against an applicant or current employee based on prior wage or salary history;
- Refusing to interview, hire, promote, otherwise employ, or otherwise retaliating against an applicant or current employee because the individual did not provide wage or salary history in accordance with the law; or
- Refusing to interview, hire, promote, otherwise employ, or otherwise retaliating against an applicant or current or former employee because the individual filed a complaint with the State's department of labor alleging a violation of the law.

The law does not prohibit applicants or employees from voluntarily disclosing salary history. However, the law permits employers to confirm salary history under certain circumstances. Finally, the law provides aggrieved individuals the right to file a civil action in court. Potential remedies include compensatory damages, injunctive relief, and attorneys' fees.

Please see our June 25, 2019, [post](#) on Proskauer's Law and the Workplace blog for more information.

### ***Equal Pay Laws***

In recent years, Alabama, Colorado, and Illinois, just to name a few, have passed or amended equal pay laws in an attempt to rectify gender pay issues. Likewise, New York recently amended its pay equity law to prohibit pay discrimination on the basis of any protected characteristic

under the NYSHRL. The Colorado, Illinois, and New York laws are discussed in more detail below.

### ***Colorado***

On May 22, 2019, Governor Jared Polis signed the Equal Pay for Equal Work Act into law. Effective January 1, 2021, the Act will prohibit employers from paying members of the opposite sex different wages for “substantially similar work” based on sex (including gender identity) or sex plus another characteristic protected by applicable law. The presence of “substantially similar work” is determined by the nature of the job itself, taking into account employee skill, effort and responsibility.

An employer may, however, avoid liability under the Act if it can demonstrate that the difference in compensation is based on at least one of the following factors: (i) a seniority system; (ii) a merit system; (iii) a system that measures earning by quantity or quality of production; (iv) the geographic location where the work is performed; (v) education, training, or other relevant experience to the extent they are reasonably related to the work in question; and (vi) travel, if travel is a regular and necessary condition of the work performed.

The Act also requires employers to make reasonable efforts to announce, post, or otherwise make known all internal opportunities for promotion to all employees on the same calendar day. Additionally, the Act requires employers to disclose in each posting the hourly or salary compensation or the range of such compensation along with a general description of all benefits and compensation offered by the job opening.

Please see our July 8, 2019, [post](#) for more information.

### ***Illinois***

The Illinois Equal Pay Act of 2003 was amended on July 31, 2019, to further prohibit employers from paying unequal wages on the basis of sex. Previously, the Act prohibited sex-based discrimination between employees who performed substantially similar work on jobs that required “equal skill, effort, and responsibility.” The amendment, however, which took effect on September 29, 2019, prohibits sex-based wage discrimination between employees who perform substantially similar work on jobs requiring “substantially similar skill, effort, and responsibility and that are performed under similar working conditions.” The law also makes identical amendments to its prohibition on discrimination between the wages of African-American employees and other employees.

A pay differential will not be deemed a violation of the law where payment is made under: (i) a seniority system; (ii) a merit system; (iii) a system that measures earnings by quantity or quality of production; or (iv) a differential based on any factor other than: (a) race or (b) a factor that would constitute unlawful discrimination under the Illinois Human Rights Act, provided that the factor:

- Is not derived from a differential in compensation based on race or any other protected characteristic;
- Relates to the position and is consistent with a business-necessity; and
- Accounts for the differential.

In addition, the Act now renders it unlawful for employers to prohibit employees from disclosing or discussing information about their wages, salaries, benefits, or other compensation. Employers who violate the Act may be subject to damages for any underpayment along with interest, compensatory damages, punitive damages, attorney's fees and costs, and/or injunctive relief as appropriate.

### ***New York***

On July 10, 2019, Governor Andrew Cuomo signed a bill into law that expanded equal pay protections. The new law broadens protections under the Equal Pay Act by requiring that no employee who falls into any one or more protected classes under the NYSHRL be paid at a rate less than the rate at which an employee outside the same protected class in the same establishment is paid for either equal work or substantially similar work, when viewed as a “composite of skill, effort and responsibility, and performed under similar working conditions.”

These new protections go beyond addressing the gender pay gap, instead providing protections for members of all protected classes under the NYSHRL. This means the protections against discriminatory differences would be provided to employees based not only on sex, but also on age, race, creed, color, national origin, sexual orientation, gender identity or expression, military status, disability, predisposing genetic characteristics, familial status, marital status or domestic violence victim status.

Please see our June 25, 2019, [post](#) for more information.

### **Paid Safe and Sick Leave Laws**

In light of legislative gridlock in Washington, D.C., many states and municipalities have begun taking matters into their own hands with respect to paid safe and sick leave laws. Below are just a few of this past year's developments in this area.

### ***Michigan***

Michigan's Paid Medical Leave Act, effective March 29, 2019, requires employers with 50 or more employees to provide paid medical leave for personal or family health needs. Eligible employees will accrue 1 hour of paid leave for every 35 hours worked, up to a maximum of 1 hour per calendar week and 40 hours per benefit year. Where employers permit employees to accrue paid medical leave, employees must also be permitted to carry over available but unused medical leave to the following year, though the maximum amount of leave to be used by employees in any given year may be capped at 40 hours. Alternatively, employers may frontload the time to be used for the same purposes and under the same conditions as accrued medical

leave, and when frontloading the time employers are not required to allow employees to carry over accrued, unused leave. New employees may be restricted from using their accrued medical leave for up to 90 days after they are hired.

### ***New York – Westchester County***

Effective October 30, 2019, Westchester County, NY, employers will be required to provide paid leave to employees who are victims of domestic violence or human trafficking. Leave under the new ordinance will be in addition to paid time off already required to be provided to employees under the Westchester County paid sick leave law, which took effect on April 10, 2019. Under the law, employees working in Westchester County for more than 90 days in a calendar year will be eligible to use up to 40 hours of paid leave per year for covered purposes relating to the employee being a victim of domestic violence, other “family offense matters” (such as harassment, sexual abuse or misconduct, and stalking), and human trafficking (“safe time”). Covered employees may use safe time to attend or testify in a criminal or civil court proceeding relating to domestic violence or human trafficking or to relocate to a safe location.

Unlike under the paid sick leave law, safe time does not accrue, but rather is available to an eligible employee on an as-needed basis, up to 40 hours per year. When the need for safe time is foreseeable, employees can be required to make a good faith effort to provide advance notice, as well as to schedule the use of leave in a manner that does not “unduly disrupt” the employer’s operations. Employers are required to keep confidential any information about an employee or family member obtained solely for purposes of safe time leave unless disclosure is required by law or the employee gives written permission for disclosure. Employers also may request reasonable documentation from employees that safe time has been used for a covered purpose, regardless of the duration of the leave. Employers will be required to provide employees with a copy of the ordinance and “written notice of how the law applies to that employee” within 90 days of the effective date of the law (*i.e.*, by January 28, 2020) or upon commencement of employment, whichever is later. Employers also will be required to display a copy of the ordinance and a poster in a conspicuous area accessible to employees.

Please see our November 2, 2018, [post](#) for more information regarding the law.

### ***Pennsylvania – Pittsburgh***

On July 17, 2019, the Pennsylvania Supreme Court upheld the City of Pittsburgh’s paid sick leave law, overturning lower court decisions that found the ordinance violated the state’s Home Rule Charter law which limits local authority to regulate businesses. The paid sick leave ordinance, signed into law in August 2015 and originally scheduled to take effect in 2016, requires employers to provide employees a minimum of 1 hour of paid sick leave for every 35 hours worked. Employers with 15 or more employees are permitted to cap earned sick leave at 40 hours per year, while employers with fewer than 15 employees can cap earned sick leave at 24 hours per year.

Prior to its effective date, the ordinance was challenged by state legislators who argued that the Home Rule Charter law precluded municipalities from determining “duties, responsibilities or

requirements placed upon businesses and employers unless authority to do so is expressly provided by statute.” The state’s Supreme Court, however, found that because the paid sick leave ordinance works to further the purpose of the state’s Disease Prevention and Control Law (“DPCL”), it does not run afoul of the Home Rule Charter law because it principally focuses on regulating health and safety rather than businesses. Explaining that for purposes of disease prevention and control, the DPCL’s “holistic” scheme “favors local regulation as informed by the expertise of a dedicated local board or department of health over state-level regulation,” the court held that local lawmakers may “impose more stringent regulations than state law provides” and the city’s paid sick leave law is a permissible regulation in this regard. While it remains unclear when the new effective date of the Act will be, the city’s mayor is expected to provide further guidance in the near future.

### ***Texas – San Antonio, Austin, and Dallas***

San Antonio’s sick leave ordinance was scheduled to take effect on August 1, 2019, for employers with more than five employees. Implementation of the City of San Antonio’s paid sick leave ordinance has been delayed, however, pending a legal challenge. On July 15, 2019, the Texas Attorney General and about a dozen business groups filed suit against the City, alleging that the paid sick leave ordinance is unconstitutional because it is preempted by the Texas Minimum Wage Act. In connection with the suit, the groups sought a temporary injunction to stop the ordinance from taking effect as scheduled. In response, the parties entered into an order agreeing to stay the implementation of the law until December 1, 2019. The order states that the stay is intended to allow the City’s Paid Sick Leave Commission to “confer with stakeholders, study the [paid sick leave] Ordinance, and recommend to the mayor and City Council revisions to the [paid sick leave] Ordinance.” Please see our August 22, 2018, [post](#) on Proskauer’s Law and the Workplace Blog for more information regarding the ordinance’s requirements.

This is the second time that the Texas Attorney General has successfully delayed implementation of a local sick leave law in the state, having intervened in a similar lawsuit against the city of Austin’s sick leave ordinance. The Austin ordinance is currently stayed pending a decision from the Texas Supreme Court on the constitutionality of the law. As of now, the Dallas paid sick leave ordinance (the state’s third and remaining local paid sick leave law) took effect on August 1, 2019, as scheduled, but the ordinance will not be enforced until April 1, 2020. The future of these paid sick leave ordinance’s remains to be seen.

## **Family and Medical Leave Developments**

### ***FMLA Leave***

The U.S. Department of Labor’s Wage and Hour Division (“WHD”) has issued an [opinion letter](#) finding that time off to attend meetings regarding a child’s Individualized Education Program (“IEP”) is a qualifying reason for leave under the FMLA. The letter addressed an inquiry by an individual with two children with serious health conditions covered by the Individuals with Disabilities Act, which requires public schools to develop IEPs for children designating special education and related services to be provided, in coordination with the child’s parents, teachers, and school administrators. To that end, the individual inquired whether time away from work to

attend meetings with the school's Commission on Special Education to review the status of the children's IEPs was qualifying time to care for a family member with a serious health condition under the FMLA. The WHD concluded that the need to attend such meetings is a qualifying reason for taking intermittent FMLA leave. Specifically, the WHD found that, pursuant to the FMLA regulations, "caring for" a family member with a serious health condition includes "mak[ing] arrangements to changes in care." The WHD stated, "it appears that . . . attendance at IEP meetings is essential to [a parent's] ability to provide appropriate physical or psychological care" to his/her children, because the meetings involve making medical decisions concerning the children's "medically-prescribed speech, physical, and occupational therapy" and "discuss[ing the] children's well-being and progress with the providers of such services." The WHD further opined that a child's doctor need not be present at such meetings for the time to qualify as intermittent FMLA leave.

### *Connecticut*

On June 25, 2019, Governor Ned Lamont signed into law the Act Concerning Paid Family and Medical Leave. Beginning in early 2022, employees will be eligible to receive partial pay benefits during leave taken under the existing Connecticut Family and Medical Leave Act ("CFMLA").

In order to take leave under the CFMLA, an employee or their family member must suffer from a serious health condition. In addition, leave may be taken pursuant to the care of a child following birth, adoption, or foster care placement. The Act also amends the CMFLA; the changes to the Act will take effect January 1, 2022, and include:

- Private employer coverage under the CFMLA will be expanded to cover businesses with one or more employees, effectively extending coverage to nearly every employer in the state.
- Employee eligibility under the CFMLA also will be expanded. Specifically, leave will be available to employees who have worked for their employer for at least 12 weeks, with no minimum hours requirement. To be eligible for paid leave benefits, employees must also have earned at least \$2,325 within a defined "base period."
- The amount of leave available under the CFMLA will change. Presently, eligible employees are entitled to up to 16 weeks of unpaid leave in a 24-month period. Under the Act, the leave amount will change to 12 weeks of partially paid leave in a 12-month period, with an additional two weeks of leave available for pregnancy-related serious health conditions.
- In addition to the currently included spouse, child, and parent, the definition of a "covered family member" under the CFMLA will be expanded to include an employee's parent-in-law, grandparent, grandchild, sibling, and "any other individual related to the employee by blood or affinity whose close association the employee shows to be the equivalent of those family relationships." The Connecticut Department of Labor ("CT DOL") is expected to provide further guidance on the scope of the "any other individual" category.

The paid leave benefit will be funded by an employee payroll tax of up to 0.5%, with contributions beginning on January 1, 2021. Employers will not be required to contribute toward the program, but will be responsible for withholding the employee tax and remitting the funds to the state Family and Medical Leave Insurance Trust Fund. Alternatively, employers will have the option to apply for permission to provide benefits through a private plan.

Employees requesting paid leave will be required to provide notice of the need for benefits, along with certification of the need for leave, to the [Authority]. The amount of the paid leave benefit will be a percentage of the employee's weekly wages up to a maximum cap set at 60 times the state minimum wage. It is anticipated that Connecticut's minimum wage at the time benefits take effect will be \$13 per hour, which would result in a maximum benefit of \$780 per week. The state's minimum wage is further slated to reach \$15 per hour in 2023, which will result in an increased maximum benefit of \$900 per week. Interestingly, the Act expressly provides that the [Authority] will have the ability to reduce benefit amounts as needed if revenue from employee contributions is insufficient to fund claims at the stated levels.

For more information, please refer to our June 18, 2019, [post](#).

Connecticut is not alone in its efforts to provide employees paid family and medical leave benefits. Massachusetts, Michigan, and Oregon also enacted their own paid family and medical leave benefits, while in New York, the paid period for leave and the maximum weekly wages both increased effective January 1, 2019.

## **Marijuana and Employment**

As the trend towards legalization of marijuana for medicinal and/or recreational uses continues nationwide, the legal landscape has seen recent developments in New Jersey, New York City, and Illinois. The New Jersey and New York City changes are discussed below:

### ***New Jersey***

The New Jersey Compassionate Use Medical Marijuana Act ("CUMMA") was signed into law on January 18, 2010, and legalized the use of medical marijuana for New Jersey residents suffering from a debilitating medical condition. As originally drafted, CUMMA did not require an employer to accommodate the medical use of marijuana in the workplace. Notwithstanding this, the Plaintiff in *Wild v. Carriage Funeral Holdings, Inc.* (N.J. Super. Ct. App. Div. Mar. 27, 2019), brought suit against his employer alleging that he was terminated on the basis of his use of medical marijuana in violation of the New Jersey Law Against Discrimination ("LAD"). Although Plaintiff tested positive for marijuana after his employer required him to undergo a drug test, Plaintiff explained that he used medical marijuana as part of his cancer treatment. Nevertheless, defendant terminated plaintiff's employment based on the positive drug test. Defendant moved to dismiss the case noting that CUMMA did not require an employer to accommodate a medical marijuana user. The trial court agreed and granted the motion to dismiss.

On appeal, however, the appellate court found that CUMMA's "refusal to require an employment accommodation for a medical marijuana user does not mean that [CUMMA] has

immunized employers from obligations already imposed elsewhere.” Accordingly, the Court concluded, CUMMA “does not immunize what the New Jersey Law Against Discrimination prohibits,” and reversed the lower court’s decision thereby permitting the plaintiff to proceed with his claim of discrimination.

On July 2, 2019, acknowledging *Wild*, New Jersey Governor Phil Murphy signed into law the Jake Honig Compassionate Use Medical Cannabis Act. The Act specifically prohibits employers from taking any adverse employment action against a person who is registered with the state as a qualifying patient for purposes of medical marijuana. This, however, does not provide employees the right to possess or use intoxicating substances during work hours. Additionally, employers are not required under the Act to commit any act that would violate federal law or result in the loss of a federal contract or federal funding. Finally, the Act imposes new obligations on employers when an employee tests positive for marijuana.

Please see our July 26, 2019 [post](#) for more information.

### ***New York***

The New York City Council overwhelmingly passed legislation that would prohibit most City employers from requiring job applicants to submit to pre-employment drug tests for marijuana use. Specifically, the bill would amend the City’s Fair Chance Act to make it an unlawful discriminatory practice for an employer (including employment agencies and their agents) to require a prospective employee to submit to testing for the presence of marijuana as a condition of employment. The bill was enacted on May 10, 2019, and will take effect on May 10, 2020.

For more information, please refer to our April 12, 2019, [post](#).

## **Executive Compensation**

### **Violations of Code of Conduct and Other Policies Constitute “Cause”**

Terminations for cause do arise from time to time, and when they happen they can trigger severe consequences. This can include forfeiture of deferred cash compensation, forfeiture of equity interests and forfeiture of carried interest and incentive fees. That makes the definition of “cause” key, and as one would expect, the definitions vary across the alternative asset world. Often one component of the definition, however, references a violation of certain company policies. One recent Federal court case (*Hosain-Bhuiyan v. Barr Laboratories, Inc.* (USDC-SDNY-8/8/19)) addressed this issue and upheld the “cause” termination of pharma company executives who owned and operated a retail pharmacy and wholesale drug distributor, which sold products to their employer without disclosing the executive’s ownership interest. The District Court found that this conduct violated several of the employer’s policies (including the Code of Conduct, Conflicts of Interest Policy and Outside Employment Policy) and that under such policies any such violation was grounds for a “cause” termination of employment. In addition, the Court held that employer properly cancelled the executive’s vested options, because the option grant provided for cancellation upon a “cause” event, which included a material violation of the Company’s policies. Firms and sponsors in the hedge fund, private equity and alternative

asset universe have a number of material policies in place to protect their businesses and it is also common for various economic interests of executives to be forfeited for cause events. The recent decision in the *Barr* case is a reminder of the economic repercussions of a “cause” termination.

## Phantom Carry Arrangements

In the last year, we have seen an uptick in “phantom” carry arrangements as an alternative to traditional profits interests. Traditional profits interests are attractive for many fund shops, because they align compensation with the fund’s performance and they provide a way for compensation to be taxed at capital gains rates rather than ordinary income rates. An important drawback, however, is that holders of profits interests generally have to be treated as partners rather than employees.

“Phantom” carry arrangements are a way to mirror the economics of a profits interest, but without making employees into partners. There are two key drawbacks to a phantom arrangement. First, payments under the arrangement are treated as ordinary income that is subject to withholding for income and employment taxes. Second, phantom arrangements are subject to Section 409A of the Internal Revenue Code (and, for some funds, Section 457A).<sup>4</sup> This means that the arrangements typically must specify a payment schedule that is less flexible than simply making payments when distributions are made under the LLC or partnership agreement. Failure to comply would result in accelerated income tax on the full value of the award (even without an underlying carry event to generate cash) plus an additional 20% tax. The taxes fall on the executive, but the employer has a reporting obligation, each of which create additional risk.

In general, there are two ways to structure a phantom carry arrangement to delay income tax until the time of payment and to avoid the 20% additional tax:

- (i) Condition payment on the executive remaining employed until shortly before the payment is made. This approach is useful for retention, but can cause problems if the fund has a long investment horizon and it does not provide the executive with any “vested” interest if he or she resigns or terminates employment involuntarily.
- (ii) Specify a payment schedule that complies with the requirements of Section 409A. (This approach is not available if the fund is subject to Section 457A.) To comply with Section 409A, the arrangement must specify in advance that payment will be made upon a permitted event (separation from service, death, disability, financial hardship, or a change in control) or at a specified time (or times). Structuring payments around a Section 409A-compliant payment schedule is complicated and requires the assistance of counsel well-versed in the Section 409A traps.

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<sup>4</sup> In general, Section 457A applies to (1) foreign corporations with respect to which significant income is not subject to tax in the U.S. or under a comprehensive foreign income tax regime, and (2) partnerships for which significant income is allocated to tax-exempt entities or to foreign persons who are not subject to income tax in the U.S. or under a comprehensive foreign income tax regime. For example, most offshore funds are subject to Section 457A.

## Worker Classification in California

In September 2019, California adopted Assembly Bill 5 (“AB 5”), the controversial new law that marks a sea change in the way that companies doing business in California will be required to classify their workers. Effective January 1, 2020, AB 5 adopts a rigorous three-factor test for determining how a company may classify its workers in California. Under the so-called “ABC” test, introduced by the California Supreme Court in its 2018 *Dynamex* decision, a worker will be considered an employee unless the company hiring the worker establishes all of the following three prongs:

- (i) the worker is free from the control and direction of the company in connection with the performance of work, both under the contract for the performance of the work and in fact;
- (ii) the worker performs work that is outside of the “usual course” of the company’s business; and
- (iii) the worker is customarily engaged in an independently established trade, occupation, or business that is of the same nature as the type of work performed for the company.

AB 5 exempts certain industries, but does not include an exemption for “gig economy” companies. Companies that are found to misclassify workers in California could face broad liabilities, including for wage orders (e.g., minimum wage, overtime and meal and rest break liability), unemployment insurance, various benefits, paid sick days and state family leave. Companies doing business in California with independent contractors should consult with counsel to determine whether the new law applies to those workers.

## #MeToo Clauses in Employment Agreements

The rise of the #MeToo movement had a direct effect on the negotiation of new executive compensation agreements and in some cases triggered the review of existing provisions. In the case of new agreements, the focus has been on including provisions designed to promote the accountability of executives on sexual harassment and discrimination matters. Most executive compensation agreements and plans include “Cause” definitions that allow an employer to terminate an executive’s employment without payment of severance and benefits. In 2019, we saw a significant increase in the inclusion of #MeToo related triggering events in Cause definitions such as (i) a breach of company policy (including the company’s sexual harassment or discrimination policies); (ii) breach of fiduciary duty; (iii) expressly engaging in sexual harassment or discrimination, or (iv) more generally engaging in conduct materially damaging to the reputation of the company. In addition, for new hires, employers frequently require executives to make representations regarding the existence of sexual harassment or discrimination allegations or investigations against them, a breach of which would be grounds for termination.

## **Section 162(m) – Newly Public Company Transition Relief and Future Outlook**

Privately held portfolio companies contemplating an initial public offering should be aware of an important tax planning opportunity currently available under current law, especially given that there are no assurances that it will continue to be available in the future.

Internal Revenue Code Section 162(m) denies a corporate tax deduction for annual compensation in excess of \$1 million per year paid by a corporation to certain of its current or former executive officers. Historically, Section 162(m) limitations did not apply to certain individuals (including chief financial officers and/or former executive officers) or to certain “qualified performance-based compensation.” The Tax Cuts and Jobs Act of 2017 modified Section 162(m) to expand the scope of “publicly held corporations” and “covered employees” subject to the limitation on deductibility of compensation over \$1 million, and to eliminate the exception to non-deductibility under Section 162(m) for qualified performance-based compensation. While those changes were effective for tax years after 2017, certain binding contracts in effect on November 2, 2017 were eligible for grandfathered relief if not materially modified on or after that date. On August 22, 2018, the IRS released guidance under Notice 2018-68 clarifying the broadened application of Section 162(m) to current and former executive officers as well as significantly narrowing the availability of transition relief for grandfathered arrangements.

Notably, neither the Tax Cuts and Jobs Act, nor Notice 2018-68, addressed pre-existing transition relief from non-deductibility under Section 162(m) for certain newly public corporations. Under such transition relief, compensation paid (and, in certain limited cases, equity-linked compensation granted) during a limited period following a corporation’s initial public offering pursuant to a plan or agreement that exists prior to and is disclosed in connection with the corporation becoming public, is not subject to the \$1 million annual deduction limitation of Section 162(m). In bar conferences and other public events, Treasury officials informally have confirmed that, unless and until further guidance is issued (or new legislation is enacted), the transition relief continues to be available for new publicly held corporations on the same basis as before the Tax Cuts and Jobs Act.

It is possible (if not *probable*) that in future guidance or rulemaking, the IRS (and/or Congress) could propose to limit or eliminate the existing IPO relief on a go-forward basis. Any such limitation or phase-out of the existing transition relief in the future could make compensation during the critical early years following a company’s initial public offering significantly more expensive than under current rules. As a result, fund sponsors and private companies considering a public offering in the future should continue to monitor guidance from the IRS and Treasury on Code Section 162(m), and take into account not only the disclosure implications in respect of their executive compensation arrangements under SEC and stock exchange rules, but also the potential economic impact of non-deductibility of compensation to its executive officers following a public offering.

## **Section 83(i) – IRS Provides Company Opt-Out from Private Company Deferral Stock Rules**

The Tax Cuts and Jobs Act also added Section 83(i) to the Internal Revenue Code, enabling certain employees of certain privately-held corporations to elect to defer taxes upon exercise of

stock option and settlement of restricted stock units for up to five years by making a special tax election within 30 days after the underlying stock is first vested and/or transferrable (generally upon receipt of shares following option exercise or restricted stock unit (RSU) settlement, as the case may be). In addition to not being publicly-traded, “eligible corporations” to which Section 83(i) applies must have a written plan under which at least 80% of employees are granted options, or RSUs, with the same rights and privileges to receive “qualified stock.” Under Section 83(i), eligible corporations are required to provide employees with certain certifications and notices in respect of qualified stock, the failure of which would trigger penalties of \$100 per occurrence, up to \$50,000 per year.

In late 2018, the IRS issued Notice 2018-97 that provided clarifications to the statutory text of Section 83(i), and introduced an important new requirement under Section 83(i) that gives companies flexibility to avoid Section 83(i) altogether. In order to facilitate and ensure consistent tax withholding in connection with 83(i) elections, the new requirement compels employees making an 83(i) election to deposit the deferral stock in an escrow arrangement with the corporation until the end of the applicable deferral period. In doing so, the Treasury Department and IRS expressly acknowledged that private corporations can effectively opt out of allowing employee Section 83(i) elections simply by declining to establish such an escrow arrangement.

## **Insurance**

During 2019, Proskauer continued to work with a wide variety of private investment funds of all types and sizes on insurance matters. This included representing fund clients in reviewing and negotiating their insurance programs, as well as recovering on their insurance claims through mediations, arbitrations and litigations. Below are a few of the key trends we saw in 2019 along with our thoughts on where we see things headed in 2020.

### **Contentious Coverage Environment**

During 2019, insurers in the fund space have taken aggressive positions in seeking to deny coverage, and we have represented a number of fund clients in coverage disputes with their insurers. We have seen insurers attempt to deny coverage on numerous grounds in the past year, including based on policy definitions, policy exclusions, consent and cooperation requirements and public policy arguments. The aggressive positions taken by insurers in denying coverage continues to reinforce the importance of carefully reviewing policies at the outset and negotiating for policy language as favorable as can reasonably be obtained.

### **Ability to Obtain Significant Coverage Enhancements**

It has been an interesting year from an insurer underwriting standpoint in the fund space. On one hand, the market has “hardened” to some extent in that many insurers have become less aggressive in negotiating premiums, leading to many clients experiencing little or no decrease (or sometimes an increase) in their premiums. However, despite underwriters being less aggressive on price competition over the past year, we have continued to see insurers in this space compete aggressively on what coverage terms they are willing to offer. Those clients that have shopped for the best coverage possible and negotiated with their insurers have often been able to improve

their coverage materially, thus reducing their insurers' ability to deny coverage in the current, contentious coverage environment. The next several trends below are some of the areas we have seen clients focus most heavily on in seeking to enhance their coverage.

### **Protection against Cyber Risks**

Although many funds still do not purchase any cyber insurance coverage, we have seen an increased interest in buying (or at least exploring) such insurance as the focus on cyber risks in the fund space continue to grow. During 2019, in an effort to attract additional business, certain insurers have made efforts to broaden their cyber policies (or cyber endorsements to their crime policies or bonds) to address key cyber risks, such as social engineering, fraudulent funds transfers, computer fraud, ransomware, direct and contingent business interruption and business losses from declines in management fees due to cyber events and resulting reputational harm. We expect the cyber insurance market to continue to mature and evolve significantly in 2020. Because of the developing market, it is particularly important to carefully review and negotiate cyber policies to ensure that they are providing the desired protection. This will be an area of intense focus for Proskauer in 2020.

### **Focus on Protecting Individuals – Including When Serving in Outside Capacities**

We have continued to see an increased focus on protecting individuals, as fund managers 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 and in serving in outside capacities (such as serving as directors for portfolio companies). This focus on individual protection has included review and negotiation of fund policies for protection of individuals in their respective capacities; review and negotiation of portfolio company policies; and an increased emphasis on obtaining dedicated insurance limits for individuals (called “Side A” policies”) or for independent directors (called “IDL” policies) and negotiating enhancements to such policies. We expect this trend of increased focus on individual protection to continue in 2020.

### **Attention to Protecting against Risks Arising from Portfolio Companies**

Private equity firms continue to face growing risks of lawsuits against firm individuals who serve as directors of portfolio companies, as well as against the sponsor private equity firm itself. Activist hedge funds face similar risks as well. In light of these risks, we have seen a growing sensitivity from private equity firms and activist hedge funds to the need for coordination of indemnification and insurance coverage at the fund level and portfolio company level. Attention to capacity exclusions, allocation provisions, and outside capacity coverage agreements is critical at this time. Careful review, negotiation and coordination of both sets of policies can help protect against the risks arising from portfolio companies to funds and individuals.

### **Attention to Coverage for Government Investigations**

The risk of SEC and other government investigations continues to be a key concern for funds. Although many insurers' standard forms provide only limited coverage for investigations – as coverage is not triggered until late in the investigation (after significant costs had already been incurred) – if the policies are negotiated, most insurers will agree to provide coverage for the

costs of defending government investigations from the earliest stages. Given the wide availability and critical importance of this broad coverage, it is a significant missed opportunity for a fund manager not to seek and obtain such enhanced coverage.

### **Attention to Costs of Correction Coverage**

This important coverage, which is usually included as an endorsement to a fund's D&O/E&O policies, provides coverage for the costs of correcting trade errors and other similar events before the customer brings a claim related to that error. Such coverage is valuable, because it allows the fund to make its customer whole without the need for litigation and before the fund's relationships or reputation have suffered significant damage. While this coverage has historically included relatively stringent requirements for being triggered, such as providing almost immediate notice to the insurer, we have seen some insurers begin to relax those requirements in the past year through negotiated enhancements.

### **Looking Ahead to 2020**

We expect that the challenging claim environment will continue into 2020, so we anticipate that there will be a number of new claim disputes in the funds space next year. Thus, it will remain critical for fund clients to take advantage of the opportunity to negotiate for strong coverage when purchasing or renewing coverage – both to minimize the chance of claims disputes and put themselves in a position of strength if a claim dispute does arise. Cyber and privacy risks should receive increased attention in 2020. We expect to see a particular focus from fund clients on attempting to secure strong coverage with respect to the key trends discussed in this summary as well as in other areas.

## **Reorganization and Chapter 11**

Over the past year, important decisions have been rendered by federal courts (i) expanding on the U.S. Supreme Court's decision regarding whether section 546(e) of the Bankruptcy Code can shield transfers made through financial institutions acting merely as "conduits" from attack as fraudulent transfers, and (ii) foreclosing debtor-licensors from terminating a trademark licensee's rights to use a trademark through rejection in bankruptcy.

### **Termination of Trademark Licensee Rights through Rejection in Bankruptcy**

Bankruptcy Code section 365(a) provides a debtor the right to reject executory contracts—*i.e.*, contracts where both parties have performance obligations remaining. Pursuant to Bankruptcy Code section 365(g), such rejection amounts to a breach of the contract. To avoid the claim from being viewed as occurring after the bankruptcy filing, section 365(g) provides the breach is deemed to occur immediately before the filing of the debtor's bankruptcy petition.

A licensee of patents or copyrights whose license is rejected may either treat the license as terminated and assert a claim for damages, or retain its intellectual property rights under the license pursuant to Bankruptcy Code Section 365(n). Section 365(n) refers to the Bankruptcy Code's definition of "Intellectual Property" which includes patents and copyrights but does not include trademarks. The legislative history of section 365(n) suggests that Congress intentionally

excluded trademarks from the definition because of the special concerns relating to trademark licensing, and expressly left that issue to the courts to decide. See S. Rep. No. 100-505, at 5, 7 (1998) (since issues relating to trademark licensing could not be addressed without more extensive study, it was determined to postpone congressional action in this area and to allow the development of equitable treatment of this situation by bankruptcy courts).

The question is whether a debtor-licensor's rejection of an executory contract deprives the trademark licensee the right to use such mark. One view adopted by the Seventh Circuit is that rejection has the effect of a breach of contract outside of bankruptcy—the contract counterparty may assert a claim for damages under the contract, but all contract rights of the counterparty remain unaffected. The First Circuit, however, had adopted the view that rejection has the same effect as contract rescission outside of bankruptcy—the contract counterparty may assert a claim for damages under the contract, but the contract is terminated. On May 20, 2019, the U.S. Supreme Court resolved this circuit split.

### *The Mission Product Holdings Decision*

The U.S. Supreme Court sided with the Seventh Circuit view in *Mission Product Holdings, Inc. v. Tempnology, LLC*, 139 S. Ct. 1652 (2019), and held that a debtor-licensor's rejection of an executory trademark license does not terminate the rights of the non-debtor licensee that would survive the licensor's breach under applicable non-bankruptcy law—including the continued use of the trademark.

The rationale is that the rejection of an executory contract is a court-authorized breach, which may give rise to a damage claim against the debtor, but does not put the parties back in the positions they had before entering into the contract, which rescission would do. This position is consistent with the general bankruptcy principle that a debtor cannot possess anything more than it had outside bankruptcy. Notably, the debtor's rejection does allow the debtor-licensor to stop providing any services the licensee may have required such as quality control or maintaining a certain image of the trademark.

In reaching its conclusion, the majority opinion focused on the general rules of rejection in Bankruptcy Code sections 365(a) and (g), and on the effect rejection has on *all* executory contracts—not just trademark licenses. That the specific provisions in section 365(n) do not include trademarks does not change the general rule that rejection of an executory contract does not rescind the rights the contract previously granted. Justice Sotomayor's concurrence highlighted the fact that the decision did not mean every trademark licensee would have rights to continue using licensed marks post-rejection. The inquiry remains whether the licensee's rights to use the trademark for the duration of the license would survive a breach under applicable non-bankruptcy law, taking into account all applicable special terms of licensing agreements or state law.

### *Implications of the Mission Product Holdings Decision*

Naturally, intellectual property licensing is a key part of many commercial arrangements. This decision sheds light on an aspect of that practice which, when disputed, was subject to different

analyses depending on the jurisdiction of the dispute. When negotiating intellectual property licenses, parties should keep this decision, the entire set of jurisprudence around section 365(n), and applicable state law regarding breach of contract in mind in order to ensure the desired outcome in the event of a bankruptcy of the licensor in the future.

### **Merit Management Revisited: 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.

Last year, the U.S. Supreme court held in *Merit Management Group, LP v. FTI Consulting, Inc.*, 583 U.S. \_\_\_\_ (2018) that the securities safe harbor under Bankruptcy Code section 546(e) does not automatically benefit transferees where an intermediary entity is a financial institution. In doing so, the Supreme Court significantly limited the Bankruptcy Code’s protection of many transactions from fraudulent transfer risk. The Court, however, left open the question of whether a debtor’s or transferee’s status as a “financial institution” under the Bankruptcy Code would change the analysis.

#### *The Tribune Decision*

The U.S. District Court for the Southern District of New York took up this open question in *In re Tribune Co. Fraudulent Conveyance Litigation*, 2019 U.S. Dist. LEXIS 69081 (Apr. 23, 2019). In a two-step leveraged buyout, the Tribune Company (“Tribune”) purchased all of its outstanding stock from its shareholders for approximately \$8 billion. In step one, the Computershare Trust Company (“CTC”) acted as “Depositary.” Tribune transmitted to CTC cash required to repurchase its outstanding shares through a tender offer, and CTC accepted and held tendered shares on Tribune’s behalf. CTC paid out the tender price of \$34 per share to tendering shareholders. The tender offer was oversubscribed in step one, and in step two, CTC acted as “Exchange Agent” for the repurchase of any remaining shares. Soon after the leveraged buyout, Tribune filed for chapter 11 bankruptcy.

Following the confirmation of Tribune’s chapter 11 plan, certain causes of action against Tribune’s directors, officers, shareholders, and financial advisors to claw back funds transferred during the leveraged buyout were transferred to a litigation trust. The litigation trustee sought to amend an existing complaint against shareholders to assert claims for constructive fraudulent conveyance—that Tribune received less than reasonable value in the LBO transaction—under Bankruptcy Code section 548(a)(1)(B).

The District Court denied the litigation trustee’s motion to amend, reasoning that, among other things, the amendment would be futile because Section 546(e)’s safe harbor provision barred the proposed fraudulent conveyance claims against Tribune’s shareholders, notwithstanding the Supreme Court’s decision in *Merit Management*. In particular, the Bankruptcy Code defines a “financial institution” to include customers of traditional financial institutions under certain circumstances: “. . . an entity that is a . . . trust company . . . and, when any such . . . entity is acting as agent or custodian for a customer (whether or not a ‘customer’, as defined in section 741) in connection with a securities contract (as defined in section 741) such customer . . .” 11 U.S.C. § 101(22)(A). The District Court found CTC was both a “bank” and a “trust company,” and Tribune was CTC’s customer in connection with the leveraged buyout. While “customer” is not defined in the Bankruptcy Code, the District Court relied on the ordinary usage of the term as “a buyer or purchaser of goods or services,” and noted that Tribune engaged in CTC’s services as depositary in exchange for a fee.

Furthermore, CTC acted as Tribune’s agent because CTC was entrusted with Tribune’s cash and making payment on Tribune’s behalf as depositary and exchange agent, which is typical of a principal-agent relationship. Accordingly, the District Court held that Tribune qualified as a “financial institution” in the leveraged buyout transaction and subject to Section 546(e) safe harbor provision.

### *Implications of the Tribune Decision*

While the Supreme Court’s decision in *Merit Management* disrupted the existing securities safe harbor that protected many transactions from fraudulent transfer risk, *Tribune* revives the application of such protection through the definition of “financial institution.” It is yet to be seen whether other jurisdictions will apply the same analysis in *Tribune*, and the decision invites more litigation surrounding the definition of “financial institution” in applying Section 546(e)’s safe harbor provision.

## **Review of Marketing Materials – Key SEC Considerations**

The SEC regulates the advertising practices of investment advisers, primarily under Section 206 of the Advisers Act, which prohibits false and misleading statements to clients and prospective clients.<sup>5</sup> Rule 206(4)-1, the SEC’s advertising rule, was adopted in 1962. Over the years, the SEC and its staff have provided guidelines with respect to adviser advertising through no-action letters, interpretive releases, risk alerts and other forms of informal guidance, as well as deficiencies noted during examinations and statements made in releases announcing settled enforcement actions.

As discussed above, on November 4, 2019, the SEC announced that it has voted to [propose amendments](#) to modernize the rules under the Advisers Act addressing investment adviser advertisements and payments to solicitors. While it is uncertain what form any changes to the

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<sup>5</sup> This discussion explores the SEC’s regulation of investment adviser advertising practices and does not address other regulatory regimes (such as CFTC, FINRA or FTC rules or regulations).

rules may take, it is likely that the revisions will result in the most significant amendments to the SEC's advertising rule since its adoption nearly 60 years ago.

In the interim, the purpose of this discussion is to provide a brief synthesis of the existing key SEC guidance in this area and to serve as a useful tool for conducting legal and compliance reviews of investment adviser marketing materials (including identifying relevant legal and regulatory precedents).

### **Rule 206(4)-1 – The “Advertising Rule”**

Rule 206(4)-1 of the Advisers Act (the “Rule”) prohibits registered investment advisers from using any advertisement that “contains any untrue statement of material fact or is otherwise misleading.”<sup>6</sup> The SEC defines “advertisements” generally as communications made to more than one prospective or existing client that offers any of the following with regard to securities: (i) any analysis, report, or publication regarding securities; (ii) any graph, chart, formula or other device for making securities decisions; or (iii) any other investment advisory services regarding securities.<sup>7</sup> In the SEC staff's view, this broad definition encompasses communications that have the purpose of inducing clients to enter into or renew their advisory contracts or subscriptions.<sup>8</sup>

Whether a communication constitutes an advertisement is highly dependent on all the relevant facts and circumstances. Communications tailored to meet individual client needs or requests, such as a statement containing account information for a single client or a response to an unsolicited inquiry, have been viewed as not falling under the definition of “advertisements.” Moreover, the SEC has stated that it does not view prospectuses and sales material soliciting investors for a registered mutual fund to be advertisements, if the materials are designed to solicit new investors or maintain existing investors in the fund rather than new or existing clients of the adviser.<sup>9</sup> Though oral communication (other than by radio or television) is not specifically covered, the use of internet (including social media) postings implicate the Rule.<sup>10</sup>

### **False and Misleading Statements**

An advertisement may be considered false or misleading if it implies, or would lead a prospective client to infer, that something about the investment adviser or its clients' experiences is not true, and the prospective client would not have made such inference had all material facts been disclosed.<sup>11</sup> Common SEC actions enforcing the Rule against advisers involve overstating the performance of accounts,<sup>12</sup> inflating the number of clients or amount of assets under

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<sup>6</sup> Rule 206(4)-1(a)(5).

<sup>7</sup> Rule 206(4)-1(b).

<sup>8</sup> *Spear & Staff, Inc.*, Advisers Act Rel. No. 188 (Mar. 25, 1965).

<sup>9</sup> See *Investment Adviser Use of Social Media*, National Examination Risk Alert, Vol. II, Issue 1 (Jan. 4, 2012); See also *Navigator Money Mgmt., Inc.*, Advisers Act Rel. No. 3767 (Jan. 30, 2014).

<sup>10</sup> *Id.*

<sup>11</sup> *New York Investors Group, Inc.*, SEC Staff No-Action Letter (Sept. 7, 1982); See also *Spear & Staff, Inc.*, *supra* note 4.

<sup>12</sup> See e.g., *Schild Mgmt. Co.*, Advisers Act Rel. No. 1872 (May 31, 2000).

management,<sup>13</sup> and exaggerating the qualifications or accomplishments of the advisers' principals.<sup>14</sup>

The use of "superlative" language in marketing materials is a common issue the SEC tends to raise during examinations. The use of such language can be particularly problematic where an adviser claims it is the "best" in a certain field, if the adviser does not have a reasonable basis for making such a claim. Even describing a strategy as "proven" can be viewed as an assurance that the strategy will continue to produce positive returns in the future.<sup>15</sup>

In addition, the Rule contains several specific restrictions which illustrate the activity it prohibits. Advertisements may not represent that any graph, chart, or formula can be used to determine which securities to buy or sell,<sup>16</sup> or refer to any report, analysis or service as "free," unless it actually is free.<sup>17</sup> Other restrictions are discussed below.

### *Testimonials*

An advertisement may not, directly or indirectly, use or refer to any testimonial concerning the adviser or any of its services.<sup>18</sup> Testimonials include any "statement of a client's experience with, or endorsement of, an adviser."<sup>19</sup> The SEC believes testimonials inherently emphasize favorable comments and activities, while ignoring those which are unfavorable.<sup>20</sup>

Over the years, the SEC has scaled back the broad prohibition on the use of testimonials through a number of exceptions. These include: (i) reprints of articles if published by "unbiased third parties," so long as they do not include a statement of a client's experiences or endorsement;<sup>21</sup> (ii) third party ratings and rankings if conditions are met suggesting that their compilation and presentation are unbiased;<sup>22</sup> (iii) complete or partial lists of clients, so long as there is no accompanying client commentary;<sup>23</sup> and (iv) public commentary on independent websites, such as social media, where the adviser has no ability to affect the commentary and the website publishes all comments unedited.<sup>24</sup>

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<sup>13</sup> See *SEC v. Locke Capital Mgmt.*, 794 F. Supp. 2d 355, 367; *Warwick Capital Mgmt., Inc.*, Advisers Act Rel. No. 2694 (Jan. 16, 2008).

<sup>14</sup> See e.g., *Source Financial Advisors, LLC*, Advisers Act Rel. No. 4702 (May 5, 2017); *FreedomTree Mutual Funds et al.*, Advisers Act Rel. No. 3095 (Sept. 30, 2010).

<sup>15</sup> Pitaro, Vincent, *Lessons on Adviser Marketing From Recent Examinations and Enforcement Proceedings*, Hedge Fund Law Report (Mar. 28, 2019).

<sup>16</sup> Rule 206(4)-1(a)(3). See *Hanes Morgan & Co., Inc. et al.*, Advisers Act Rel. No. 3326 (Nov. 29, 2011).

<sup>17</sup> Rule 206(4)-1(a)(4). See *Marketlines, Inc.*, Advisers Act Rel. No. 206 (Jan. 20, 1967) (SEC Opinion).

<sup>18</sup> Rule 206(4)-1(a)(1).

<sup>19</sup> *Cambiar Investors, Inc.*, SEC Staff No-Action Letter (Aug. 28, 1997).

<sup>20</sup> Advisers Act Rel. No. 121 (Nov. 2, 1961).

<sup>21</sup> *Stalker Advisory Services*, SEC Staff No-Action Letter (Jan. 18, 1994); See also *Patricia Owen-Michel*, Advisers Act Rel. No. 1584 (Sept. 27, 1996).

<sup>22</sup> *DALBAR, Inc.*, SEC Staff No-Action Letter (Mar. 24, 1998); See also *Investment Adviser Ass'n.*, SEC Staff No-Action Letter (Dec. 2, 2005).

<sup>23</sup> *Denver Investment Advisors, Inc.*, SEC Staff No-Action Letter (July 30, 1993) (full list); *Cambiar Investors, Inc.*, *supra* note 15 309 (partial list).

<sup>24</sup> IM Guidance Update No. 2014-4 (Mar. 2014).

Recently, an SEC settlement order found that an investment adviser used its Twitter feed to “retweet” certain positive posts from employees, investors and clients who received free services from the adviser, but failed to disclose the financial benefit they received from making those positive statements.<sup>25</sup> In another settlement order involving testimonials, an investment adviser had engaged a local radio station to air advertisements, when one of the station’s hosts, unprompted, began discussing his own positive experiences with the firm live on the air. The SEC asserted the adviser failed to tell the host not to provide testimonials and failed to monitor the host’s presentations and maintain control over the advertisements as the station continued to air the host’s recorded testimonials.<sup>26</sup>

### *Past Specific Recommendations*

An advertisement may not refer to past specific recommendations that were or would have been profitable by the adviser, unless the advertisement sets out a list of *all* recommendations made by the adviser during the preceding year.<sup>27</sup> The primary concern is that an adviser could “cherry pick” its profitable investments while ignoring those that were unprofitable.<sup>28</sup>

The SEC staff has permitted some exceptions to the cherry picking rule. Reports to existing clients are not viewed as “advertisements” merely because they refer to past specific recommendations, unless the context in which the past specific recommendations are presented suggests otherwise.<sup>29</sup> Moreover, responses to unsolicited requests for information,<sup>30</sup> presentation of past specific recommendations based on “objective, non-performance based criteria,”<sup>31</sup> and lists showing the relative contribution to performance of certain securities in advertisements (e.g., “best and worst performers”)<sup>32</sup> have all been permitted.

Advisers attempting to navigate the cherry-picking rule are encouraged to review the no-action letters addressing the rule in greater detail but should not rely on being able to cite a no-action letter as a defense to an enforcement action.

### **Performance Advertising**

Advertisements containing performance information are considered to be misleading if they imply something about an adviser’s competence or potential future investments that an investor could reasonably expect to be unwarranted had all facts been presented.<sup>33</sup> The adequacy of the

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<sup>25</sup> See *Wealthfront Advisers, LLC*, Advisers Act Rel. No. 5086 (Dec. 21, 2018).

<sup>26</sup> See *Creative Planning, Inc.*, Advisers Act Rel. No. 5035 (Sept. 18, 2018).

<sup>27</sup> Rule 206(4)-1(a)(2).

<sup>28</sup> See *Dow Theory Forecasts, Inc.*, SEC Staff No-Action Letter (Aug. 26, 1983); *Starr and Kuehl, Inc.*, SEC Staff No-Action Letter (Apr. 17, 1976).

<sup>29</sup> *Investment Counsel Ass’n. of America*, SEC Staff No-Action Letter (Mar. 1, 2004).

<sup>30</sup> *Id.*

<sup>31</sup> See *Franklin Mgmt., Inc.*, SEC Staff No-Action Letter (Dec. 10, 1998) (permitting presentation of past specific recommendations chosen based on “objective, non-performance based criteria,” so long as the materials do not include performance information that allows an investor to “back into” the investment’s performance).

<sup>32</sup> See *The TCW Group, Inc.*, SEC Staff No-Action Letter (Nov. 7, 2008) (providing that an adviser may present its top five (or more) best performing investments so long as it also presents an equal number of its worst performing investments with equal prominence).

<sup>33</sup> *Edward F. O’Keefe*, SEC Staff No-Action Letter (Apr. 13, 1978); *Anametrics Investment Mgmt.*, SEC Staff No-Action Letter (May 5, 1977).

disclosure accompanying performance data is critical. Advisers registered with the SEC are required to maintain all working papers and records “necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities recommendations.”<sup>34</sup> Generally, records must have been made contemporaneously with the recommendations made, but records published or generated subsequently may be used so long as such records were accumulated contemporaneously.<sup>35</sup> The retention of third-party records could also satisfy the rule, even though the rule anticipates the adviser’s own records would be used to substantiate its performance.<sup>36</sup>

### *Actual Performance of Accounts*

When an adviser has actual performance to rely on, it should use actual performance in its marketing materials. Actual performance must be presented net of expenses, including advisory fees, brokerage and any other fee a client would have paid or actually paid.<sup>37</sup> SEC staff may scrutinize fund-level returns where a significant portion of the investors have preferential fee arrangements in place, out of a concern that the returns may appear to be higher than what those who will not be subject to such preferential arrangements should expect. Advisers are permitted to present performance results reflecting both gross and net of fees, if presented with equal prominence.<sup>38</sup>

When account performance is compared to an index of securities, the index must reflect reinvestment of dividends or adequately disclose the effect of failing to do so.<sup>39</sup> Advertisements should disclose the effect of any material market conditions on performance<sup>40</sup> as well as any investment strategy that may have been utilized to generate returns that are unlikely to be replicated in the future.<sup>41</sup>

The Global Investment Performance Standards (“GIPS”) are published by the CFA Institute. Even if performance data is otherwise accurate, any false claims of compliance with the voluntary GIPS standards and principles are considered violations of the Rule.<sup>42</sup>

### *Model Performance*

Performance results of a model portfolio may be advertised where advice was historically given, but actual trading never occurred. This, however, is subject to the requirement that fees and expenses are reflected and that appropriate disclosure of all assumptions is made.<sup>43</sup>

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<sup>34</sup> Rule 204-2(a)(16).

<sup>35</sup> Advisers Act Rel. No. 1135 (Aug. 17, 1988).

<sup>36</sup> *Jennison Associates LLC*, SEC Staff No-Action Letter (July 6, 2000); *Salomon Brothers Asset Mgmt.*, SEC Staff No-Action Letter (July 23, 1999).

<sup>37</sup> *Clover Capital Mgmt., Inc.*, SEC Staff No-Action Letter (Oct. 28, 1986).

<sup>38</sup> *Ass’n. for Investment Mgmt. Research*, SEC Staff No-Action Letter (Dec. 18, 1996).

<sup>39</sup> *See Trust & Investment Advisors, Inc., et al.*, Advisers Act Rel. No. 4087 (May 18, 2015); *Seaboard Investment Advisors, Inc.*, Advisers Act Rel. No. 1918 (Jan. 10, 2001).

<sup>40</sup> *Clover Capital Mgmt., Inc.*, *supra* note 33.

<sup>41</sup> *Nevis Capital Mgmt., LLC*, Advisers Act Rel. No. 2214 (Feb. 9, 2004).

<sup>42</sup> *Riggs Investment Mgmt. Corp. v. Columbia Partners, LLC*, 966 F. Supp. 1250, 1268 (D.D.C. 1997).

<sup>43</sup> *See Modern Portfolio Mgmt., Inc.*, Advisers Act Rel. No. 3702 (Oct. 23, 2013).

## *Back-Tested Performance*

Although no definition of “back-testing” has been codified, the practice is generally viewed as applying an investment strategy retroactively to historical market data. Back-testing attempts to demonstrate the outcome of investment decisions that would have occurred had a later-developed strategy been followed. Because the strategy has the benefit of hindsight, back-testing is viewed highly skeptically by SEC staff.<sup>44</sup> The SEC has yet to provide any meaningful guidance that could shape how advisers might develop and advertise back-tested performance, but has brought a number of enforcement actions against advisers that range from failure to disclose performance was back-tested<sup>45</sup> to failure to disclose the limitations or aspects of back-tested performance.<sup>46</sup>

In *Raymond J. Lucia Company, Ltd. v. SEC*, a federal appeals court upheld an SEC opinion finding that an adviser violated Section 206 of the Advisers Act where the adviser failed to apply its own strategy and assumptions when back-testing performance, was unable to replicate the back-tested reports, and could not provide support for its results.<sup>47</sup> The court affirmed that a generalized disclaimer that back-tested performance contained some hypothetical assumptions could not cure the misleading “overall impression” of an advertisement.

In August 2018, the SEC fined an investment adviser \$1.9 million for making material misstatements about hypothetical returns. In 2001, the adviser had introduced a research strategy that it claimed would outperform a portfolio based on buy ratings from quantitative models or analyst ratings. The adviser relied on marketing charts that showed since 1995, the strategy outperformed each of the other two. The SEC settlement order asserted, among other claims: (i) the adviser falsely claimed its quantitative research dated back to the “mid-90s,” despite not creating the model until 2000; and (ii) the adviser labeled the charts “hypothetical” but did not disclose that certain results were also back-tested.<sup>48</sup>

In another enforcement proceeding from 2018, the SEC fined an adviser \$175,000 for alleged misstatements and inaccurate disclosures. The adviser followed a rule-based investment approach and hired a third-party index to back-test its performance. Some of the third-party’s calculations, however, were incorrect and occasionally did not follow the adviser’s strategy. The SEC settlement order suggested that there were enough miscalculations that the adviser should have caught the mistakes made.<sup>49</sup>

## *Portability of Performance*

Advisers sometimes wish to market performance of accounts managed by a predecessor adviser or portfolio managers as their own while employed by different firms. So long as the adviser using the predecessor’s performance has access to records substantiating the performance, the SEC has taken the view that use of such performance is not, in and of itself, misleading provided

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<sup>44</sup> See, e.g., *Arlington Capital Mgmt., Inc.*, Advisers Act Rel. No. 4885 (Apr. 6, 2018).

<sup>45</sup> See *F-Squared, Inc., et al.*, Advisers Act Rel. No. 3988 (Dec. 22, 2014).

<sup>46</sup> *William J. Ferry*, Advisers Act Rel. No. 1747 (Aug. 19, 1998).

<sup>47</sup> *Raymond J. Lucia Cos. v. SEC*, 832 F.3d 277 (D.C. Cir. 2016), *rev’d on other grounds sub nom., Lucia v. SEC*, 138 S.Ct. 2044 (2018).

<sup>48</sup> *Massachusetts Financial Services Company*, Advisers Act Rel. No. 4999 (Aug. 31, 2018).

<sup>49</sup> *Sterling Global Strategies LLC*, Advisers Act Rel. No. 5085 (Dec. 20, 2018).

that: (i) the person(s) who managed the accounts at the successor adviser were primarily responsible for the prior performance results; (ii) the accounts at the predecessor adviser are similar to those under management at the successor adviser; (iii) all accounts managed that were managed in a substantially similar manner are advertised, unless the exclusion of such account would not result in a materially higher performance; (iv) the advertisement is consistent with staff interpretations with respect to advertising performance results; and (v) the advertisement includes all relevant disclosures.<sup>50</sup>

## Potential Amendments to the Rule

Amending the Rule has been on the SEC's agenda for quite some time. The SEC staff has discussed the idea of creating a "bifurcated rule" to establish different approaches for advertisements geared toward retail versus those geared toward institutional investors. This is premised on the idea that professional investors should be able to understand marketing materials at a higher level. Crafting a clear definition for "sophisticated investors," however, remains a challenge to this approach. Moreover, any changes the SEC makes to the Rule must take into account the rapidly evolving technology for marketing, which may require changes that are more "general and thematic." The rise of unconventional marketing techniques, the role of social media and "influencers," and a host of other trends make any potential amendments to the Rule challenging.<sup>51</sup> While there is no clear timeline for amendment of the Rule or its implementation, the consensus remains that changes must be made.

## European Union

### Brexit: Uncertainty Remains

In 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 were expected to be agreed. Whilst it was anticipated that the UK would leave the EU on 29 March 2019, this date has since been extended twice with the current date upon which the UK is due to exit the EU being 31 January 2020. It is possible that this may yet further be extended depending on what is agreed between the UK and the EU in future.

In the latest version of the withdrawal agreement, the UK and the EU had built in a transitional period, under which it was 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, albeit the uncertainty surrounding the position post-31 December 2020 would still be disruptive to the UK and the EU respectively.

If there is no withdrawal agreement agreed by 31 January 2020 and there is no extension of the UK's membership of the EU agreed, then the UK would leave the EU on a no-deal or 'hard

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<sup>50</sup> *Horizon Asset Mgmt. LLC*, SEC Staff No-Action Letter (Sept. 13, 1996).

<sup>51</sup> Marlow, Charlie, *Is the Advertising Rule Obsolete? (Part Two of Two)*, Hedge Fund Law Report (Sept. 5, 2019).

Brexit’ basis. This would have an impact on UK fund managers and financial services firms which currently benefit from the financial services “passport” as detailed below. A ‘hard Brexit’ outcome would not impact US fund managers in the same way as they do not have access to such “passports” and so would need to continue to market their funds *via* the national private placement regime (NPPR) of the relevant countries, where it is feasible to do so.

### ***Brexit - 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, whether through the provision of services or the establishment of a branch in other EU Member States. After the UK has left the EU, and subject to any transitional period being agreed, the UK will become a “third country” (*i.e.*, a non-EU 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 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 looks unlikely based on current negotiating positions of the EU and UK respectively.

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 any proposed transitional period is implemented.

### ***Extension of the Senior Managers and Certification Regime for UK Firms***

In the UK, the Senior Managers and Certification Regime (SMCR) will be extended to all firms authorised by the Financial Conduct Authority (FCA) from 9 December 2019.

The SMCR will replace the current Financial Conduct Authority (FCA) Approved Person Regime for practically all FCA authorised firms, including UK AIFMs, placement agents and investment advisers. The purpose of the extension of the regime is to strengthen individual accountability within FCA-authorised firms in the UK. The FCA’s view is that the introduction of the SMCR to all FCA-authorised firms will support its aim to reduce harm to consumers and strengthen market integrity by ensuring that key personnel are held to account for what they do.

SMCR will impose requirements and regulatory obligations (to varying degrees) on senior managers, individuals carrying on significant functions and general staff members working for

authorised firms. The level of requirements that will apply to a particular firm will depend on whether the firm is classified as an “enhanced firm”, “core firm” or a “limited firm”. The majority of FCA-authorised firms, including most UK AIFMs, would fall within the “core firm” category and will therefore be subject to the “core” SMCR requirements being the senior managers’ regime, the certification regime and conduct rules.

FCA authorised firms established in the UK will need to be compliant with SMCR from 9th December 2019. SMCR is not applicable to non-UK firms (e.g., U.S. fund managers marketing in the UK).

For further details on the SMCR regime, please refer to our client alert on this subject, [here](#).

### *Changes to Rules Relating to the Pre-Marketing of Funds in 2021*

In June 2019, the EU published the legislative package (being made up of Directive (EU) 2019/1160<sup>52</sup> and Regulation (EU) 2019/1156<sup>53</sup>) aimed at reducing the regulatory barriers for the cross-border distribution of funds in the EU (the “CBDF Package”). Specifically the CBDF Package is designed to address certain issues in the AIFMD and UCITS Directive relating to the marketing of funds under the AIFMD or UCITS marketing passports. EU Member States are required to implement the CBDF Package into their national law by 2 August 2021.

Under the CBDF Package, there is to be a harmonised definition of “pre-marketing” of funds. At the moment, the interlinked concepts of “pre-marketing” and “marketing” are interpreted differently by Member States. Some EU Member States, in particular, take a more restrictive view as to what activities can be carried on as “pre-marketing”, e.g. only allowing for high level discussions about the fund manager and its track record, with no reference of the oncoming fund to be raised. Should a fund manager or its agents seek to provide more information on the fund to investors in such EU Member States then approval for the marketing of the fund must be obtained from that Member State’s regulator. In other EU Member States, there is currently a wide interpretation of pre-marketing which allows for a significant amount of fund specific information and documentation to be provided to a potential investor ahead of needing marketing approval.

The new ‘pre-marketing’ definition in the CBDF Package applies a wide interpretation to the concept and would allow for fund specific information, including draft PPMs or offering documents, to be provided to potential investors and for this to still fall within the scope of pre-marketing. Pre-marketing activity will not need to be notified to EU Member State regulators in advance, but fund managers will need to send a letter to their local home state regulator within two weeks of beginning their pre-marketing. This letter will need to specify where and for which periods the pre-marketing is taking or has taken place, with a brief description of the pre-marketing (including information on the investment strategies presented and the AIF(s) covered).

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<sup>52</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019L1160&from=EN>

<sup>53</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R1156&from=EN>

It remains to be seen how the requirement to provide this pre-marketing letter will work in practice.

Under the CBDF Package there is also a requirement for any third party carrying out pre-marketing on behalf of a fund manager to be authorised as an investment firm under MiFID, a credit institution, a UCITS management company or an AIFM under AIFMD, or act as a tied agent in accordance with MiFID. In addition, the agent will be directly subject to the pre-marketing rules in the CBDF Package. Placement agents and fund distributors will need to make sure that they are prepared for this change, which could include having to set-up an EU based firm with the appropriate authorisations.

It is important to note that the requirements of the CBDF Package apply to EU fund managers marketing their EU fund. The requirements do not apply to non-EU AIFMs (e.g. US managers) marketing funds under the NPPRs nor do they apply to EU AIFMs marketing non-EU AIFs under the NPPRs. However, the CBDF Package does contain a provision prohibiting EU Member States from adopting laws and regulations that are more advantageous for non-EU AIFMs than for EU AIFMs and, therefore, it is likely that Member States will adopt similar rules for non-EU AIFMs seeking to market under the NPPRs. However, it remains an open question as to how similar these rules will be and so any developments in this area should be closely monitored by non-EU fund managers.

Irrespective of whether the UK has left the EU by August 2021 it is expected that the UK will implement requirements in its domestic regime equivalent to those in the CBDF Package.

### *New Prudential Rules for EU Investment Firms in 2021*

In October 2019, the European Council adopted a new Investment Firm Regulation (“IFR”) and Directive (“IFD”) comprising a set of legal rules amending the existing prudential framework applicable to investment firms in the EU authorised under MiFID. The new regime will provide certain changes to the risk management, regulatory capital and remuneration requirements applicable to such EU firms. The date when the requirements of the IFR and IFD will become applicable is not confirmed but this is expected to be during Q2 2021.

The new IFR/IFD rules will therefore impact (for example) investment advisers, portfolio managers and corporate finance advisers, amongst others. Currently, EU firms that are authorised under MiFID are subject to varying regulatory capital requirements depending on the investment services and activities for which they are authorised and their ability to hold client money or assets. Different firms, therefore, are currently subject to different regimes. However this will no longer be the case going forward, as the IFR/IFD rules will impact all MiFID- authorised firms, except those which are deemed to be “systemically large investment firms” (being extremely large firms typically with assets over €15 billion and which deal on their own account or carry on underwriting services). These extremely large firms will remain subject to the Capital Requirements Directive IV and Capital Requirements Regulation, rather than the IFR/IFD. EU investment managers which manage assets for their clients would not typically fall within the “systemically large investment firms” designation.

The exact impact of the IFR/IFD rules on MiFID-authorized firms will depend on the relevant firm's size and activities. Firms designated as "non-systemically important investment firms" will be subject to changes to capital and remuneration, governance and risk-management requirements as noted above. Smaller firms designated as "small and non-interconnected investment firms" will be subject to certain capital requirements but the remuneration, governance and risk management requirements will not apply.

The new regulatory capital requirements will require all firms subject to the IFR/IFD to hold an "initial capital" requirement as well as an additional capital amount by reference to their "annual fixed overheads". In particular, this is expected to impact certain adviser-arranger firms in the UK (known as "exempt CAD") firms who are currently required to hold an initial capital requirement of €50,000. This is expected to increase to €75,000 along with the requirement to hold additional capital by reference to fixed overheads. This could see a significant increase in the regulatory capital requirements that some EU firms will be subject to when the new IFR/IFD requirements come into force.

The remuneration requirements under the IFD framework will apply to individuals who are senior managers, risk-takers, and staff engaged in controlled functions and certain other highly paid functions within the relevant firm. Under the rules, there is no cap imposed on "variable remuneration", but certain restrictions may apply depending on factors such as the size and complexity of the relevant firm, and firms will be required to set "appropriate" fixed-to-variable remuneration ratios.

The IFR/IFD regime is not expected to take effect in EEA Member States until mid-2021, although it is not clear at the moment how the new regime will be implemented in the UK in the context of Brexit. Notwithstanding this being the case, UK firms should continue to work on the basis that the new rules will be implemented in the UK.

## UK Tax

Given the current international focus on tackling tax avoidance and on increasing the transparency of tax arrangements more generally, we discuss here two particular areas of development in this respect: hybrid mismatches and DAC6.

### Hybrid Mismatches

As highlighted in previous Proskauer Annual Review publications, the Organisation for Economic Co-operation and Development's (OECD) base erosion and profit shifting (BEPS) project is continuing to change the international tax landscape.

One particular area of development during the course of the last few years is in relation to Action 2 ("neutralising the effects of hybrid mismatch arrangements") with both UK domestic legislation and EU legislation being introduced to tackle mismatch situations. In general terms, these measures seek to prevent deductions or credits being available in one country where the relevant income is not taxed in the counterpart jurisdiction. The rules cover a wide range of factual situations including: double deductions, deductions without inclusion, and double tax credits.

The UK was quick to respond to the OECD's recommendation on Action 2, bringing in legislation under the Finance Act 2016 with anti-hybrid rules taking effect from 1 January 2017. The extended "reverse" hybrid rules, also recommended under Action 2 (and required under ATAD2, discussed below), have not yet been enacted in the UK. Market practice following implementation of the anti-hybrid rules is still taking shape as practitioners consider the practical effect and correct interpretation of the rules.

Across the EU, hybrid mismatch arrangements have been targeted by the "Anti-Tax Avoidance Directive" (ATAD) and its update, ATAD2. ATAD2 extends the scope of the relevant rules beyond the EU Member States to include transactions with third countries. ATAD was required to have been implemented by EU Member States by 1 January 2019, and ATAD2 is currently in the course of being implemented. The elements of ATAD2 dealing with the anti-hybrid rules will have effect from 1 January 2020. The second stage "reverse" hybrid rules will have effect from 1 January 2022.

The anti-hybrid rules cover a wide range of situations and could operate to prevent deduction (or provide for obligatory inclusion) of certain payments made under hybrid instruments or involving hybrid entities (whether hybrids payees or payers). These can arise in cases where there are hybrid financial instruments, hybrid permanent establishment mismatches, hybrid entity mismatches or imported mismatches. The "reverse" hybrid rules, once in force (from 2022) could – depending on how investors in the relevant entities treat them for tax purposes result in certain transparent entities being treated as opaque (and, therefore, taxable) in their home jurisdiction (i.e., a reverse hybrid mismatch).

The rules being implemented under ATAD2 are highly complex and specialist advice should be sought in instances where such rules are believed to apply.

There are a number of particular consequences which we are seeing in response to the impact, or anticipated impact, of the hybrid rules on investment fund structuring:

- (i) A greater awareness of possible "hybrid" entities when designing and implementing fund structures. Hybrid entities (for example, partnerships treated as opaque in other jurisdictions) are being used only with care and advance planning.
- (ii) Prospective investors being required, in subscription agreements, to confirm how they will treat certain fund entities (e.g., limited partnerships) in their own jurisdiction for tax purposes. If an investor treats such transparent fund vehicles as opaque this could, for example, cause a denial of deductions for fund portfolio companies paying interest on shareholder loans.
- (iii) Limited partners being required to pick up hybrid mismatch costs "caused" by their own status or the treatment of fund vehicles in their home jurisdictions.
- (iv) Awareness of the future impact of "reverse" hybrid rules coming into force in 2022. General partners are increasingly seeking powers to restructure funds as necessary and to monitor the continued effect of such rules on the fund structure's tax efficiency. The particular concern, that partnerships could be treated as opaque taxable entities depending on the mix of investors and their local tax treatment, means

that more detailed and involved monitoring of fund structures will be needed going forward to ensure continued tax efficiency. The local implementation of ATAD2 in jurisdictions across the EU will also provide further detail as to the changing shape of the international tax landscape in this respect. For example, both the Netherlands and Luxembourg recently published draft legislation to implement ATAD2 which includes a number of potentially important exemptions, particularly where the relevant entity is a regulated collective investment fund. These local laws are still not finalized and are subject to numerous conditions and restrictions.

## DAC6

The sixth version of the European Union's Directive on administrative co-operation (DAC6) introduces rules for disclosure of "reportable cross border arrangements". These rules further widen the scope of international tax reporting requirements in order to target and stop tax avoidance.

To fall within the scope of the rules, there needs to be a cross-border arrangement involving at least one EU Member State and which contains at least one of the "hallmarks" prescribed in the directive. The rules are very widely drafted with a long list of hallmarks, many of which do not require a tax avoidance motive to apply.

Under DAC6, disclosure is required by "intermediaries" as defined in the directive. "Intermediary" is purposely very widely defined ("any person that designs, markets, organises or makes available for implementation or manages the implementation of a reportable cross-border arrangement") to ensure the broadest class of persons could be required to submit a report in respect of a relevant arrangement. If there are multiple intermediaries involved in a relevant arrangement, each intermediary is only exempt from making a report if it has proof that a report has already been filed by another intermediary. What is considered acceptable proof is to be determined by domestic implementing legislation and, if there is any doubt as to whether another intermediary has reported the arrangement, an intermediary must still make its own disclosure.

Where an intermediary is not involved (or does not make a required report due to, for example, legal professional privilege), a relevant taxpayer will be required to submit a report on the relevant arrangement.

In terms of the timeline for introduction of DAC6, any transaction undertaken on or after 25 June 2018 will be reportable, with the first reports required by 31 August 2020. Individual EU Member States must introduce domestic legislation by the end of 2019.

Significant penalties and accompanying reputational damage for non-compliance mean that DAC6 will need to be considered alongside other tax reporting regimes when advising on fund structuring matters, as well as more discrete client queries. Intermediaries will need to make it clear to clients from the outset that they will need to submit a report if they consider that the DAC6 regime is applicable.

The UK published draft regulations implementing the DAC6 regime in July 2019, alongside a consultation for input from affected practitioners and taxpayers. Following publication of these draft regulations, there remains a level of uncertainty as to certain aspects (for example, the

scope of the regulations, the impact of Brexit and the form of any evidence of another intermediary's disclosure) and so the progress of the consultation and implementation of the regulations should be closely monitored.

## China

### New Registration Rules on Private Fund Manager Registration

In China, a private equity fund management firm should register with the Asset Management Association of China (AMAC), the de facto industry regulator of the country, as a private fund manager before it raises any funds within China. The registration of private fund managers is regulated by the *Securities Investment Fund Law of the PRC*, the *Interim Measures for the Supervision and Administration of Private Investment Funds* and rules, regulations, instructions and guidance published by AMAC from time to time. On December 7, 2018, AMAC updated its *Instructions for the Registration of Private Fund Managers* (the "New Registration Instructions"). In addition to clarifying certain existing rules, the New Registration Instructions also provide certain new requirements for registration and post-registration compliance of private fund managers, which are stricter than the existing rules. Although the New Registration Instructions are generally applicable to both PRC domestic private fund managers and international fund managers applying for or holding a private fund manager license in China, most of the above-referenced new requirements target PRC domestic private fund managers (in particular those that fail to operate in compliance).

The New Registration Instructions require applicants for a private fund manager license to maintain a simple and clear shareholding structure, and provide that AMAC shall tighten its review of the shareholding structure of the applicants. An applicant whose shareholding structure changed during the one (1) year period before the filing of its application will draw special attention from the AMAC, which may require the applicant to provide justification for such change. The New Registration Instructions prohibit nominee equity holding arrangements and require the shareholders of an applicant to provide documents that can evidence their true identity. Also, the New Registration Instructions expressly prohibit an asset management product from serving as a shareholder or actual controller of an applicant.

The New Registration Instructions provide certain new requirements regulating competition with affiliates. If an affiliate of an applicant is a private fund manager license holder, the applicant will need to wait until the affiliate has completed the filing of its first fund product with the AMAC before the applicant's application for a private fund manager license could be accepted by AMAC. Where an applicant is controlled by an entity which also controls other private fund manager license holders, the controlling entity and the affiliated private fund manager license holders are required to make written commitments to undertake joint and several liability for any possible non-compliance of the applicant. The controlling entity is also required to make written commitments to continue to hold the shares in or control the applicant for at least three (3) years after the applicant gets its private fund manager license.

The New Registration Instructions clarify and supplement the existing rules on personnel of private fund manager license holders. Under the New Registration Instructions, a private fund manager license holder is required to have at least five (5) employees. The New Registration

Instructions also provides certain restrictions on the ability of senior officers (which are defined to include, but not limited to, legal representatives/executive partners, general managers, deputy general managers and chief compliance officers) to take concurrent positions in other institutions. Specifically, a senior officer is not allowed to take concurrent positions in any unaffiliated private asset management institutions or any institutions whose businesses may conflict with the private fund management business of the private fund manager license holder. Where a senior officer (other than a legal representative) takes a concurrent position in an affiliated private asset management institution that meets the above-referenced requirements, relevant supporting documents justifying the current positions held are required to be filed with the AMAC. Moreover, no more than half of the senior officers of a private fund manager license holder are allowed to take concurrent positions in affiliated private asset management institutions. Where a senior officer leaves a private fund manager license holder, his/her replacement is required to be appointed within three (3) months. Employees of a private fund manager license holder who are not senior officers are required to be full-time employees.

### **Proposed New Rules on Private Funds**

It is reported that AMAC is drafting a set of new rules on private funds (the “Draft New Rules”). Although the full text of the Draft New Rules has not been publicized, the publicly available information about the Draft New Rules seems to indicate that the Draft New Rules would be stricter than the existing rules. It is reported that under the Draft New Rules: (i) the thresholds for registering a private fund product with AMAC are set as RMB 10 million yuan for private securities investment funds and venture capital funds, RMB 30 million yuan for private equity funds and RMB 50 million yuan for asset allocation funds; (ii) the investment amount in a single portfolio cannot exceed twenty percent (20%) of a fund’s assets; (iii) the co-investment made by the fund manager and its employees cannot exceed twenty percent (20%) in any fund; (iv) the term of private securities investment funds cannot exceed fifteen (15) years, while that of private equity funds and venture capital funds cannot be shorter than five (5) years (a term of seven (7) or more years is encouraged); and (v) the exit date(s) of portfolio(s) of a fund cannot be later than the expiration date of the fund term.

Note that the Draft New Rules remain under discussion and they are likely to be further revised. It is difficult to predict when the Draft New Rules will be finalized and officially released.

## **Hong Kong**

### **SFC Amends Guideline on Anti-Money Laundering and Counter-Financing of Terrorism**

In late 2018, the Securities and Futures Commission (SFC) published the conclusions to its consultation paper on proposed amendments to its Guideline on Anti-Money Laundering and Counter-Terrorist Financing (now retitled “Guideline on Anti-Money Laundering and Counter-Financing of Terrorism”) to keep them in line with the latest FATF standards. The Guideline has been substantially amended as of October 2018 and includes the following key changes:

- (i) an expansion of the types of politically exposed persons (PEPs) to include persons who have been entrusted with a prominent function by an international organization,

and extending the special requirements for foreign PEPs to high risk business relationships with domestic PEPs and international organization PEPs;

- (ii) a requirement for licensed corporations (LCs) incorporated in Hong Kong to implement group-wide AML/CFT systems in all of their overseas branches and subsidiary undertakings (this applies downstream only) 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 of the overseas branch or subsidiary 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 the host jurisdiction's laws and regulations permit;
- (iii) a requirement for 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. The Guideline does not prescribe specific examples of the types of new and developing technologies;
- (iv) allowing LCs to stop pursuing the customer due diligence (CDD) process if they reasonably believe that performing the process will tip-off the customer. The LC would then be required to file a suspicious transaction report to the Joint Financial Intelligence Unit; and
- (v) a requirement for 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, unusually large transactions).

### **Updating of Financial Resources Rules**

Following the publication of the SFC's consultation conclusions on the Securities and Futures (Financial Resources) Rules, the Rules were amended on 1 April, 2019. The principal purpose of the changes was to update the computational basis of the financial resources requirements in response to market developments and to facilitate the business operation of LCs.

The principal changes included clarifying the treatment of currencies subject to exchange control or assets the proceeds of which upon realization are subject to remittance control; clarifying the treatment for non-freely floating foreign currencies; introducing and updating haircut percentages for certain types of securities and investments; replacing the proposed cap on aggregate uncollateralized receivables from affiliated banks and brokers with a proposed control requirement; clarifying the treatments of different types of qualifying debt securities and special debt securities; updating the list of specified exchanges to include four mainland Chinese commodity exchanges; and refining the treatments for amounts receivable arising from securities transactions.

### **SFC's new regulatory approach for virtual assets**

On 1 November, 2018, the SFC issued a statement on its position with respect to the regulatory framework for virtual asset portfolios managers, fund distributors and trading platform operators.

Whilst the SFC had already issued circulars in 2017 and 2018 clarifying its regulatory stance on virtual assets, it also acknowledged that many types of virtual assets may not fall within the definition of “securities” or “futures contracts” under the Securities and Futures Ordinance (SFO), and consequently, the management of funds investing solely in virtual assets may not amount to a “regulated activity”, for which a license would be required.

Under its revised regulatory approach, the SFC will bring a significant portion of virtual asset portfolio management activities into its regulatory net. Broadly, the SFC adopts the approach that all licensed portfolio managers intending to invest in virtual assets should observe essentially the same regulatory requirements even if the portfolios (or parts of them) under their management invest solely or partially in virtual assets (subject to a de minimis threshold), irrespective of whether these virtual assets amount to “securities” or “futures contracts”. And for this purpose, the SFC has developed a set of standard terms and conditions which captures the essence of the existing requirements applicable to LCs, adapted as needed to better address the risks associated with virtual assets.

Likewise, LCs that distribute in Hong Kong third party funds that manage virtual assets will also be subject to the revised regulatory approach. In each case, the SFC’s oversight will be imposed, by way of licensing conditions, on LCs in relation to (a) their management of portfolios (or parts of them) that invest in virtual assets, and (b) their financial resources if they plan to hold virtual assets on behalf of portfolios under their management. For example, only professional investors as defined under the SFO should be allowed to invest in any virtual asset portfolios.

In the same move, the SFC also set out a conceptual framework for the potential regulation of virtual asset trading platforms, but with a view to exploring (and forming a view after this exploratory stage) whether virtual asset trading platforms were suitable for regulation. If the SFC decided to require that any virtual asset trading platforms be licensed, their approach would be for the regulatory standards to be comparable to those applicable to existing LCs which are providers of automated trading services.

### **Further changes to the OTC derivatives regulatory regime**

As we reported last year, Hong Kong’s over-the-counter (OTC) derivatives regulatory regime is still in its implementation phase and the SFC continues to fine tune some of its detail.

Following the release of its consultation conclusions in December, 2018 on proposals to enhance the OTC derivatives regime and to address conduct risks posed by dealings with group affiliates and other connected persons, the SFC introduced amendments to the Code of Conduct.<sup>54</sup>

LCs that are contracting parties to non-centrally cleared OTC derivative transactions or are licensed for Type 9 (asset management) regulated activity (i.e., Type 9 LCs which execute non-

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<sup>54</sup> Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.

centrally cleared OTC derivative transactions on behalf of any collective investment schemes (CIS) managed by them (except when the measures required are handled by the governing body of the CIS or its delegate)) will be subject to risk mitigation requirements.<sup>55</sup> These requirements took effect on 1 September 2019.

LCs providing client clearing services for OTC derivative transactions will be subject to segregation, portability and disclosure requirements. These requirements will take effect on the commencement date for the Type 12 regulated activity. This date has yet to be announced.

In addition, LCs which have dealings with group affiliates and other connected persons will be subject to conduct requirements to ensure that risks are properly managed, they act in clients' best interest and appropriate risk disclosure is provided. These requirements took effect on 14 June, 2019.

### **Updating of SFC's licensing process**

With effect from February, 2019, the SFC introduced revamped licensing forms, a new edition of its Licensing Handbook and mandatory electronic submission of all annual returns and notifications. The new forms have been tailored to provide more granular information to the SFC about an applicant's business profile and internal control systems to enable it make a more efficient assessment of an applicant's fitness and properness to be licensed and to identify potential regulatory issues at an early stage.

### **Extension of profits tax exemption to onshore private funds**

The Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Ordinance 2019 was enacted on 20 February 2019, and extended the profits tax exemption for funds to onshore private funds. Prior to this, the exemption was available to both onshore and offshore retail funds, as well as to offshore privately offered funds, and onshore privately offered funds but structured specifically as open-ended fund companies incorporated under the SFO, in each case subject to specific eligibility criteria set out in the Inland Revenue Ordinance. Onshore private funds that were not so structured therefore did not have the benefit of the exemption.

The legislation was in response to the Council of the European Union (EU) identifying Hong Kong's tax system as containing ring-fencing features (i.e., where preferential tax treatment is partially or fully isolated from the domestic economy) that were harmful insofar as the profits tax exemption was available to offshore, but not onshore, funds, and only allowed offshore funds to have profits tax exemption with investment in private companies incorporated overseas but not locally. A failure by the Government to address this issue would have resulted in the EU putting Hong Kong on its list of non-cooperative jurisdictions for tax purposes.

Whilst there are a number of conditions to be satisfied to qualify for the expanded tax exemption, the overall amendments are these:

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<sup>55</sup> These requirements cover trading relationship documentation, trade confirmation, valuation, portfolio reconciliation, portfolio compression and dispute resolution.

- (i) onshore private funds will be given tax exemption parity with offshore funds;
- (ii) the profits tax exemption is available for an investment not only in a non-Hong Kong private company but now also in a Hong Kong private company; and
- (iii) tainting provisions have been removed, which previously, if any single transaction by a fund was not a qualifying transaction, had the effect of disqualifying all of the fund's transactions from receiving the tax exemption. The amendment now means that a fund that makes a non-qualifying transaction will be able to rely on the exemption for all of its other qualifying transactions.

Concerns that the Government would include in the amending legislation a specific regime for the taxation of carried interest turned out to be unfounded, meaning that the existing approach to the tax treatment of remuneration of Hong Kong based investment managers has not changed. This was well received by the industry.

## Latin America

### The Enactment of the Brazilian Economic Liberty Act

On September 20, 2019, the Brazilian Economic Liberty Act (Law No. 13,874) was enacted, comprising a wide range of business-friendly legal topics, including corporate, civil, labor and administrative matters. The Economic Liberty Act is part of an extensive liberal economic program envisioned by the Brazilian government and was initially established by the Brazilian president through a provisional measure (*medida provisória*).

Pursuant to the Brazilian legislative process, the provisional measure was debated and voted by both houses of the Brazilian congress and passed into a bill, which was submitted to final presidential approval in the beginning of September. As a result of such congressional debates, the Brazilian senate removed certain topics from the initial text proposed by the president, mainly concerning labor and social security aspects.

Overall, the Economic Liberty Act brings important improvements to the corporate Brazilian legal system, many of which were long expected by domestic and foreign investors. We outline below certain provisions enforced by the Act that may influence the carrying out of entrepreneurial activity and investments in Brazil. Although these new statutory provisions have not yet been tested in court, the occurrence of the new standards described below may benefit the risk assessment of domestic and foreign investors who plan on entering the Brazilian market.

### *Principles guiding the Economic Liberty Act*

The Economic Liberty Act inaugurates a “Declaration of Economic Liberty Rights” with the intended goal of (i) protecting the liberty of enterprise and the free exercise of economic activities in Brazil and (ii) controlling actions by the government in its capacity as regulator. In addition to the Brazilian Federal Constitution, which already lays down principles of private property protection and free enterprise, the Economic Liberty Act sets forth that any governmental regulation shall be interpreted in favor of the economic liberty, the good faith and

the respect to contracts, investments and private property. In this regard, the Act adopts the following principles:

- Liberty as a guarantee in the exercise of economic activities;
- Good faith of the individual towards the public power;
- Subsidiary and extraordinary governmental intervention over the exercise of economic activities; and
- Recognition of the individual's vulnerability towards the government.

Every person – individual or entity – is entitled to the rights stated in the Declaration of Economic Liberty Rights. Among other provisions, the Act forbids any agent of the Brazilian government from using its regulatory power to prevent the entrance of new domestic or foreign competitors into the Brazilian market, or to increase transaction costs without demonstrating benefits therefrom.

Moreover, the Economic Liberty Act provides for a regulatory impact analysis, which shall precede any proposal to issue or amend federal regulations that have a “general interest” to economic agents or to the users of the relevant service rendered. Such regulatory impact analysis shall comprise data about the possible effects of the respective regulation and the reasonability of its economic impacts. The federal executive branch is expected to issue more guidance on the content, minimum requirements and methodology of this regulatory impact analysis.

### *New Statutory Landmark for Investment Funds*

The Economic Liberty Act has enacted a new chapter into the Brazilian Civil Code to regulate all classes of investment funds organized under Brazilian law, representing a new statutory landmark for the industry. As highlighted in our [2016 Annual Review](#) (please refer to section *Introduction to the Legal Framework of Brazilian Funds*), Brazilian funds are formed as condominiums (pool of assets). The Act preserved the nature of investment funds as condominiums without legal personality, but clarified that funds have a special nature. Accordingly, the general rules applicable to condominiums under Brazilian law – including real property condominiums – shall not apply to investment funds.

In many aspects, the new rules in the Act have provided the Brazilian funds industry the tools to bring it closer to general practices of the international market. Until now, the Brazilian funds regime had been somewhat rigid and did not permit structuring certain commercial arrangements between sponsors and investors. Furthermore, the conservative approach adopted by Brazilian regulators with respect to the sponsors' liabilities led many administrators to require hold-harmless letters from investors, as well as to engage into heavy indemnity negotiations with managers. The innovations brought by the Economic Liberty Act are expected to allow for new standards and a clearer allocation of liability for both sponsors and investors within the Brazilian industry. We highlight below the main topics covered by the Act.

**Registration:** Pursuant to the previous regime, organizational documents for any Brazilian investment fund should be registered with both the Registry of Titles and Deeds (*Registro de*

*Títulos e Documentos*) and the Brazilian Securities Commission (*Comissão de Valores Mobiliários*). While registration with the Brazilian Securities Commission is still mandatory, the Act has eliminated the duplicity of registration.

Limited Liability: Investors in Brazilian funds used to have unlimited liability, and administrators and managers were considered jointly liable for their acts. Under the new regulations, the governing documents of the fund may establish (i) limited liability to all investors and (ii) several, and not joint, liability to the service providers of the fund, including administrators and managers, as well as parameters to assess such liability. However, the liability limitation will be effective with respect only to events occurring after the adoption of such provision in the fund's governing documents.

Service Providers: The fund's service providers will not respond with their assets to liabilities of the fund, except for losses caused as a result of such providers' bad faith or willful misconduct. The assessment of the service provider's liability shall take into account the risks that are inherent to investments in the markets targeted by the fund.

Segregated Portfolios: Brazilian funds are now authorized to issue different classes of interests (*cotas*), each of which with different rights and liabilities, including the creation of segregated portfolios for each class.

Insolvency: As another innovation brought by the Act with respect to limitation of liability, insolvency proceedings may apply to investment funds that adopt limited liability for their investors. Under the new rules, the following parties are entitled to file insolvency claims against a fund with limited liability that is not able to meet its obligations: the relevant fund's creditors, its investors (if such claim is approved in a properly convened meeting of the fund's investors), or the Brazilian Securities Commission. In general, creditors under such insolvency claims will be paid according to the following priority: first, secured creditors; second, expenses related to the liquidation of the insolvent fund's assets, and taxes due the current and previous year of the claim; and third, unsecured creditors.

We note that the Brazilian Securities Commission is expected to issue regulations in respect of all provisions described above. Therefore, the provisions of the Act may not be directly applied by fund administrators and managers while the relevant regulation is still pending. We will continue to closely monitor this matter as the Brazilian Securities Commission submits new proposed rules to comments by the public.

### *Disregarding the Corporate Entity and Single-Member Companies*

Brazilian law prescribed that a corporate entity could be disregarded due to a "deviation from the corporate purpose or commingling of assets." On its turn, the Economic Liberty Act amended the Brazilian Civil Code to include further restraints on the courts' ability to pierce the corporate veil and reach assets of members/shareholders and managers. In comparison to the previous wording of the law, the new Act sets forth more objective standards, such as the following:

- "Deviation from the corporate purpose" shall be understood as using the corporate form to harm creditors and practice illegal actions of any nature;

- Only members/shareholders and managers who directly or indirectly benefited from the abuse of the corporate entity may have their assets forfeited;
- “Commingling of assets” shall be deemed as the *de facto* absence of asset segregation characterized by (i) the repetitive payment of shareholders’ or managers’ obligations by the corporate entity or vice-versa; (ii) the transferring of assets or liabilities among affiliates without proper consideration; and (iii) other acts of disregard of asset segregation.

The Act also clarifies that these same requirements shall be applied by the courts when extending shareholders’ or managers’ obligations to the corporate entity. Additionally, the mere existence of an economic group without presenting such requirements shall not empower any court to pierce the corporate veil.

As a related matter, the formation of limited liability companies (*sociedades limitadas*) under Brazilian law used to require at least two members. The Economic Liberty Act has abolished this requirement and expressly authorized the formation of single-member companies. According to the Act, the same organizational and registration requirements applicable to multi-member companies shall control the formation of single-member companies, as applicable.

### *Interpretation of Contracts*

While the Brazilian Civil Code required contracts to be interpreted pursuant to the principles of good faith and usage and customs, the Economic Liberty Act significantly expanded such guidelines and introduced interpretation rules similar to those found in common law jurisdictions, such as the State of New York. Under the Act, the courts’ interpretation of contractual terms shall ascribe the meaning that:

- Was confirmed by the parties’ behavior after execution of the agreement;
- Corresponds to the usage, customs and market practices relevant to the sort of agreement;
- Corresponds to good faith;
- Is more beneficial to the party that did not draft the relevant contract provision, if identifiable; and
- Corresponds to the parties’ reasonable negotiation, as inferred from the remaining contractual provisions and the economic rationality of the parties based on the information available at the time of the agreement’s execution.

Pursuant to the Economic Liberty Act, private contractual relationships shall be governed by the principles of minimum intervention and rarity of contractual review. The parties are now expressly authorized to stipulate their own interpretation rules even if different from the rules prescribed by law, including for filling gaps, integrating and terminating contracts. Lastly, except for certain specific statutory regimes, contracts under civil and corporate law are presumed to be equal and symmetric until concrete elements rebut such presumption. In this regard, the risk allocation agreed to by the parties shall be duly respected.

## Ongoing Developments on the Disclosure of Ultimate Beneficial Owners of Feeder Funds

As discussed in last year's review, Brazilian fund administrators continue to place particular emphasis on implementation of know your client (KYC) procedures for investors in Brazilian private equity investment funds (*fundos de investimento em participações*, or FIPs). Brazilian tax regulations require the disclosure of ultimate beneficial owners (UBOs) of investment structures, and impose liability to Brazilian fund administrators for applying the proper tax rate and withholding relevant taxes on each distribution by a FIP. Considering the current Brazilian tax benefits applicable to dividends and capital gains distributed by FIPs to non-Brazilian investors, administrators have adopted a conservative approach in their KYC procedures in order to identify UBOs and apply (or not) the tax benefit to international feeders investing in FIPs.

Brazilian administrators have recently been subject to tax auditing and assessments by the Brazilian Revenue Service, which developed into administrative proceedings that are still ongoing. Therefore, KYC procedures continue to be a concern for administrators, managers and limited partners.

In order to comply with Brazilian regulations, the sponsors, general partners and non-Brazilian administrators should obtain counsel advice as to address specific requirements regarding tax, KYC and confidentiality obligations in the limited partnership agreement, subscription agreement and other governing documents of international feeders investing in FIPs. Legal and commercial discussions around this topic have become prominent in the formation of new FIPs, as well as whenever distributions are made by existing FIPs.

International players, Brazilian and international law firms (such as Proskauer) and Brazilian fund administrators (directly and through industry associations, such as the Brazilian Private Equity & Venture Capital Association – ABVCAP) have been discussing potential actions and structures to comply with the relevant regulations, including (i) disclosing UBO information to Brazilian tax authorities without breaching confidentiality obligations under the governing documents of international feeders; (ii) withholding Brazilian taxes on distributions by FIPs to international feeders without breaching tax provisions in the governing documents of international feeders, or (iii) restructuring the international feeders to avoid jurisdictions that are deemed as tax havens by the Brazilian tax authorities and/or segregate limited partners that may not be entitled to the tax benefit.

All stakeholders mentioned above are holding discussions with the Ministry of Economy and the Brazilian Revenue Service in order to reach a consensus on new regulations and/or interpretation of the tax rules currently in place. While we continue to follow this matter closely, we cannot anticipate when such new rules or interpretations will be issued. As recommended in our 2018 Annual Review, the KYC procedures and UBO disclosures should be discussed with Brazilian administrators very early in the fund structuring process in order to avoid delays in closing new funds or in distributions of proceeds.

## New Rules for Administrative Proceedings of the Brazilian Securities Commission

In June 2019, the Brazilian Securities Commission issued Instruction No. 607 to regulate the proceedings related to the Commission's sanctioning powers, which are applicable to all investment advisers and fund administrators acting in Brazil. The new rule was issued in connection with Law No. 13,506 of November 2017, which was passed by the Brazilian congress as the new framework for administrative proceedings conducted by the Brazilian Securities Commission and the Brazilian Central Bank.

Instruction No. 607 and Law No. 13,506 have increased the financial cap for penalties that may be applied by the Brazilian Securities Commission to the highest of the following: (i) R\$50 million; (ii) twice the amount of the irregular transaction; (iii) three times the amount of the economic advantage obtained (or the loss avoided) as a result of the illegal act; or (iv) twice the amount of losses caused to investors as a result of the illegal act. Nevertheless, such figures may be multiplied by three in the event of recurrence in the infraction.

The new Instruction also regulates the execution of administrative agreements in oversight proceedings (*acordos administrativos em processos de supervisão*) of the Brazilian Commission, commonly referred to as "Oversight Agreements" (*Acordos de Supervisão*). The Oversight Agreements may be entered into with individuals or entities that admit the practice of securities laws violations and, as a result, the Commission may agree to completely withdraw or reduce the applicable penalties by 1/3 to 2/3. Likewise, the Commission will reduce penalties by 1/3 to 2/3 if all financial damages are fully indemnified by the violator before the final judgment of the administrative proceeding, even if an Oversight Agreement is not executed.

Nonetheless, the reduction of penalties under Oversight Agreements are limited to administrative proceedings and, consequently, violators may still be subject to civil or criminal charges. Furthermore, the execution of Oversight Agreements by the Brazilian Commission will be conditioned upon the violator's effective and permanent collaboration in the investigations, particularly in (i) identifying other individuals and entities involved in the offense and (ii) obtaining information and documents that may be used as evidence to prove the occurrence of the violation.

Also, Instruction No. 607 introduced a simplified track for the investigation and administrative judgment of violations of minor complexity, and created a list of aggravating and mitigating circumstances. If these circumstances are identified in any infraction, they may increase or decrease penalties in 25%.

### **Brazilian Government's Economic Agenda and Investment Opportunities**

In addition to the Economic Liberty Act described above, the Brazilian government has openly adopted a liberal economic agenda for the country. The economic team of the current presidency is engaged in developing actions to enhance Brazil's micro and macroeconomic scenarios, which involve several intended legislative reforms. The social security reform has been approved by the lower house of the Brazilian congress and will soon be debated in the senate. Meanwhile, the Ministry of the Economy is discussing bill projects that are expected to be heavily debated in both houses of the congress, such as the tax reform.

Additionally, in June 2019, a new Law No. 13,842 amended the Brazilian Aeronautics Code and modified the conditions for granting of concessions for air transportation services in Brazil. The

new rules still require air companies, such as commercial airlines and air taxis, to be incorporated under Brazilian law, with headquarters and management in Brazil. However, the new law eliminated statutory restrictions that (i) limited foreign investments to a maximum 20% of voting shares of any Brazilian air company and (ii) required the organizational documents of such companies to be approved by the Brazilian National Agency of Civil Aviation. Accordingly, the Brazilian aviation market is now open for unlimited investment by foreign players.

The Brazilian government has also expressed the intent to privatize many of the public enterprises that are currently controlled by the federal power. In the executive branch, several working groups are engaged in analyzing the possibility of, and are currently conducting, privatization processes, involving the Ministry of Economy, the Ministry of Infrastructure and the Ministry of Mining and Power. As a preparatory measure, each privatization must obtain legislative approval from the Brazilian congress, and the sales are usually carried out through public auctions on the stock market. If the national plan for privatization intended by the current presidency is successful, domestic and foreign players may soon find many opportunities for investments and financing arrangements. Targets include several federal toll roads, railways, ports (including SUAPE, Belém and Vila do Conde), airports (including Confins, Galeão and Infraero's shares at Guarulhos), mining concessions, and state-owned enterprises such as Casa da Moeda, Correios and Eletrobras.

### **Venture Capital Opportunities**

The Brazilian venture capital market has shown major improvements, concentrating many interesting investment opportunities for domestic and foreign investors. More recently, successful cases of venture capital deals have developed into the first Brazilian unicorns, such as 99, Nubank, Gympass and QuintoAndar. Additionally, the SoftBank Group has officially entered the Brazilian market, signaling the intent of deploying a significant amount of capital into a diversified portfolio of companies with high potential of growth.

Opportunities in the venture capital industry may be attractive not only for equity investments backed by traditional players with strong reserves of capital, but also for structured financing involving convertible debt and FIPs.

### **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 March 30, 2020 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 29, 2020 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 29, 2020 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 February 29, 2020 for the quarter ending December 31, 2019).
- **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 29, 2020 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, 2020 for the quarter ending December 31, 2019).

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 2019, the first Form 13F filing deadline in 2020 will be February 14, 2020 (for the quarter ending December 31, 2019).

### ***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, 2020 for 2019). 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, 2020 for 2019).

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 2019 amendments will be February 14, 2020.

### ***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, 2020 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, 2020 for 2019). 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 February 29, 2020 for 2019).

Annual Reports and Account Statement Requirements. Each registered CPO, including a CPO relying on CFTC Rule 4.7, must file financial statements of each commodity pool it operates with the NFA within 90 days after each such commodity pool’s fiscal year-end (by March 30, 2019, 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)
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The upcoming filing deadlines for the period ending on December 31, 2019 will be February 29, 2020 for Large CPOs and March 30, 2020 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, 2019 will be February 14, 2020. 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 **January 23, 2020** for December 2019). 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 2019, 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 2019 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 2019 will be the due date (including any applicable extensions) of that U.S. person's 2019 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 2019 (and subsequent years), the deadline will be the due date (including any applicable extensions) of the private fund's 2019 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 2019 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 2019 U.S. federal income tax return.

## Other Annual Requirements and Considerations

### Audited Financial Statements Delivery

Rule 206(4)-2 of the Advisers Act (the 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 29, 2020, if the fiscal year ends on December 31); or
- within 180 days of the private fund's fiscal year-end, if the private fund is a fund-of-funds (by June 30, 2020, 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

Following changes to the Gramm-Leach-Bliley Act contained in the Fixing America's Surface Transportation Act of 2015 (the FAST Act), delivery of annual privacy notices is now required only if a financial institution's privacy policies and practices have changed since the last distribution of a privacy notice. Specifically, 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.

As discussed above, on April 16, 2019, OCIE issued a [risk alert](#) based on compliance issues identified in recent examinations of investment advisers and broker-dealers relating to Regulation S-P, the primary SEC rule requiring distribution of privacy notices and safeguarding policies of registrants. Footnote 5 of this Risk Alert acknowledges the SEC staff's conformance of the requirements of Regulation S-P to the FAST Act amendment to the annual delivery requirement.

Additionally, on April 19, 2019, the CFTC [approved a final rule](#) revising the annual privacy notice delivery requirements applicable to CFTC registered commodity trading advisors, commodity pool operators, futures commission merchants, introducing brokers, retail foreign exchange dealers, swap dealers, and major swap participants. The new amendment conforms the requirements of CFTC Regulation 160.5 to the FAST Act amendment to the annual delivery requirement.

Finally, on August 10, 2018, the Bureau of Consumer Financial Protection [finalized amendments](#) to Regulation P (applicable to most private funds with natural persons as beneficial owners) that allows financial institutions that meet certain requirements to be exempt from sending annual privacy notices to their customers in accordance with the FAST Act.

## 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, also known as a 408(b)(2) notice, by reference to the relevant section of ERISA.

### **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 had not been previously 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.

## 2020 Federal Filings and Other Document Delivery Calendar

<b><u>Filing / Delivery</u></b>	<b><u>Who must file</u></b>	<b><u>Deadline</u></b>
<b><u>November 2019</u></b>		
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	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 23 <sup>rd</sup> calendar day of the following month, but if the 23 <sup>rd</sup> 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)

<b><u>Filing / Delivery</u></b>	<b><u>Who must file</u></b>	<b><u>Deadline</u></b>
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).
<b><u>December 2019</u></b>		
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 16 (for November 2019). Note: Usually filed on the 15 <sup>th</sup> calendar day of the following month, but if the 15 <sup>th</sup> 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 16 (for November 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	December 23 (for November 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)	December 30 (for November 2019)
<b><u>January 2020</u></b>		
Form PF	Large Liquidity Fund Advisers	January 15 (for the quarter ending December 31, 2019)

<b><u>Filing / Delivery</u></b>	<b><u>Who must file</u></b>	<b><u>Deadline</u></b>
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 2019)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding \$350 million as of any month	January 15 (for December 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)	January 21 (for the quarter ending December 31, 2019) (Martin Luther King, Jr. Day is on January 20, 2020)
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 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	January 30 (for the quarter ending December 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)	January 30 (for December 2019)

<b><u>Filing / Delivery</u></b>	<b><u>Who must file</u></b>	<b><u>Deadline</u></b>
<b><u>February 2020</u></b>		
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, 2019)
Schedule 13G Annual Amendment	Beneficial owners of at least 5% of a class of outstanding equity securities of a U.S. public company eligible to file Schedule 13G ( <i>i.e.</i> , Qualified Institutional Investors and/or passive investors)	February 14 (for 2019)
Form 13H Annual Amendment	Large traders of Regulation NMS securities	February 14 (for 2019)
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, 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)	February 18 (for January 2020). Note: Usually filed on the 15 <sup>th</sup> calendar day of the following month, but if the 15 <sup>th</sup> day is a holiday, Saturday or Sunday, the filing deadline is extended until the next business day. (Presidents' Day is on February 17 <sup>th</sup> , 2020)

<b><u>Filing / Delivery</u></b>	<b><u>Who must file</u></b>	<b><u>Deadline</u></b>
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding \$350 million as of any month	February 18 (for January 2020). Note: Usually filed on the 15 <sup>th</sup> calendar day of the following month, but if the 15 <sup>th</sup> day is a holiday, Saturday or Sunday, the filing deadline is extended until the next business day. (Presidents' Day is on February 17 <sup>th</sup> , 2020)
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 24 (for January 2020). Note: Usually filed on the 23 <sup>rd</sup> calendar day of the following month, but if the 23 <sup>rd</sup> day is a holiday, Saturday or Sunday, the filing deadline is extended until the next business day.
Form PF	Large Hedge Fund Advisers	February 29 (for the quarter ending December 31, 2019)
CFTC Form CPO-PQR	Large CPOs	February 29 (for the quarter ending December 31, 2019)
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)	February 29 (for 2019)
<b><u>March 2020</u></b>		
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 1 (for January 2020)

<b><u>Filing / Delivery</u></b>	<b><u>Who must file</u></b>	<b><u>Deadline</u></b>
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 16 (for February 2020) Note: Usually filed on the 15 <sup>th</sup> calendar day of the following month, but if the 15 <sup>th</sup> 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	March 16 (for February 2020) Note: Usually filed on the 15 <sup>th</sup> calendar day of the following month, but if the 15 <sup>th</sup> 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	March 23 (for February 2020)
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 2020)
CRS Information Reports	Financial institutions in “Participating Jurisdictions” (which currently do not include the US)	Consult local advisers
Form ADV Annual Update	Registered investment advisers and exempt reporting advisers	March 30 (for an investment adviser with a December 31 fiscal year-end)
NFA Commodity Pool Annual Financial Statements Filing	Registered CPOs	March 30 (for a pool with a December 31 fiscal year-end)

<b><u>Filing / Delivery</u></b>	<b><u>Who must file</u></b>	<b><u>Deadline</u></b>
FATCA Information Report	Participating FFIs (except for FFIs in Model 1 IGA jurisdictions)  FFIs in Model 1 IGA jurisdictions	Consult local advisers
<b><u>April 2020</u></b>		
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, 2020)
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 2020)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding \$350 million as of any month	April 15 (for March 2020)
TIC Form BQ-1, BQ-2 and BQ-3	U.S. residents with reportable cross-border claims or liabilities in excess of \$50 million (or \$25 million with respect to an individual country) (Form BQ-1 and BQ-2 Part 1), in excess of \$50 million (no country limit) (Form BQ-2 Part 2), or in excess of \$4 billion (no country limit) (Form BQ-3)	April 20 (for the quarter ending March 31, 2020)
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 2020)

<b><u>Filing / Delivery</u></b>	<b><u>Who must file</u></b>	<b><u>Deadline</u></b>
Delivery of Updated Form ADV Part 2A to Clients	Registered investment advisers	April 29 (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 29 (for private fund 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 29 (for an investment adviser 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, 2020)
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below \$500,000)	April 30 (for March 2020)
<b><u>May 2020</u></b>		
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, 2020)
NFA Form PR	All registered CTAs	May 15 (for the quarter ending March 31, 2020)
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 2020)

<b><u>Filing / Delivery</u></b>	<b><u>Who must file</u></b>	<b><u>Deadline</u></b>
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding \$350 million as of any month	May 15 (for April 2020)
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 26 (for April 2020) Note: Usually filed on the 23 <sup>rd</sup> calendar day of the following month, but if the 23 <sup>rd</sup> day is a holiday, Saturday or Sunday, the filing deadline is extended until the next business day. (Memorial Day is May 25 <sup>th</sup> )
Form PF	Large Hedge Fund Advisers	May 30 (for the quarter ending March 31, 2020)
CFTC Form CPO-PQR	Large CPOs	May 30 (for the quarter ending March 31, 2020)
NFA Form CPO-PQR	All registered CPOs, except Large CPOs	May 30 (for the quarter ending March 31, 2020)
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 2020)
<b><u>June 2020</u></b>		
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of \$50 million (or \$25 million with respect to an individual country)	June 15 (for May 2020)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding \$350 million as of any month	June 15 (for May 2020)

<b><u>Filing / Delivery</u></b>	<b><u>Who must file</u></b>	<b><u>Deadline</u></b>
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding \$1 billion as of the last day of any calendar month	June 23 (for May 2020)
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below \$500,000)	June 30 (for May 2020)
Delivery of Annual Audited Financial Statements to Private Fund Investors	Registered investment advisers (with respect to fund-of-funds)	June 28 (for a fund-of-funds with a December 31 fiscal year-end)
<b><u>July 2020</u></b>		
Form PF	Large Liquidity Fund Advisers	July 15 (for the quarter ending June 30, 2020)
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 2020)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding \$350 million as of any month	July 15 (for June 2020)
TIC Form BQ-1, BQ-2 and BQ-3	U.S. residents with reportable cross-border claims or liabilities in excess of \$50 million (or \$25 million with respect to an individual country) (Form BQ-1 and BQ-2 Part 1), in excess of \$50 million (no country limit) (Form BQ-2 Part 2), or in excess of \$4 billion (no country limit) (Form BQ-3)	July 20 (for the quarter ending June 30, 2020)

<b><u>Filing / Delivery</u></b>	<b><u>Who must file</u></b>	<b><u>Deadline</u></b>
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 2020)
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, 2020)
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 2020)
<b><u>August 2020</u></b>		
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, 2020)
NFA Form PR	All registered CTAs	August 14 (for the quarter ending June 30, 2020)
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 17 (for July 2020) Note: Usually filed on the 15 <sup>th</sup> calendar day of the following month, but if the 15 <sup>th</sup> day is a holiday, Saturday or Sunday, the filing deadline is extended until the next business day.

<b><u>Filing / Delivery</u></b>	<b><u>Who must file</u></b>	<b><u>Deadline</u></b>
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding \$350 million as of any month	August 17 (for July 2020) Note: Usually filed on the 15 <sup>th</sup> calendar day of the following month, but if the 15 <sup>th</sup> 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	August 24 (for July 2020) Note: Usually filed on the 23 <sup>rd</sup> calendar day of the following month, but if the 23 <sup>rd</sup> day is a holiday, Saturday or Sunday, the filing deadline is extended until the next business day.
Form PF	Large Hedge Fund Advisers	August 29 (for the quarter ending June 30, 2020)
CFTC Form CPO-PQR	Large CPOs	August 29 (for the quarter ending June 30, 2020)
NFA Form CPO-PQR	All registered CPOs, except Large CPOs	August 29 (for the quarter ending June 30, 2020)
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 2020)
<b><u>September 2020</u></b>		
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of \$50 million (or \$25 million with respect to an individual country)	September 15 (for August 2020).

<b><u>Filing / Delivery</u></b>	<b><u>Who must file</u></b>	<b><u>Deadline</u></b>
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding \$350 million as of any month	September 15 (for August 2020)
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 2020)
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 2020)
<b><u>October 2020</u></b>		
Form PF	Large Liquidity Fund Advisers	October 15 (for the quarter ending September 30, 2020)
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 2020)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding \$350 million as of any month	October 15 (for September 2020)
TIC Form BQ-1, BQ-2 and BQ-3	U.S. residents with reportable cross-border claims or liabilities in excess of \$50 million (or \$25 million with respect to an individual country) (Form BQ-1 and BQ-2 Part 1), in excess of \$50 million (no country limit) (Form BQ-2 Part 2), or in excess of \$4 billion (no country limit) (Form BQ-3)	October 20 (for the quarter ending September 30, 2020)

<b><u>Filing / Delivery</u></b>	<b><u>Who must file</u></b>	<b><u>Deadline</u></b>
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 2020)
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, 2020)
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 2020)
<b><u>November 2020</u></b>		
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, 2020)
NFA Form PR	All registered CTAs	November 14 (for the quarter ending September 30, 2020)
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 16 (for October 2020) Note: Usually filed on the 15 <sup>th</sup> calendar day of the following month, but if the 15 <sup>th</sup> day is a holiday, Saturday or Sunday, the filing deadline is extended until the next business day.

<b><u>Filing / Delivery</u></b>	<b><u>Who must file</u></b>	<b><u>Deadline</u></b>
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding \$350 million as of any month	November 16 (for October 2020) Note: Usually filed on the 15 <sup>th</sup> calendar day of the following month, but if the 15 <sup>th</sup> 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	November 23 (for October 2020)
Form PF	Large Hedge Fund Advisers	November 29 (for the quarter ending September 30, 2020)
CFTC Form CPO-PQR	Large CPOs	November 29 (for the quarter ending September 30, 2020)
NFA Form CPO-PQR	All registered CPOs, except Large CPOs	November 29 (for the quarter ending September 30, 2020)
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 2020)
<b><u>Other Floating Deadlines</u></b>		

<b><u>Filing / Delivery</u></b>	<b><u>Who must file</u></b>	<b><u>Deadline</u></b>
Form D	Private funds conducting an offering under Regulation D	<p>Initial Filing: Within 15 days of the initial sale of securities</p> <p>Annual Amendment: Anniversary date of the previous Form D filing</p> <p>Interim Amendment: As soon as practicable after certain changes in information</p> <p>Note: Additional state blue sky filing requirements may apply</p>
Schedule 13D	Beneficial owners of at least 5% of a class of outstanding equity securities of a U.S. public company	<p>Initial Filing: Within 10 days of crossing the 5% threshold</p> <p>Amendment: Promptly after any material change in beneficial ownership percentage</p>
Schedule 13G	Beneficial owners of at least 5% of a class of outstanding equity securities of a U.S. public company eligible to file Schedule 13G ( <i>i.e.</i> , Qualified Institutional Investors and/or passive investors)	<p>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)</p> <p>Annual Amendment: Within 45 days of year-end (<a href="#">see above</a>)</p> <p>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%</p>

<b><u>Filing / Delivery</u></b>	<b><u>Who must file</u></b>	<b><u>Deadline</u></b>
Form 13H	Large traders of Regulation NMS securities	<p>Initial Filing: Promptly (usually 10 days) after reaching reporting threshold</p> <p>Annual Amendment: Within 45 days of year-end (<a href="#">see above</a>)</p> <p>Interim Amendment: Promptly after quarter-end if there is any change in information</p>
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	<p>Prior to completion of the proposed business transaction</p> <p>Note: Filers are generally subject to 30-day waiting period after submitting their HSR notice filing</p>

<b><u>Filing / Delivery</u></b>	<b><u>Who must file</u></b>	<b><u>Deadline</u></b>
Form BE-13A or BE-13 Claim for Exemption	<p>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</p> <p>If the cost of the transaction exceeds \$3 million, then the U.S. entity should file Form BE-13A</p> <p>If the cost of the transaction does not exceed \$3 million, then the U.S. entity should file a BE-13 Claim for Exemption</p>	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 ( <a href="#">see above</a> )	Annually
Delivery of ERISA/VCOC Annual Certification to ERISA Investors	Private funds operating as a VCOC or pursuant to the 25% cap	As per fund documents and/or other contractual agreements with ERISA investors (typically no more frequently than 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 2019	Due date (including any applicable extension) of that entity's 2019 U.S. federal income tax return

<b><u>Filing / Delivery</u></b>	<b><u>Who must file</u></b>	<b><u>Deadline</u></b>
QEF Election	In the case of a private fund that has invested in a non-U.S. portfolio company that is (or may be) a PFIC, the first U.S. person in the PFIC's ownership chain ( <i>e.g.</i> , the fund itself if a U.S. fund, or each U.S. investor if a non-U.S. fund)	Due date (including any applicable extensions) of that U.S. person's 2019 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 2019 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 2019 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 2019 U.S. federal income tax return

## Contacts

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

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