Proskauer

2024 Proskauer Annual Review

for Private Investment Funds

Delivering Results for Private Capital

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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/investment managers (collectively, advisers) to private funds should consider in 2024.

Highlights from this year's Annual Review include:

- **A summary of the new Private Fund Adviser Rules** adopted by the SEC in August 2023, which may have seismic impact on the hedge fund and private equity industries if enacted without judicial intervention.
- **A summary of SEC examination priorities** impacting the private funds industry, including a review of recent staff-level guidance and certain trends in examinations such as an increased focus on alternative data, off-channel electronic communications, ESG, conflicts of interest and fees and expenses.
- **A review of recent SEC-enforcement actions** related to off-channel electronic communications, cryptocurrencies, SPACs, trading violations, fees and expenses, conflicts-of-interest, valuations and misleading disclosures.
- **A review of other SEC policy and rulemaking initiatives,** including updates to ESG, Cybersecurity, and Custody rules, as well as revisions to beneficial owner and Form PF reporting regulations.
- **Key SEC considerations when reviewing marketing materials**, including guidance on complying with the Agency's recently implemented "marketing rule."
- **U.S. and UK tax updates**, including an overview of 'OECD Pillar Two' efforts to implement a 15% minimum tax on multi-national enterprises above a certain revenue threshold.
- **A comprehensive overview of required U.S. regulatory filings** across the many agencies overseeing the private funds industry, including a quick-reference table for monthly filings in 2024.

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Table of Contents

SEC Examination Update

The SEC's Division of Examinations continues to conduct an aggressive inspection program, with more than 1,100 employees annually examining around 15% of the approximately 15,000 investment advisers registered with the SEC.

The Examinations Division recently issued its 2024 examination priorities. The Division also issued nine risk alerts during its most recent fiscal year, covering topics such as the marketing rule, preparedness for LIBOR transition, operation and supervision of branch offices, and prevention of identity theft.

Examinations continue to be conducted remotely, with relatively short advance warning. Most exams begin with a communication announcing the beginning of the exam, followed quickly by a letter requesting documents, typically requesting production within 1-2 weeks, and then conference calls with selected personnel of the adviser. Exams can range in duration from weeks to months or even years.

We also saw sweep exams on the use of artificial intelligence, ESG, the use of personal communication devices and the marketing rule. In exams going forward, advisers should expect additional scrutiny on their recordkeeping policies and practices regarding text messaging and other "off-channel" communications, an area that the Enforcement Division is also pursuing.

Among the key priorities that we observed in examinations of investment advisers (all reinforced in the SEC's list of examination priorities and various risk alerts) are:

- **marketing practices**, policies and materials, including:

accuracy of statements in marketing materials;

accuracy of and back-up support for past performance presentations; and

potentially misleading uses of selective examples of past investment performance or recommendations

- **conflicts of interest**, including:

allocation of investment and trading opportunities;

allocation of expenses between the adviser and clients or co-investors;

side-by-side management of different client accounts, or different client accounts and proprietary accounts, using the same or similar strategies;

proprietary trading by the adviser and the personal trading activities of supervised advisory personnel;

arrangements with or services provided by (and fees paid to) affiliates of the investment adviser; and

principal transactions, cross transactions and other transactions where the adviser or any other affiliated party may have an interest;

- **adviser compensation arrangements**, including:

confirming accurate calculation and allocation of fees and expenses (including fee offsets);

valuation of illiquid assets;

calculation of post-commitment period management fees; and

adequacy of client and investor disclosures;

- **safeguarding of client assets**, including:

compliance with the custody rule and completion of timely audits of private funds; and

adequacy of internal controls;

- **privacy and cybersecurity policies and practices**, including:

steps taken to safeguard client assets, accounts and information and prevent account intrusions;

due diligence and oversight of vendors and service providers;

actions taken in response to events such as ransomware attacks, phishing or account intrusions;

controls regarding remote work by employees, including access to online and mobile applications and investor account information; and

business continuity and disaster recovery plans;

- **due diligence practices**, including consistency with policies, procedures and disclosures, particularly with respect to private equity and venture capital fund assessments of prospective portfolio companies;
- compliance with contractual requirements regarding **limited partnership advisory committees** or similar structures (e.g., advisory boards), including adhering to any contractual notification and consent processes, and status as an access person;
- policies and practices on material **non-public information (MNPI)**, including:

trading records for unusually successful trades, trades that do not match a manager's stated investment strategy, and trades that take place around the time of public company announcements;

meetings, communications and relationships with public company insiders, and the processes used by compliance personnel to monitor such meetings, communications and relationships;

positions held by an investment adviser's personnel on portfolio company or other public or private company boards of directors, creditor committees or other positions providing potential access to non-public information;

the use and effectiveness of information barriers;

relationships with fund investors who are corporate insiders;

use of restricted lists and trading of companies on restricted lists;

controls and compliance policies and procedures around the creation, receipt and use of alternative data; and

due diligence and oversight of alternative data providers; and

- **digital assets**, including:

portfolio management and trading practices;

custody and safety of client assets; and

valuation issues.

SEC AI Sweep

In December 2023, SEC Chair Gary Gensler warned the industry against "AI washing" – or making unfounded claims relating to the use of AI – comparing it to "greenwashing" in the ESG space. Moreover, in a speech entitled "Newton to AI" in July 2023, Gensler noted several micro and macro challenges of AI, including explainability (the AI "black box" problem), bias (the potential for unfair outcomes that reflect historical biases), robustness (the potential for inaccuracy in GenAI output), data privacy (related to the AI training process), deception (the use of AI to foster fraud and deceptive content), and other systemic concerns (e.g., the possibility of one or even a small number of AI platforms dominating the market and potentially affecting market stability).

Given such concerns, it is not surprising that the SEC undertook some preliminary investigations of firms about their use of AI. During the second half of the year, SEC staff conducted sweep examinations of how

private fund advisors use AI, submitting a set of various questions. The inquiry focused on such things as:

- AI Disclosures and Marketing: Documenting where the use of AI by the investment adviser is stated or referred to specifically in a disclosure.
- AI Models and Techniques: Describing all AI models and techniques developed and implemented by the investment adviser to manage client portfolios or make investment decisions and transactions.
- Algorithmic Trading Signals and Associated Models: Describing all algorithmic trading signals generated by AI models, including input data sources along with their vendor or, if generated in-house, method of acquisition as well as primary data inputs.
- Data Sources: Listing all data sources utilized by artificial intelligence systems.
- Compliance Policies and Procedures: Outlining all compliance and operational policies and procedures concerning the supervision of artificial intelligence systems.
- Data Security: Documenting data security measures when using AI.
- Incident Reports: Reporting on any incidents where AI use raised any regulatory, ethical, or legal issues.
- Data Acquisition Errors and Adjustments: Disclosing all data acquisition errors and/or adjustments to algorithmic modifications due to data acquisition errors during the examination period.

The sweep appeared to have two principal objectives: first, examining whether firms may have overstated their AI functionality, and second, gathering information about current use cases. The information could be used to produce a future guidance or risk alert, and, in some cases, may signal future enforcement actions.

SEC Enforcement Update

SEC Enforcement

Over the past two years, the SEC has pushed an aggressive slate of rulemaking affecting the private funds industry that imposes new restrictions and arm regulators with additional tools to identify, examine, and investigate market practices. As 2024 begins, we expect to see more scrutiny of private fund managers as the SEC takes steps to enforce the new rules and the principles it has espoused in its rulemaking—for example, its focus on the fiduciary obligations of private fund managers.

The SEC's Enforcement Director observed earlier in 2023 that private funds were a "substantive priority area" for the division, specifically noting concerns about potential conflicts of interest and fee and expense issues. On November 14, 2023, the SEC's Division of Enforcement announced its Enforcement Results for Fiscal Year 2023. Below are some key takeaways for fund managers:

- The Commission brought 760 total enforcement actions in FY 2023, which represents a 3% increase over FY 2022. The SEC also filed 501 new standalone enforcement actions, representing an 8% increase over the prior year.
- The SEC obtained orders and judgments for over $4.9 billion in disgorgement and penalties, the second highest amount in its history. This number was second only to last year's $6.4 billion (which notably included several sizable settlements against large broker-dealers in the SEC's off-channel messaging sweep).
- Overall, 18% of the SEC's actions this year involved either investment advisers or investment companies, which is roughly in line with last year's 23%. Over the past eight years, actions involving investment advisers/investment companies have consistently comprised the highest or next highest percentage of total SEC matters by category.

- With respect to the SEC's Whistleblower Program, the Commission set several noteworthy records this year. Namely, the SEC received a record number of whistleblower tips, awarded a record number of whistleblower awards, and awarded the largest ever award of nearly $279 million to a single whistleblower. In addition, the SEC imposed a record-high $10 million penalty against a private fund manager for violations under Rule 21F-17, which prohibits impediments to whistleblowing.
- The SEC highlighted its "initiative investigating noncompliance with the Marketing Rule," which resulted in nine investment advisers being charged with violations relating to hypothetical performance.
- The SEC emphasized several high-profile actions involving recordkeeping, reporting, and other compliance related violations "targeting misconduct that undermines its effective oversight of the securities industry." The SEC imposed significant civil penalties in these actions against regulated entities and issuers despite the absence of any allegations of investor harm.
- The SEC further highlighted multiple enforcement actions addressing ESG issues, including cases involving misstatements made during the marketing of ESG-branded investment products.
- The SEC came down especially hard on crypto-related matters this year, filing charges against a host of crypto exchanges, lending/staking products, and other intermediaries. The SEC brought several high-profile litigated matters that will challenge the scope of its regulatory authority in the crypto space. This is part of a growing willingness on the part of the SEC to litigate matters when necessary. More than 40 percent of the standalone matters for FY 2023 were filed in whole or in part as litigated actions, against both entities and individuals.

Enforcement Actions Filed in Fiscal Years 2018 to 2023

	FY 2023	FY 2022	FY 2021	FY 2020	FY 2019	FY 2018
Disgorgement and Penalties Ordered (in billions)	$4.95	$6.44	$3.80	$4.68	$4.35	$3.95
Total Actions	784	760	697	715	862	821
% of Total Actions Involving Investment Advisers / Investment Companies	18%	23%	23%	19%	29%	21%

These results demonstrate an SEC that has been active on the enforcement front. A summary of notable matters involving private fund managers follows.

Disclosure and Conflicts

The SEC settled several actions in September 2023 focused on alleged failures to disclose conflicts of interest.

The SEC charged Prime Group Holdings LLC, a private equity firm that focused on alternative real estate asset classes, for failing to adequately disclose millions of dollars of real estate brokerage fees that were paid to an affiliated firm. Prime Group's fund purchased self-storage real estate properties. Brokerage fees from those transactions were paid to a real estate brokerage firm that was wholly owned by Prime Group's CEO. Prime Group failed to adequately disclose this conflict of interest in the fund's limited partnership agreement, private placement memorandum, and due diligence questionnaires.

Similarly, the SEC charged Forepont Capital LLC for failing to obtain its clients' prior written consent for principal transactions involving the fund, certain executives, and a venture partner of Forepont. The SEC

separately charged Forepont for failing to disclose other conflicts and material facts related to certain aspects of the principal transactions, namely that the assets sold to the fund included the securities of a company whose CEO and co-founder was the brother of Forepont's CEO. Among other charges, the SEC also charged Forepont with violations of the Custody Rule for failing to timely distribute annual audited financial statements under the audit exception.

Finally, the SEC settled an action against American Infrastructure Funds involving a series of violations, including causing a soon-to-be expiring private equity fund to transfer assets to another fund it advised in exchange for interests in the new fund, all without the consent of investors or full disclosure to the fund's LPAC. The transfer effectively locked up client and investor money into the investment for an additional 11 years. AIF also failed to disclose a loan from one of its funds to another of its funds, and additionally amended a portfolio monitoring fee agreement and accelerated the applicable monitoring fee without obtaining LPAC consent or disclosing the ability to do so to investors.

Off-Channel Messaging Sweep(s)

The SEC has continued its off-channel messaging sweep investigation involving certain investment advisers, and large broker-dealers. As communications through personal devices have become a part of everyday personal and business communication (so-called "off-channel" methods), this has become a key focus area.

As the SEC presses this issue, asset managers should prepare for scrutiny of their compliance with recordkeeping requirements relating to off-channel communications. To minimize potential exposure, firms should reevaluate their policies and procedures (particularly as they relate to required records under the Advisers Act), focusing on detection and surveillance, identification of permissible devices and platforms, and evaluation of how to address internal noncompliance. The sheer magnitude of SEC penalties in the broker-dealer settlements showcases how seriously the SEC views recordkeeping.

For example, as a result of the existing SEC sweep, the SEC settled charges in August of 2023 against 11 Wall Street firms – including large multinational financial services firms – for alleged widespread failures in maintaining and preserving their employees' off-channel communications. Issues related to off-channel communications extend beyond recordkeeping; for example, in one matter, an investment adviser was charged with violating the recordkeeping provisions of Rule 204 of the Advisers Act for failing to monitor or retain its employees' off-channel communications relating to certain business matters. In September of 2023, the SEC settled charges against another 10 broker-dealers and investment advisers for widespread recordkeeping failures, bringing the total number of firms charged in this area to 40, with civil penalties exceeding $1.6 billion. In each of these matters, the SEC required the firms to retain compliance consultants.

Valuation and Fee Calculations

Fees and fee calculations continue to be a focus of SEC enforcement efforts. In one instance, the SEC charged private equity adviser Insight Venture Management, LLC for charging excess management fees as a result of inaccurately applying its permanent impairment policy by analyzing impairment at the "portfolio company" level rather than the "portfolio investment" level, as required by the funds' LPAs. The order also alleged a failure to disclose a conflict of interest to investors concerning the latitude afforded to the manager in the application of that policy.

In May 2023, the SEC charged Sciens Investment Management with failing to appropriately adopt and implement valuation procedures for Level 3 assets held in certain private equity funds. While Sciens had a basic valuation policy that tracked GAAP requirements, the SEC took issue with the fact that those policies did not provide enough substantive guidance on how to properly value the most illiquid assets in the funds. This lack of guidance resulted in Sciens' auditors issuing a qualified valuation opinion, and then withdrawing that opinion when they could not obtain sufficient support for the valuation of certain Level 3 assets. The SEC order cited violations of the Compliance Rule under the Advisers Act, notwithstanding that the manager had written down some of its investments and retroactively adjusted management fees.

In April 2023, the SEC charged Chatham Asset Management for allegedly manipulating trades in order to increase the valuation of certain securities. Chatham facilitated the sale of bonds from one of its clients to another at prices that Chatham proposed, which, when used as an "independent" valuation input, allowed the manager to mark up the remaining positions in those bonds and allegedly increase the fund fee base. The SEC's charges here underscore the importance of ensuring that assets involved in cross-trades have proper valuation documentation, including evidence that assets were valued at prices derived from the broader market.

In June 2023, the SEC filed a settled action against Infinity Q Capital Management, LLC for mispricing the net asset value of its public mutual fund and private fund. This action followed the criminal and civil matters filed in 2022 against Infinity Q's former Chief Investment Officer, as well as a fraud settlement with the fund itself. The SEC alleged that for four years, Infinity Q Capital Management actively manipulated valuation models and altered inputs to mask its funds' poor performance, resulting in an alleged overvaluation of over $1 billion. Notably, even though the management company took certain steps to remove the CIO and preserve value in the fund, the SEC still brought charges against the management company for fraudulent conduct by the CIO.

Marketing Rule

In September 2023, the SEC announced settled charges against nine investment advisers for advertising hypothetical performance to mass audiences on their websites without the Marketing Rule's required policies and procedures. Investment advisers had until November 4, 2022, to comply with the new Marketing Rule. Investment advisers' policies and procedures shall ensure that advertised hypothetical performance is appropriate for the likely financial situation and investment objectives of the intended audience. According to the SEC, attention-grabbing hypothetical performance presents an elevated risk for possible investors. The charges do not allege inaccurate information or fraud. Instead, the SEC is focused on policies, procedures, and presentations on websites aimed towards the general public, rather than to a particular intended audience. The nine settled investment advisers ranged from $42 million to $1.28 billion in regulatory assets under management.

MNPI Policies

Over the past few years, the SEC has focused on whether advisers have implemented appropriate policies and controls to prevent the misuse of material, nonpublic information (MNPI), both in the exam and enforcement context. On December 26, 2023, the SEC announced settled charges against OEP Capital Advisors, L.P. for failing to adhere to its MNPI policies. The SEC alleged that adviser personnel unnecessarily divulged the Funds' confidential information and M&A-related MNPI involving public companies to current investors, potential investors, and industry contacts. The adviser's written policies and procedures governing the disclosure of MNPI required a determination that disclosure was "necessary for legitimate business purposes." Although the adviser used non-disclosure agreements to protect MNPI and all investors were generally subject to confidentiality obligations, the SEC Oder alleged that adviser personnel did not always follow the firm's policy requiring a determination that disclosure was necessary for legitimate business purposes. Such disclosures of MNPI were often made in unofficial update emails, at times in the context of seeking additional investment. In other instances, disclosures were made during the firm's internal, weekly investment update meetings with guests who signed NDAs but had attended without the appropriate legitimate business purpose determination. The SEC Order also alleged that adviser personnel failed to adhere to the firm's written policies regarding performance claims in advertisements by including unapproved valuations and not seeking prior approval of the communications. The adviser agreed to a cease-and-desist order, a censure, and a $4 million civil money penalty.

Trading Violations

The SEC continues to bring enforcement actions in connection with trading violations. In June 2023, the SEC filed charges in federal court against Sabby Management LLC and its principal, alleging illegal "naked short selling" in the stock of at least 10 public companies that generated over $2 million in illegal profits. The complaint alleged that Sabby and its principal knowingly or recklessly placed short sales when they

had not borrowed or located the shares, and then failed to timely deliver the shares. The SEC seeks injunctive relief, disgorgement, and civil penalties.

On February 21, 2023, the SEC separately announced settled charges against Candlestick Capital Management and HITE Hedge Asset Management for violating Rule 105 of Regulation M of the Securities Exchange Act of 1934 ("Exchange Act"). In October 2023, the SEC announced settled charges against Anson Advisors under the same rule. Rule 105 restricts purchasing securities in a public offering within five days of short-selling those securities. Candlestick purchased stock for two private fund clients in a public offering, HITE purchased stock for five private fund clients in a public offering, and Anson purchased stock for private fund clients in three public offerings, respectively, all within Rule 105's restricted period after selling short the same respective stocks. The three actions imposed cease-and-desist orders, disgorgement, and civil money penalties.

Custody Rule

The SEC continued the targeted sweep concerning violations of the Investment Advisers Act's Custody Rule and Form ADV requirements by private fund advisers. In September 2023, the SEC announced settled charges against five advisory firms for violating the Custody Rule or associated Form ADV violations. The Custody Rule violations arose in part from failure to have independent audits of funds performed or delivered to investors in a timely manner under the Custody Rule's audit exemption for private fund sponsors. This follows a first set of cases charging nine advisory firms in September 2022. In a sign of increasing penalties, in December 2023, the SEC announced settled charges against Eagan Capital Management for failing to comply with the surprise examination requirement or audited financials alternative, which in addition to a cease-and-desist order and a civil money penalty, required Eagan to hire an independent compliance consultant.

SPACs

While the market for special purpose acquisition companies ("SPACs") has continued to wane, the SEC has continued to resolve investigations into the historical practices by investment advisers in the space, with particular focus on conflicts of interest for SPAC sponsors who received equity through founder shares or a "promote." In 2023, the SEC separately announced settled charges against three advisory firms for failure to disclose conflicts of interest concerning their personnel's ownership of SPACs sponsors, or related Schedule 13G untimeliness. The firms advised clients to invest in those respective SPACs. Each firm agreed to a cease-and-desist order, a censure, and a civil money penalty.

Fraud/Misappropriation

The SEC brought a handful of matters relating to more egregious conduct and fraud involving private fund managers.

In February 2023, the SEC filed insider trading charges against Kevin Van de Grift and Gil Friedman. The complaint alleged that Friedman, a then-consultant at Francisco Partners Management, tipped his friend, day-trader Van de Grift, with material, nonpublic information concerning the 2018 acquisition of Verifone Systems by Francisco Partners. The SEC alleged that Van de Grift illegally profited around $300,000 by purchasing shares before the acquisition announcement and selling one day after the announcement.

In August 2023, the SEC announced settled charges against fund administrator Theorem Fund Services for missing the multiyear Ponzi-like scheme at EIA All Weather Alpha Fund Partners involving misappropriation and misuse of investor funds. The SEC alleged that Theorem failed in its gatekeeper responsibilities by failing to recognize clear red flags.

In September 2023, the SEC brought charges against investment advisory firm Third Friday Management and its sole managing member, Michael E. Lewitt. The complaint alleged that Lewitt stole $4.7 million from fund investors for personal gain, and failed to disclose a material change in investment strategy, leading to

more than $19 million in fund assets being loaned to a distressed company outside of the fund's mandate.

In November 2023, the SEC filed an action for fraud against John Hughes, the President and Chief Compliance Officer of investment advisory firm Prophecy Asset Management. The complaint alleged that Hughes misled investors for years, to believe their investments were protected from losses, while Hughes fabricated documents and transactions to conceal hundreds of millions of dollars of losses.

SEC Policy and Rulemaking Updates

(i): New Private Fund Adviser Rules

On August 23, 2023, the SEC adopted new rules which will apply to private fund advisers (the "Private Fund Adviser Rules"). After its adoption, we issued alerts summarizing the Private Fund Adviser Rules, discussing their applicability to non-U.S. investment advisers and the Private Fund Adviser Rules compliance dates. More recently, we held an in-depth discussion of the changes brought about by these rules in an installment of "The Bottom Line" webinar series.

Although scaled back from the proposed rules, the Private Fund Adviser Rules represent a shift from a disclosure-based regime and still impose burdensome new obligations on investment advisers. However, the Private Fund Adviser Rules do not affect all advisers in the same way. How the Private Fund Adviser Rules affect advisers varies from adviser to adviser, and from fund to fund, based on the facts and circumstances of each situation. Even similarly sized advisers are likely to face different challenges in terms of implementation. It is key for each adviser to assess its own approach going forward.

Overview

Quarterly Statement Rule (in scope: RIAs only; compliance date: March 14, 2025)

The Quarterly Statement Rule[1] requires the preparation of a quarterly statement in plain English to fund investors that includes certain information regarding fees, expenses and performance. The quarterly statement must include (1) a fund expense table and (2) a portfolio investment expense table.

The quarterly statement's fund expense table must include the following:

- A detailed accounting of all compensation, fees and other amounts allocated or paid to the adviser or any of its related persons during the reporting period by the private fund, with separate line items for each category of allocation or payment (e.g., management, advisory, sub-advisory or similar fees or payments, performance-based compensation and other compensation);
- A detailed accounting of all fees and expenses allocated to or paid by the private fund during the reporting period, with separate line items for each category of fee or expense reflecting the total dollar amount, without "bucketing" (i.e., grouping expenses into broad categories that obfuscate the nature and/or extent of the fees and expenses)[2] and without grouping any expenses under a "miscellaneous" category or omitting any *de minimis* amounts,[3] including

[1] Rule 211(h)(1)-2.

[2] In adopting the rule, the SEC gave the following example: "If a fund paid insurance premiums, administrator expenses, and audit fees during the reporting period, a general reference to "fund expenses" on the quarterly statement will not satisfy the rule's detailed accounting requirement. Instead, an adviser is required to separately list each category of expense (i.e., in the example above, insurance premiums, administrator expenses, and audit fees) and the corresponding total dollar amount." Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Advisers Act Rel. No. IA-6383 (Aug. 23, 2023) ("Adopting Release"), at pp. 83-84.

[3] As the SEC explained in the Adopting Release, "If we were to allow advisers to group small expenses generally into broad categories, they might be able to obscure certain costs from investors, including those that could raise conflict of interest issues. Similarly, advisers might use a de minimis exception to avoid disclosing individual expenses that, in aggregate, could be significant." *Id.*, at p. 85.

cross references to the sections of the fund's organizational and offering documents that set forth the applicable provisions; and

- The amount of any offsets or rebates carried forward during the reporting period to subsequent periods to reduce future payments or allocations to the adviser or its related persons.

The quarterly statement's portfolio investment expense table must include all payments by covered portfolio investments to the adviser or any of its related persons, including a detailed accounting of all portfolio investment compensation allocated or paid to the adviser or any of its related persons by the covered portfolio investment during the reporting period, with separate line items for each category of allocation or payment reflecting the total dollar amount, presented both before and after the application of any offsets, rebates or waivers.

The quarterly statement must prominently disclose the manner in which all expenses, payments, allocations, rebates, waivers and offsets are calculated. The quarterly statement must also cross reference the sections of the fund's organizational and offering documents that describe the applicable calculation methodology.

Before sending out the quarterly statement, advisers must categorize their funds as either liquid or illiquid funds. Depending on which type of fund it is, funds must provide different types of information, in each case , as follows:

- Liquid funds (funds that permit voluntary redemptions or withdrawals) must provide:

annual net total returns for each fiscal year over the past 10 fiscal years or since inception, whichever is shorter;

average annual net total returns over one, five, and ten-year fiscal periods; and

the cumulative net total return for the current fiscal year as of the most recent financial quarter covered by the statement.

- Illiquid funds (defined as a private fund that (i) is not required to redeem interests upon an investor's request and (ii) has limited opportunities, if any, for investors to withdraw before termination of the fund) must provide, from inception (in each case computed with and without the effect of any fund-level subscription facilities that are secured by the unfunded capital commitments of the private fund's investors):

gross and net IRR;

gross and net MOIC;

gross IRR and gross MOIC for the realized and unrealized portion of the illiquid fund's portfolio, with the realized and unrealized performance shown separately; and

a statement of the illiquid fund's contributions and distributions.

The quarterly statements must provide consolidated reporting for similar pools of assets if that would provide more meaningful information to investors.[4]

The quarterly statement must be delivered to private fund investors within 45 days (Q1-Q3) or 90 days (Q4) of quarter-end. For funds of funds, the respective deadlines are 75 days (Q1-Q3) and 120 days (Q4).

Quarterly reports can be used to meet certain Restricted Activities Rule disclosure requirements (as described below), but only if delivered within that Rule's 45-day requirement, with no exceptions for the fourth quarter or for funds of funds.

[4] As stated in the Adopting Release, "private fund advisers generally should take into account any input received from investors on what approach to consolidation that they view as most meaningful." *Id.*, at p. 154.

Newly-formed funds must comply after the second full fiscal quarter of generating operating results.

For hedge funds and other liquid funds with side pockets, advisers should consider how the performance of side pocket investments should be calculated and reported.[5]

Private Fund Audit Rule (in scope: RIAs only; compliance date: March 14, 2025)

The Private Fund Audit Rule[6] requires that RIAs ensure that each of their funds undergoes an annual financial statement audit. The audit must adhere to the same standards as the Custody Rule's audit requirements.

The Private Fund Audit Rule also requires such audits be conducted annually within 120 days of the private fund's fiscal year-end and promptly upon liquidation. Given that the rule incorporates the Custody Rule's audit-related provisions by reference, all of the related provisions and SEC guidance under the Custody Rule -- both historical and future – would apply here as well, including the 180-day timeframe afforded to advisers to funds-of-funds, and including the SEC staff's previous relief regarding special purpose vehicles ("SPVs") that are wholly-owned by one or more of the adviser's audited private funds.

If the adviser is an unaffiliated sub-adviser of a fund's primary adviser, the sub-adviser must make (and document) all reasonable efforts to cause the fund to undergo an audit that meets the Custody Rule requirements. This requirement will likely create difficulties for sub-advisers to non-US funds with non-US primary advisers. The unaffiliated sub-adviser would need to ask for the fund to undergo a US GAAP audit or reconciliation.

In a change from the rule as initially proposed, auditors will not be required to notify the SEC in connection with issues arising under these audits.

The Private Fund Audit Rule effectively eliminates the option under the Custody Rule for funds that the adviser causes to undergo a surprise examination, which the SEC felt did not provide investors with sufficient information regarding their investments in the fund.[7]

Neither the Private Fund Audit Rule nor the SEC's Adopting Release address how private fund advisers might be able to comply with the rule cost-effectively in the case of funds that are winding down or that otherwise have diminished resources to pay the required audit costs – a known issue across many private fund advisers impacting compliance with the Custody Rule, which could previously be addressed through that rule's surprise examination procedures (which effectively will become unavailable as an option to private fund advisers upon the Private Fund Audit Rule's compliance date). In terms of potential solutions in such cases, advisers could seek to establish liquidating trusts administered by an unaffiliated trustee, or otherwise seek to liquidate (or distribute in-kind to the fund's investors) the fund's remaining assets.

Adviser-Led Secondaries Rule (in scope: RIAs only; compliance date: September 14, 2024 or March 14, 2025, depending on adviser size – see below for more information)

The Adviser-Led Secondaries Rule[8] requires an RIA, prior to the due date of the election form for an adviser-led secondary transaction, to (1) obtain and distribute a fairness opinion or valuation opinion from

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5 The Adopting Release is silent on this point, but advisers to hedge funds and other liquid funds may want to consider being guided by what the fund's investors are likely to find more meaningful, which is one of the primary policy goals of the rule.

6 Rule 206(4)-10.

7 The SEC cited the following examples: "For example, audited financial statements prepared in accordance with U.S. GAAP, which are the responsibility of the private fund adviser or its related person, include disclosures regarding the level of fair value hierarchy within which the fair value measurements are categorized in their entirety and a description of the valuation techniques and inputs used in the fair value measurement of the fund's investments. These audited financial statements also include disclosures regarding material related party transactions. In addition, fund borrowings, such as margin borrowings or fund-level subscription facilities, are disclosed in the financial statements." [footnotes omitted] Adopting Release, at p. 164.

8 Rule 211(h)(2)-2.

an independent opinion provider and (2) prepare and distribute a written summary of any material business relationships that the adviser or any of its related persons have, or have had, within the two-year period immediately prior to the issuance of the fairness opinion or valuation opinion, with the independent opinion provider.

For purposes of the Adviser-Led Secondaries Rule, an "adviser-led secondary transaction" is defined as any transaction initiated by the investment adviser or any of its related persons that offers private fund investors the choice between either (i) selling all or a portion of their interests in a private fund or (ii) converting or exchanging all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons.[9]

"Larger" private fund advisers (i.e., those having $1.5 billion in private fund "regulatory assets under management ("RAUM")) must comply by September 14, 2024. "Smaller" private fund advisers (i.e., those having less than $1.5 billion in private fund RAUM) must comply by March 14, 2025.

Restricted Activities Rule (in scope: all advisers, whether registered or not; compliance date: September 14, 2024 or March 14, 2025, depending on adviser size – see below for more information)

The Restricted Activities Rule[10] restricts private fund advisers from engaging in certain activities unless specific disclosures are made and, in some cases, investor consent is obtained. In the context of this rule, "consent" means approval by a majority in interest of fund investors that are not an adviser's related persons.[11]

The Restricted Activities Rule specifically restricts:

- Subject to limited grandfathering (as described below), charging or allocating to a private fund advised by the adviser any regulatory, compliance or examination-related fees or expenses of the adviser or its related persons, unless disclosed to the fund's investors within 45 days after the end of the quarter in which charged or allocated. Disclosure will need to include the dollar amount being charged and a detailed itemization.[12]
- Charging or allocating to a private fund advised by the adviser any fees or expenses associated with an investigation of the adviser or its related persons by any governmental or regulatory authority, unless the adviser provides advanced notice to and obtains informed consent from investors as described above, but only if the adviser or its related persons have not been sanctioned for violations of the Advisers Act.
- Charging or allocating fees and expenses related to a portfolio investment or potential portfolio investment on a non-pro rata basis when more than one private fund or other client advised by the adviser or its related persons have invested or are proposed to invest, unless the non-pro

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9 This definition of "adviser-led secondary transaction" is **narrower** than the definition of the same term as used in Form PF for current reports of adviser-led secondary transactions in private equity funds. Per the Adopting Release, this difference appears deliberate, with the SEC acknowledging that the Adviser-Led Secondaries Rule disclosure requirement and the Form PF reporting requirement use "different means, entail different burdens, and employ modified definitions". Adopting Release, fn. 564 at p. 184.

10 Rule 211(h)(2)-1.

11 As noted in the Adopting Release, approval by a private fund's limited partner advisory committee, advisory board or similar body established under a fund's governing documents to waive conflicts of interest (an "LPAC") will not be sufficient for purposes of obtaining investor consent under the rule: "current private fund governance mechanisms, such as the LPAC, may not have sufficient independence, authority, or accountability to effectively oversee and consent to conflicts or other harmful practices". Adopting Release, at p. 206.

12 As the SEC explained in the Adopting Release, "Advisers should generally list each specific category of fee or expense as a separate line item and the dollar amount thereof, rather than group such fees and expenses into broad categories such as "compliance expenses."" *Id.*, fn. 630 at p. 209. Such disclosure can be made through quarterly statements delivered under the Quarterly Statement Rule, but only if delivered within 45 days of quarter-end. Thus, the required disclosures under this provision of the Restricted Activities Rule may need to be made prior to delivery of quarterly statements under the Quarterly Statement Rule in cases where the adviser is availing itself of the delayed reporting available under the Quarterly Statement Rule (i.e., 90 days after Q4 for non-funds of funds, or 75120 days for funds of funds.

rata charge or allocation is fair and equitable under the circumstance and Prior to charging or allocating such fees or expenses to a private fund client, the adviser distributes to each investor of the private fund a written notice of the non-pro rata charge or allocation and a description of how it is fair and equitable under the circumstances.

- Reducing the amount of any performance compensation clawback by actual, potential or hypothetical taxes applicable to the adviser, its related persons or their owners unless the adviser notifies investors of the aggregate amounts clawback before and after any such reduction within 45 days after the end of the applicable quarter.[13]
- Subject to limited grandfathering (as described below), borrowing, or receiving a loan or extension of credit, from a private fund client, unless the adviser provides advanced notice to and obtains informed consent from investors as described above.

"Larger" private fund advisers must comply by September 14, 2024. "Smaller" private fund advisers must comply by March 14, 2025.

Preferential Treatment Rule (in scope: all advisers, whether registered or not; compliance date: September 14, 2024 or March 14, 2025, depending on adviser size – see below for more information)

Preferential Redemptions

The Preferential Treatment Rule[14] prohibits, with limited grandfathering, granting an investor in a private fund or in a similar pool of assets the ability to redeem on terms that the adviser reasonably expects to have a material, negative effect on other investors in that private fund or similar pool of assets, with two exceptions:

- Where an investor's ability to redeem "is required by the applicable laws, rules, regulations, or orders of any relevant foreign or U.S. Government, State, or political subdivision to which the investor, the private fund, or any similar pool of assets is subject".[15]
- Where such rights are offered to all other existing investors in the fund and any similar pool of assets and will continue to be offered to all future investors in the private fund or similar pool of assets.[16]

Preferential Transparency

The Preferential Treatment Rule also prohibits, with limited grandfathering, providing information regarding the portfolio holdings or exposures of the private fund, or of a similar pool of assets, to any investor in the private fund if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or similar pool of assets, except where the adviser offers such information to all other existing investors in the private fund at the same time or substantially the same time.

In connection with any disclosures of portfolio-related information to selected fund investors in cases where

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[13] As noted above, such disclosure can be made through quarterly statements delivered under the Quarterly Statement Rule, but only if delivered within 45 days of quarter-end.

[14] Rule 211(h)(2)-3.

[15] Per the Adopting Release, an investor's internal policies or resolutions (e.g., an investor's restricted investments policy) does not suffice as a basis for this exception. Adopting Release, at p. 274 ("excluding redemptions pursuant to these more informal arrangements could compromise the investor protection goals of the rule and would incentivize investors to adopt policies or resolutions to circumvent the rule").

[16] Per the Adopting Release, this exception is only available where the rights are offered to investors without qualifications (e.g., no requirements as to commitment size or investor affiliation, or other limitations), although different redemption rights could permissibly be tied to different fee classes. *Id.*, at p. 275 ("To qualify for the exception, an adviser must have offered the same redemption ability to all other existing investors and must continue to offer such redemption ability to all future investors without qualification (e.g., no commitment size, affiliation requirements, or other limitations). For example, an adviser offering a fund with three share classes, each with different liquidity options but that are otherwise subject to the same terms (Class A, Class B, and Class C), cannot restrict Class A to friends and family investors if the adviser reasonably expects such liquidity rights to have a material, negative effect on other investors." [footnotes omitted]).

the information relates to publicly-traded issuers, advisers should consider reviewing their nondisclosure agreements and similar agreements signed by such investors to assess whether those agreements are sufficient to prevent investors from using such information to trade (i.e., whether the agreement contains a standstill or non-use provision) and to prevent them from "tipping" or otherwise disclosing such information to others in ways that could lead to losses or other harm for other investors. Advisers should also consider similar implications in the context of preferential transparency provided in the course of investor due diligence requests, investor meetings and similar contexts.

Other Preferential Treatment and Disclosure of Preferential Treatment

Material Economic Terms: The Preferential Treatment Rule also requires advisers to provide to prospective private fund investors, prior to the investor's investment in the fund, a written notice with specific information about any preferential treatment related to any "material economic terms" that the adviser or its related persons provide to other investors in the same private fund. As explained by the SEC in the Adopting Release, "material economic terms" include "those terms that a prospective investor would find most important and that would significantly impact its bargaining position (i.e., material economic terms, including, but not limited to, the cost of investing, liquidity rights, fee breaks, and co-investment rights)."[17] In discussing the need for such terms to be disclosed prior to an investor's decision to invest in the fund, the SEC explained that its goal was to "provide them with transparency regarding how the terms may affect their investment, how the terms may affect the adviser's relationship with the private fund and its investors, and whether the terms create any additional conflicts of interest".[18]

All Other Terms: In addition, the rule requires advisers to disclose all other preferential treatment granted to any investor in a private fund, in writing, to other current investors in the same fund as follows: (i) for illiquid funds, as soon as reasonably practicable following the end of the private fund's fundraising period, and (ii) for liquid funds, as soon as reasonably practicable following the investor's investment in the private fund.[19] The SEC clarified that any preferential term must be described specifically in order to convey its relevance.[20]

Annual Disclosures of New Terms Not Previously Disclosed: In addition, the rule requires advisers to disclose, on an annual basis, any preferential terms granted to any investor in a private fund that was not previously disclosed to other investors in that same fund (e.g., through a side letter entered into with a fund investor admitted as a transferee into an existing illiquid fund after the end of the fund's fundraising period).[21]

Additional Considerations

The Preferential Treatment Rule applies not only to terms granted to specific investors through side letters,

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[17] *Id.*, at pp. 289-290. The SEC further explained why it felt that co-investment rights should be viewed as "material economic terms", saying "Co-investment rights will generally qualify as a material, economic term to the extent they include materially different fee and expense terms from those of the main fund (e.g., no fees or no obligation to bear broken deal expenses). Even if co-investment rights do not include different fee and expense terms, and for example, are offered to provide an investor with additional exposure to a particular investment or investment type, investors often negotiate for those rights and give up other terms in the bargaining process in order to secure access to co-investment opportunities. As a result, co-investment terms generally will be material given their impact on an investor's bargaining position." I*d.*, fn. 882 at p. 290.

[18] *Id.*, at p. 289.

[19] Although the rule does not provide a specific timeframe for measuring "as soon as reasonably practicable", the SEC explained that "it would generally be appropriate for advisers to distribute the notices within four weeks". *Id.*, at p. 295.

[20] *See id.*, at. p. 293 ("We do not believe that mere disclosure of the fact that other investors are paying lower fees is specific enough. For example, if an adviser provides an investor with lower fee terms in exchange for a significantly higher capital contribution than paid by others, an adviser must describe the lower fee terms, including the applicable rate (or range of rates if multiple investors pay such lower fees), in order to provide specific information as required by the rule.").

[21] *See id.*, at p. 292 ("We believe that the annual notice requirement will require advisers to reassess periodically the preferential terms they provide to investors in the same fund, and investors will benefit from receiving periodic updates on preferential terms provided to other investors in the same fund (e.g., investors will benefit because they will be able to assess whether such preferential treatment presents new conflicts for the adviser).").

but also to terms granted to classes of investors under a fund's governing documents.[22]

With respect to preferential redemptions and transparency:

- The rule defines the term "similar pool of assets" very broadly, as a pooled investment vehicles with "substantially similar investment policies, objectives, or strategies" as the private fund. In adopting a broad definition, the SEC's goal was to prevent advisers from "attempting to structure around the preferential treatment prohibitions".[23]
- The rule does not define the term "material, negative effect". Accordingly, deciding whether there is a material, negative effect on other investors requires an analysis of all of the facts and circumstances.
- While these provisions of the rule are likely to be more relevant in the context of liquid funds, the SEC declined to limit these provisions of the rule to liquid funds, noting that under certain circumstances preferential redemptions or portfolio information could result in a material negative effect even on investors in illiquid funds, with the analysis turning on the adviser's reasonable expectation of harm to other investors.

"Larger" private fund advisers must comply by September 14, 2024. "Smaller" private fund advisers must comply by March 14, 2025.

Amendments to existing Compliance Rule (in scope: RIAs only; compliance date: November 13, 2023)

Unlike the other Private Fund Adviser Rules which come into effect in 2024 or 2025, the amended Compliance Rule[24] became effective on November 13, 2023.

The amendments to the Compliance Rule require that all RIAs document in writing their required annual review of their compliance policies and procedures. Previously, the Books and Records Rule required that if an RIA created a written report of their annual review, then the adviser had to keep the report. However, the Books and Records Rule did not require that RIAs create a written report. These amendments resolve this gap.

Because creating the report is a regulatory requirement, the report's content generally would not be subject to privilege claims in most cases, even if it was prepared by outside counsel. Even so, the amendments do not prevent privileged communications between investment advisers and their lawyers, which can continue to occur (e.g., regarding whether or not certain information is required to be included in such a written report or whether the information may be omitted).

Grandfathering/ "Legacy" Status

The Restricted Activities Rule and Preferential Treatment Rule provide for grandfathering with respect to certain of the Rules' provisions for certain "legacy" contractual agreements that govern the fund or that

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[22] *See id.*, at p. 275 ("While preferential liquidity terms provided via side letter are more explicitly targeted to particular investors, we believe that favorable liquidity terms provided through the fund's governing documents (i.e., by a fund offering different share classes, some with more favorable liquidity terms than others) presents the same concerns that our final rule seeks to address.").

[23] *Id.*, at p. 283. The SEC intentionally broadened the definition from the similar term "related portfolio" used in the Marketing Rule, which in that rule means a portfolio with substantially similar "investment policies, objectives, **and** strategies…" (emphasis added). By contrast, the Preferential Treatment Rule's "similar pool of assets" includes a pooled investment vehicle with similar "investment policies, objectives, **or** strategies…" (emphasis added) (the Preferential Treatment Rule's "similar pool of assets" also does not include the word "substantially," indicating its broader meaning in this rule as compared to the Marketing Rule). *Id.*, fn. 857 at p. 282. See also *id.*, at p. 282 ("the definition will likely capture vehicles outside of what the private funds industry would typically view as "substantially similar pools of assets." For example, an adviser's healthcare-focused private fund may be considered a "similar pool of assets" to the adviser's technology-focused private fund under the definition.").

[24] Rule 206(4)-7.

govern any borrowing, loan, or extension of credit entered into by a fund, if the agreements both (1) were entered into prior to the relevant compliance date and (2) would need to be amended in order to ensure compliance with the rules, as described in more detail below.

Specifically, legacy agreements relating to a fund bearing investigation-related expenses, or to the adviser borrowing from a fund, are grandfathered without the need to obtain investor consent if the agreement would otherwise need to be amended to comply. However, agreements permitting a fund to bear expenses related to sanctioned matters are not grandfathered.

In addition, legacy preferential redemption or information rights are not subject to the rule's prohibition of such terms if the relevant agreement granting such rights would otherwise need to be amended in order to comply with the rule. However, grandfathered terms must still be disclosed pursuant to the rule's notice provisions.

Carve-Out for "Offshore" Advisers Advising "Offshore" Funds

In the adopting release, the SEC highlighted that none of the Private Fund Adviser Rules (apart from the amended Compliance Rule) will apply to advisers that have their principal office and place of business outside of the United States to the extent that they advise non-U.S. domiciled funds.

This carve-out applies to both RIAs and exempt advisers (i.e., non-U.S. ERAs or advisers relying on the foreign private adviser exemption).

Carve-Out for Advisers to Securitized Asset Funds

Similarly, none of the Private Fund Adviser Rules (apart from the amended Compliance Rule) will apply to any advisers to the extent that they advise securitized asset funds.

This carve-out applies to both RIAs and exempt advisers.

What's Next: Litigation Challenges to the Private Fund Adviser Rules

On September 1, 2023, six trade associations filed a lawsuit with the federal Court of Appeals in the Fifth Circuit (the "Court") challenging the validity and enforceability of the Private Fund Adviser Rules. The lawsuit was filed in the form of a Petition for Review pursuant to Section 213(a) of the Advisers Act, which authorizes such a petition for persons "aggrieved" by the actions of the SEC.

The Petition asserts that the new Rules "exceed the Commission's statutory authority, were adopted without compliance with notice-and-comment requirements, and are otherwise arbitrary, capricious, an abuse of discretion, and contrary to law, all in violation of the Administrative Procedure Act…and of the Commission's heightened obligation to consider its rules' effects on 'efficiency, competition, and capital formation'" in violation of requirements for SEC rulemaking under the Advisers Act.

The filing of such a lawsuit does not automatically pause the Rules' transition periods or otherwise delay their compliance dates. However, such a stay of the rules may be requested or granted, either by court order as part of the proceedings or as otherwise determined by the SEC.

The Petition was submitted jointly by the following six trade associations:

- National Association of Private Fund Managers
- Alternative Investment Management Association
- American Investment Council
- Loan Syndications and Trading Association

- Managed Funds Association
- National Venture Capital Association

Each organization's statement on the lawsuit is available at the above links.

The Court has agreed to proceed on an expedited schedule and the Petitioners, the SEC and Amici have filed briefs in support of each side. The parties (including *amici curiae*) have now fully briefed their arguments, and oral arguments were heard on February 5, 2024. Petitioners had previously requested a final ruling by the end of May 2024, and although the court has not agreed to provide its final ruling by any specific date, such a ruling could be issued at any time between now and then.

(ii): Environmental, Social and Governance Disclosures for Investment Advisers and Investment Companies

Over the last few years, the SEC has focused on ESG practices among advisers because of the agency's concern that investors may be vulnerable to misleading adviser claims about ESG. On May 25, the Securities and Exchange Commission ("SEC") issued proposed rules under the Investment Advisers Act of 1940 ("Advisers Act") for advisers to private funds that consider environmental, social or governance factors ("ESG") as part of one or more significant investment strategies. The proposed rules would require advisers employing ESG strategies to report additional information about those strategies to the SEC and provide additional, more detailed disclosure to clients.[25]

The proposed rules are part of an effort by the SEC to address the growth in ESG-focused investing and concerns that claims made by advisers about their ESG practices do not meet investor expectations.[26] The SEC's consideration of the rule proposals came only days after the SEC settled its first ESG-related enforcement action against an adviser to mutual funds, alleging that the adviser misled investors into believing that all of the funds were being managed in accordance with certain ESG principles.[27] The proposal marks a continuation of the SEC's focus on ESG practices among investment advisers, beginning in 2019 with a series of ESG-focused examinations[28] followed by a 2021 Division of Examinations Risk Alert on this topic.[29]

The SEC does not currently require detailed disclosures by an adviser about ESG or any other investment strategy employed by it. The proposing release explained that the SEC believes that ESG-focused investors may need more specific disclosure because they face special risks of being misled by advisers about their ESG policies.

The proposed rules would have the greatest impact on registered investment companies, *i.e.*, mutual funds, ETFs, closed-end funds and BDCs. They would have a lesser but still significant effect on advisers to private funds, particularly those registered with the SEC.

Comments are due 60 days after the proposing release is published in the Federal Register. We note that the comment period is twice as long as some recent comment periods for SEC rule proposals, which the SEC extended and re-opened after numerous industry complaints.

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[25] *Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices*, Advisers Act Rel. No. 6034 (May 25, 2022).

[26] *Investment Company Names*, Investment Company Act Rel. No. 34593 (May 25, 2022).

[27] *BNY Mellon Investment Adviser, Inc.*, Advisers Act Rel. No. 6032 (May 23, 2022). The SEC has previously brought similar enforcement actions that predate adoption of the term ESG, alleging failure to manage a fund consistent with disclosures made to investors. *See e.g.*, *Pax World Management Corp.*, Advisers Act Release No. 2761 (July 30, 2008).

[28] *ESG Funds Draw SEC Scrutiny*, The Wall Street Journal (December 16, 2019).

[29] *The Division of Examinations' Review of ESG Investing*, Risk Alert, SEC Division of Examinations (April 9, 2021)

Scope of the Proposed Rules

The proposed rules would apply to all advisers registered with the SEC under the Advisers Act and exempt reporting advisers that "consider" ESG factors as part of one or more "significant" investment strategies provided to clients. Many, if not all, advisers consider some aspects of ESG in selecting investments within an investment strategy primarily focused on achieving positive returns for clients. As a practical matter, an adviser's use of ESG factors in formulating investment advice would likely be considered "significant" under the proposed rules where the adviser discloses or promotes its use of ESG strategies to clients and prospective investors. Advisers that do not disclose or promote ESG strategies would likely be unaffected by the rule proposals.

Environmental, Social or Governance Factors

The proposed rules are designed to address current market confusion about what exactly are ESG investment strategies. Whether they would accomplish that objective was the subject of debate at the open Commission meeting, at which Commissioner Hester Peirce expressed skepticism given that the proposed rules would not define "E," "S" or "G."[30]

Environmental matters (the "E") are generally understood to involve the extent to which a company safeguards the environment, and its policies to address such matters as climate change, waste, pollution and resource depletion. Social matters (the "S") are generally understood to refer to how a company deals with its employees, suppliers and customers, and the communities in which it operates. Governance (the "G") is generally understood to deal with a company's leadership, executive pay, internal controls and shareholder rights.

Market participants take different positions based on subjective judgments as to whether a particular industry, practice or policy is favorable from an ESG perspective, as well as the relative importance of one or more of the ESG factors. Moreover, ESG investing is known by different terms, including "socially-responsible investing," "sustainable investing" and "green investing," each of which may be understood somewhat differently by market participants. In addition, there are many organizations currently providing competing guidelines, screens or methodologies to investors that are seeking to bring ESG factors to bear in their investment activities, including a growing number of private funds.

The SEC acknowledges that there are many approaches to ESG investing and seeks to organize the universe of ESG strategies not by their substance but by the nature of the adviser's commitment to incorporating ESG into its investment strategy. The SEC would thus require advisers to group the ESG strategies they employ into three buckets and, in the case of registered advisers, describe the strategies to their clients.

- "ESG Integration" strategies consider one or more of the ESG factors, but ESG is not dispositive to an investment decision. These strategies incorporate ESG considerations into the investment process alongside traditional factors and analysis that make up the investment strategy.

- "ESG Focused" strategies, according to the SEC, use one or more factors "as a significant or main consideration in either selecting investments or in engaging with portfolio companies." This might include an adviser that selected companies for investments because of their favorable ESG characteristics, as well as a company that did not have favorable ESG characteristics but the adviser planned to engage with the company (through proxy voting or direct engagement) to enhance its ESG characteristics.

[30] *Statement on Environmental, Social, and Governance Disclosures for Investment Advisers and Investment Companies*, Commissioner Hester M. Pierce (May 25, 2022).

- "ESG Impact" strategies are those that have "a stated goal that seeks to achieve a specific ESG impact or impacts that generate specific ESG-related benefits." *The SEC treats ESG Impact strategies as a subset of ESG-Focused strategies.*

Reporting to the SEC—Part 1A of Form ADV

The SEC proposed to amend Part 1A of Form ADV to obtain a "census" of advisers that use ESG factors, including their use of ESG consultants. The new reporting requirements would identify SEC advisers employing ESG strategies, allowing SEC examiners to identify candidates for future examinations to help safeguard against "greenwashing" (*i.e.*, overstating or otherwise misrepresenting the ESG factors incorporated into portfolio selection). The SEC notes that, because Form ADV is public, the new information will also permit the public to better identify advisers providing various levels of ESG strategies.

Items 5 (separately managed accounts) and Item 7 (private funds) would be amended to require an adviser to report (on corresponding sections of Schedule D) whether it considers ESG factors as part of one or more strategies and, if so, whether that strategy is "ESG Integration," "ESG Focused" or "ESG Impact." An adviser that considers ESG factors must report which factor(s) it considers (i.e., "E," "S," and/or "G"). If the adviser follows one or more third-party frameworks in connection with its ESG strategies, Item 5.M. would require it to identify the framework(s).

Items 6 (description of business) and 7 (financial industry affiliations) would be expanded to require that advisers report whether they themselves act as an ESG consultant or service provider or have a related person that is an ESG consultant or service provider. This information is designed to help the SEC and clients identify potential conflicts when an adviser uses a related person who is an ESG service provider.

The proposed ESG reporting would apply to both registered and exempt reporting advisers.[31]

Client Brochure—Part 2A of Form ADV

Item 8 of Part 2 of Form ADV currently requires registered advisers to disclose the methods of analysis and strategies the adviser uses in formulating advice provided to clients. For each "significant method of analysis or investment strategy" used, the adviser must disclose the material risks of that strategy. Currently, the risks of a strategy must be disclosed in detail only if the strategy involves "significant" or unusual risks. A strategy is "significant" for purpose of Item 8 if "more than a small portion of the adviser's clients' assets are advised using the method or strategy."[32]

The SEC proposes to amend Item 8 to add several new items. Item 8.D. would require an adviser to disclose ESG factors, if any, it considers for each significant investment strategy and how the adviser incorporates the factors (and which factors (i.e., E, S and/or G) it incorporates) when advising its clients. Thus, an adviser that employed an ESG strategy for selecting or excluding certain securities would need to disclose the criterion or methodology it employs, including any internal or third-party framework, screen or index.

The proposed form language would appear to require disclosure of ESG factors considered in any significant investment strategy employed by the adviser, regardless of whether the ESG factors are a significant element of a significant strategy.[33] This would seem to be a drafting error that we expect to be

[31] The amendments to Item 5 of Form ADV apply only to registered advisers inasmuch as exempt reporting advisers are not required to complete Item 5. Reporting would not be required for clients that are investment companies, for which the SEC proposed separate reporting requirements.

[32] *Amendments to Form ADV*, Advisers Act Rel. No. 3060 (July 28, 2010) (amending Form ADV to add the current narrative brochure requirements) at n.74.

[33] For example, an adviser to a private equity fund, in evaluating the acquisition of a prospective portfolio company, might take into account the proposed post-acquisition governance structure of the company as one of many factors considered, but with company valuation and operations being much more significant elements of the adviser's overall evaluation.

pointed out by commenters.

Item 10 (other industry activities and affiliations) would be amended to require advisers to disclose material relationships they or their control persons have with ESG consultants and service providers. Finally, Item 17 (proxy voting) would be amended to require advisers with specific voting policies that include ESG considerations to disclose them and how they consider them, including whether the adviser may employ different strategies to vote proxies for different clients.

Private Funds

Only a portion of the amendments proposed by the SEC would directly affect advisers to private funds. Exempt reporting advisers are not required to prepare or deliver a brochure and, thus, would not be directly affected by the proposed Part 2 brochure amendments, nor are they required to complete Item 5 of Part 1A.

Form ADV does not directly speak to disclosures made to investors in private funds. It is not unreasonable, however, to anticipate that whatever ESG disclosure requirements the SEC ultimately adopts, private fund advisers will feel a need to include the disclosures in fund offering documents, both to address regulatory concerns and investor expectations.

More directly, the SEC's focus on ESG strategies by advisers would likely have a significant spill-over effect that private fund advisers could not afford to ignore under existing law. The SEC's release proposing the new ESG rules emphasized that existing legal obligations, including the anti-fraud provisions of the Advisers Act, apply to all advisers, including advisers to private funds. To the extent that private fund advisers make representations or provide other assurances to investors or prospective investors about a fund's ESG strategies, it is expected that they would be exposed to the same liabilities as the mutual fund adviser that was the subject of the foregoing settled enforcement action.

And we note that the SEC is watching. The Division of Examinations included both private funds and ESG investing at the top of its list of significant focus areas for 2022.[34] Specifically, it cautioned that the Division would be examining advisers to determine whether they (i) were accurately disclosing their ESG investing approaches and had adopted policies and procedures designed to prevent violations of the Advisers Act in light of the ESG-related disclosures; (ii) were voting client securities in accordance with their proxy voting policies; or (iii) were overstating or otherwise misrepresenting the ESG factors incorporated into portfolio selection (*i.e.*, "greenwashing"). For at least the next year, advisers to private funds with ESG strategies can expect SEC examiners conducting an examination to drill into how those strategies are being implemented and the compliance policies around that implementation.

In light of these developments, private fund advisers should review their strategies, marketing materials and client/investor disclosures to determine whether they are fully consistent with the ESG strategies that they employ. In addition, they should be prepared to demonstrate (*i.e.,* document) compliance around these issues to SEC examiners.[35] Although they are yet to be adopted, the proposed rules provide insights into the SEC's view of the application of existing legal obligations of fund managers who employ ESG strategies.

Please see the "SEC Enforcement Update" section below for an additional discussion on ESG-related SEC enforcement.

(iii): Amendments to Form PF (One and Two)

The SEC proposed amendments to Form PF and related rules under the Advisers Act on January 26, 2022

[34] *2022 Examination Priorities*, SEC Division of Examinations (March 30, 2022).

[35] For example, SEC examiners often request copies of Investment Committee memos or other records evidencing the implementation of any ESG screening criteria described in the adviser's marketing materials.

("January Proposal"), and again jointly with the Commodity Futures Trading Commission (the "CFTC") on August 10, 2022 ("August Proposal").

On May 3, 2023, the SEC adopted the January Proposal (the "Amendments"), to Form PF. Form PF is a confidential reporting form for SEC-registered investment advisers to private funds to report information to the SEC and the Financial Stability Oversight Counsel ("FSOC") about private funds. Exempt reporting advisers are not required to file Form PF. **[The August Proposal is still in proposed form and has not yet been adopted.]**

Background

The SEC adopted Form PF in 2011 after enactment of the Dodd-Frank Wall Street Reform and Accountability Act of 2012, which directed the SEC to collect information about private funds for use by the FSOC to help in its assessment of systemic risk in the financial system. Advisers to hedge funds, private equity funds and liquidity funds (i.e., private money market funds) are required to file Form PF.

Amendments

The Amendments added new questions to the form and creates two new Form PF sections: (i) Section 5 (current report for large hedge fund advisers to qualifying hedge funds) and (ii) Section 6 (quarterly event report for advisers to private equity funds).

Once effective, the Amendments require the following:

- *Large hedge fund advisers*. Large hedge fund advisers that manage one or more "qualified hedge funds" (i.e., a hedge fund with more than $500 million in net asset value) must complete new Section 5 and file Form PF within 72 hours if any of the following events occur:

Investment losses of 20% or more within a ten-day period;

Increase in margin, collateral or equivalent of 20% or more within a ten-day period;

Notice of default by a fund for its inability to meet a call for margin, collateral, or equivalent;

Default by a fund counterparty;

A prime broker terminates or materially restricts its relationship with a fund;

A fund or its adviser experiences a significant disruption or degradation of its critical operations; or

A fund is unable to satisfy redemption requests or suspends redemptions.

- *Private equity fund advisers*. Private equity fund advisers (i.e., an adviser with at least $150 million in private equity AUM) must complete Section 6 and file Form PF within 60 calendar days following the end of any fiscal quarter in which any of the following events occur:

Completion of an adviser-led secondary transaction;

Notification that investors have removed the fund's General Partner (or similar control person); or

Notification that investors have elected to terminate the fund or its investment period.

- *Large private equity fund advisers*. In addition to the requirements listed immediately above, large private equity fund advisers must answer additional questions within 120 calendar days after the fiscal year-end. The new questions cover the following topics:

The occurrence of a general partner or limited partner clawback(s) of 10% or more of aggregate commitments;

The investment strategy of the reporting fund; and

The nature of any default by the fund or one of its portfolio companies.

August Proposal

As summarized in the 2022 PIF Annual Review, on August 10, 2022, the SEC and the CFTC jointly released the August Proposal, which, if implemented, would expand the information required to be reported by private fund advisers, including (i) more detailed information about fund borrowings, counterparty exposures, performance and hedge fund holdings; (ii) investments in cryptocurrency and other digital assets; and (iii) disaggregated information about fund structures, such as master-feeder, parallel funds and trading vehicles.

Proposed Amendments Applicable to all Form PF Filers: General Instructions

The SEC would amend the instructions to Form PF that would be applicable to all Form PF filers, including the reporting of certain identifying information, the calculation of assets under management, withdrawals and redemptions, inflows and outflows of assets, creditors and beneficial ownership. The amendments would also change the way master-feeder arrangements, funds of funds, and parallel funds are reported.

- *Master-feeder and Parallel Fund Structures*. Data reported on a master-feeder structure (and a parallel fund) would generally have to be reported separately for each component rather than in aggregate as currently permitted. An exception would be when a single feeder invests all of its assets in a single master fund and or cash and cash equivalents (a "disregarded feeder fund"). A private fund adviser would continue to aggregate a master-feeder structure for purpose of determining reporting thresholds, e.g., whether a particular hedge fund is a "large hedge fund."
- *Parallel Managed Account*. The SEC would require private fund advisers to exclude reporting of parallel managed account, which are separately managed accounts or other pools of assets that pursue substantially the same investment strategies. Form PF currently permits (but does not require) private fund advisers to report such accounts, and the SEC explained that the data from them has diminished the value of the fund data because the characteristics of these accounts are different from private funds. The value of parallel managed accounts would, however, continue to be reported on the form in a separate Question 16, and counted to determine whether the private fund adviser (or fund) meets the Form PF reporting threshold, e.g., whether the private fund adviser has $150 million of private fund assets under management.
- *Investments in Other Funds*. Private fund advisers that invest in other private funds ("Underlying Funds") currently include the value of the Underlying Funds for purpose of determining whether the private fund adviser meets the Form PF reporting threshold, i.e., whether the private fund adviser has $150 million of private fund assets under management. Private fund advisers are, however, permitted to exclude investment in private funds for purposes of determining whether the private fund meets the other threshold (e.g., to be a large hedge fund) as well as reporting in other sections of the form as long as they do so consistently. Under the August Proposal, the calculation of the Form PF thresholds would remain the same, but private fund advisers would, in responding to some questions, be required to "look through" an Underlying Fund to identify the indirect holdings (i.e., equity, debt, or other securities) unless the fund is a "trading vehicle" (discussed below). If adopted, this change would require the private fund adviser to have access to position-level information about Underlying Funds managed by third-party advisers.
- *Trading Vehicles*. The August Proposal would require reporting of special purpose vehicles, alternative investment vehicles, blocker entities, or other holding entities of reporting funds ("Trading Vehicles"). If the reporting fund owns all the equity in the trading vehicle, private fund advisers would have the option of aggregating its assets with those of the reporting fund or reporting them as a separate fund. A Trading Vehicle owned or used by multiple reporting funds would have to be reported as a separate private fund and separately characterized as a hedge fund, private equity fund or liquidity fund depending upon its activities. This particular change could create significant additional reporting burdens for funds that employ SPVs as

blockers or for other tax purposes.

- *Reporting Timelines*. The August Proposal would require private fund advisers that have quarterly filing obligations to update Form PF within a certain number of days after the end of each calendar quarter, rather than fiscal quarter. This change is designed to improve the quality of the data FSOC receives.

Basic Information about all Private Fund Advisers and Private Funds: Section 1a and 1b

The August Proposal would revise Section 1b of Form PF, on which private fund advisers report certain identifying information about themselves and the private funds they advise.

- *Identifying Information*. The August Proposal would require private fund advisers to provide additional identifying information, including legal identifiers, about the private fund adviser, its related persons, as well as the private funds.
- *Assets under Management*. Question 3 of Form PF requires private fund advisers to report assets under management and net assets under management attributable to private funds. The August Proposal would require private fund advisers to exclude the value of its private funds' investments in any other private fund managed by the private fund adviser ("Internal Funds") to avoid double counting. The amended instruction reflects the common understanding that a private fund adviser to a master feeder structure should not count both the master and feeder fund in determining the private fund adviser's RAUM.
- *Withdrawal and Redemption Rights*. The August Proposal would require private fund advisers to each reporting fund (and not only private fund advisers to hedge funds) to disclose whether the fund provides investors with withdrawal or redemption rights "in the ordinary course." If the reporting fund does provide for redemptions or withdrawals, the frequency would have to be reported. The information would have to be reported notwithstanding any notice, gating, lockups or other restrictions. The SEC explains that, even though private equity and venture capital funds that would be covered if the amendments are adopted rarely provide investors with these rights, the information would give the FSOC a better "picture" of private funds.
- *Gross Asset Value and Net Asset Value*. The August Proposal would require private fund advisers filing quarterly updates to report gross asset value and net asset value as of the end of each month of the reporting period, rather than only reporting the information as of the end of the reporting period as Form PF currently requires. Also private fund advisers would be required to separately break out the value of unfunded commitments included in the gross and net asset values. This information will alert FSOC of funds in their early stages whose asset values consist primarily of unfunded commitments are not yet playing with real money.
- *Inflows and Outflows*. The August Proposal would add a new Question 14 asking about contributions to the reporting fund as well as withdrawals, redemptions and any distributions to investors. Private fund advisers would be required to report the amount of all new contributions from investors, but exclude contributions of committed capital that they have already included in gross asset value calculated in accordance with Form ADV instructions. Quarterly filers would provide this information for each month of the reporting period. The SEC explained that information about cash flows would give FSOC better information about stresses on funds.
- *Borrowings and Types of Creditors*. Question 18 of Form PF currently requires private fund advisers to report the value of the reporting fund's borrowings and the types of its creditors. (The question is a short-form version of the more detailed reporting requirements applicable to large hedge funds in Section 2 of Form PF and thus not applicable to them.) The August Proposal would codify SEC staff interpretations of Form PF (which currently refers only to secured and non-secured debt) in a new Question 18 to include "synthetic long positions," and provide a non-exhaustive list of other types of less exotic borrowings. In addition, private fund advisers would be required to report whether a creditor is based in the U.S. and, if it is, whether it is a U.S. depository institution (rather than a bank).
- *Fair Value Hierarchy*. Form PF requires private fund advisers to report assets and liabilities of

reporting funds in categories based upon the fair value hierarchy of U.S. GAAP. The August Proposal would require private fund advisers to report the date of categorization, the absolute value of liabilities, and an explanation of any negative valuations. Cash and cash equivalents would be separately reported but not based on the fair value hierarchy.

- *Beneficial Ownership*. Private fund advisers would be required to provide more granular information regarding beneficial owners of the reporting fund's equity. Question 16 currently requires private fund advisers to report a good faith estimate of the percentage of the reporting fund's equity that is beneficially owned by different groups (or types) of investors. The question would be revised (and re-designated as Question 22) to ask whether certain groups are or are not U.S. persons (broker-dealers, insurance companies nonprofits, pension plans, banking and thrift institutions), and whether beneficial owners that are themselves private funds are Internal Funds or are "external funds." Private fund advisers that report beneficial owners in the "other" category would have to explain (in Question 4) why the owners would not qualify for other groups and explain the selection of "other."
- *Fund Performance*. The August Proposal would change the way funds report performance information in a number of respects, including the circumstances when monthly and quarterly performance must be reported (when reported to investors, et al.) and the currency in which it is reported (the one used in reports to investors), and when dollar-weighted return should be reported ("IRR") instead of time-weighted return (i.e., when IRR is reported to investors, et al.). Use of local currency would remove currency fluctuations from the reported data, permitting the FSOC to convert using a standard methodology.

Proposed Changes to Reporting for all Hedge Funds: Section 1c

Section 1c of Form PF reports information about hedge funds. The amendments, if adopted, would revise the way private fund advisers report information about the strategies they employ, counterparty exposures, and trading and clearing mechanisms.

- *Fund Investment Strategies*. The August Proposal would expand and update the current reporting requirements of hedge fund strategies (including the percentage of fund assets represented by the strategy), including more granular types of equity strategies (factor driven, statistical arbitrage, emerging markets); and debt strategies (litigation finance, emerging markets, and asset backed/structured products). New categories would include real estate and digital assets. Private fund advisers that select the "other category" of strategies would be required to explain why none of the categories specifically listed work. The SEC explained that it is trying to reduce the number of "other responses" to improve the quality of the data it receives.
- *Counterparty Exposures*. The August Proposal would revise Form PF to require private fund advisers to report additional information about a hedge fund's borrowing and financing arrangements and its exposure to counterparties (its non-portfolios credit exposure). The new table would not apply to large hedge funds, which are required by proposed new Questions 41-43 of Section 2 to report the same exposures on a quarterly basis. Responses to new Questions 26 through 28 would be reported annually.

  Proposed new Question 26 would require private fund advisers to hedge funds (other than Qualifying Hedge Funds) to complete a new "consolidated counterparty exposure table" reporting the aggregate amount of exposures that the reporting fund has to creditors and counterparties. The information in the new table would be broken down into the various types of exposures (e.g., secured and unsecured debt, margin, reverse repos, cleared and uncleared derivative positions, and short positions).

  Proposed new Question 27 would require private fund advisers to hedge funds to identify significant fund counterparties. Question 22 currently requires private fund advisers to identify and provide information about the five creditors and counterparties to which the fund has the greatest mark-to-market exposure. Proposed new Question 27 would, instead, require private

fund advisers to only identify counterparties to which the fund's total mark-to-market exposure (before posted collateral) is equal to or greater than, either (i) five percent of net asset value as of the data reporting date or (ii) $1 billion. If there are more than five such counterparties, the private fund adviser only would report the five counterparties to which the reporting fund owes the largest dollar amount. If there are fewer than five such counterparties, the private fund adviser would only report the counterparties meeting the threshold. Proposed new Question 28 would replace current Question 23 and provide information about counterparties' that have the greatest exposure to the fund using a similar test (except that posted collateral would not reduce the exposures).

- *Trading and Clearing Mechanisms*. Form PF requires private fund advisers to report estimates of the volume of securities, derivative, and repo trades that were traded and cleared using various modes, e.g., on a regulated exchange or swap execution facility, bilaterally, etc.). The information gives FSOC an understanding of the extent to which a fund trades away from regulated exchanges and clearing systems. The August Proposal would require the information to be provided in response to new Questions 29 and 30 the same information except in dollar values rather than as a percentage of value and trading volume.

Proposed Amendments for Hedge Fund Advisers: Section 2

Large Hedge Fund Advisers must file Section 2a of Form PF and must also complete Section 2(b) of the form with respect to any Qualifying Hedge Funds that they advise.

The August Proposal would eliminate some reporting requirements for hedge fund advisers, but would substantially increase reporting for Qualifying Hedge Funds. All of the changes appear intended to improve the data set FSOC receives, will require significant retooling of fund administrators' systems, and in some cases collection of new information.

- *Elimination of Section 2a*. The August Proposal would eliminate the three current questions (26, 27 and 28) comprising Section 2a which require reporting of aggregate information about hedge funds sub-asset class exposure, turnover and the geographical breakdown of their investments. Similar questions in the proposed new Section 2 (32, 34 and 35) would provide FSOC with similar information, although only from the larger qualified hedge funds.
- *Investment Exposure Reporting*. The August Proposal would replace the current table in Question 30 (re-designated as Question 32) with a series of "drop down" menu selections for each sub-asset class and the information required for each. The question would continue to require the aggregate dollar value of long and short position to various asset sub-classes for each Qualified Hedge Fund, but a significant amount of changes to data requirements would be made.

Sub-Asset Class Reporting. The August Proposal would merge some sub-classes and tailor the responses to require reporting by "instrument type" within the asset classes to identify whether the exposure is achieved through cash or physical investment exposure, through derivatives or other synthetic positions, or indirectly through a pooled investment vehicle (subject to a de minimis test). Form PF currently permits private fund advisers to combine such exposures when reporting certain debt and other sub-classes and to report pooled interest positions without regard to the indirect exposures.

Adjusted Exposure. The August Proposal would also add new "adjusted exposure" metric for each sub-asset class, which would net the long and short positions that are in same sub-asset class and share the same reference security. The Amendments would also prescribe a uniform method of calculating interest rate risk required to be reported on certain debt obligations.

- *Currency Exposures*. Question 30 currently requires private fund advisers to report direct exposure to currency for sub-asset classes related to foreign-exchange derivatives and non-US currency holdings. The August Proposal would expand currency exposure by adding a new Question 33 that would also require reporting of significant indirect currency exposures, i.e., those exposures from a holding of a pooled investment vehicle the value of which is equal

to or greater than either five percent of net asset value or $1 billion.

- *Country and Industry Exposures*. Currently, Question 28 of Form PF requires private fund advisers to report geographic exposures across eight regions and six countries, based on the percent of the reporting fund's net asset value. The August Proposal, if adopted, would replace Question 28 with a new Question 35 that requires reporting of the long and short value of a fund's exposure to various countries, and would also add a new Question 36 that would require reporting of a fund's industry exposure, each as of month-end. In responding to proposed Questions 35 and 36 private fund advisers would identify exposures, in either case, that are equal to or greater than, either (i) five percent of net asset value as of the data reporting date or (ii) $1 billion. Private fund advisers would be required to report, based on reasonably estimates, country and industry exposures that are direct or indirect (e.g., through an investment in other private funds, mutual funds, ETFs). Country exposures would be reported using International Organization for Standardization (ISO) codes, and industry exposures would be reported using the respective by North American Industry Classification System (NAICS) codes.
- *Turnover*. Currently, Question 27 requires private fund advisers to report a fund's portfolio turnover for each month, across ten categories of sub-asset classes (e.g., listed equities, corporate bonds, and sovereign and municipal bonds). If adopted, this question would be replaced with a similar new Question 34, which would be expanded to 26 categories (e.g., listed equity derivatives, foreign exchange derivatives, and derivative exposure to sovereign bonds).
- *Reporting Reference Assets*. One of the most significant changes in the August Proposal is related to reporting of granular information regarding "reference assets" (also commonly referred to as the underlying, in the case of a derivative or option contract). Currently, private fund advisers provide summary information regarding the total number of their open positions, and report large positions that are greater than 5% of the reporting fund's net asset value. However, the SEC and FSOC have found it difficult to make meaningful comparisons among funds because private fund advisers use different methods for calculating their open positions. The August Proposal would redesign these questions to provide insights regarding concentrated positions held by funds.

Open Position Reporting. In proposed new Question 39, private fund advisers would be required to identify the total number of reference assets, of which the reporting fund had a "netted exposure" during each month. Netted exposure is calculated by offsetting any long and short positions of the same underlying, to more accurately reflect the true economic exposure to the reference asset, whether net long or net short. In addition to counting the number of long and short reference assets, new Question 39 would also require private fund advisers to report, for each month, (i) the percentage of the fund's net assets represented by the reference assets that comprise the fund's top five long and short positions, and (iii) the percentage of the reporting fund's net assets that are comprised of the reference assets which make up the fund's top 10 long and short netted positions.

Large Position Reporting. Proposed new Question 40, would require private fund advisers to report, for each month, detailed information about reference assets that represent concentrated positions, including: a description of the asset; its CUSIP or Ticker; the dollar value of the long and/or short position; and its netted exposure. This proposed change would afford FSOC with regular insights into proprietary portfolio information about the reporting fund. Currently, Form PF only requires private fund advisers to report large positions by sub-asset class, and not does not require such precise information about large positions.

- *Counterparty Exposures*. The August Proposal would include a new Question 41, which would create a consolidated counterparty exposure table similar to the new consolidated counterparty exposure table in proposed Question 26 in section 1c. This table would require reporting of the aggregate amount of exposures that a Qualified Hedge Fund has to creditors and counterparties, broken down into the various types of exposures (e.g., secured and unsecured debt, margin, reverse repos, cleared and uncleared derivative positions, and short positions). However, unlike the proposed table in section 1c, proposed Question 41 would require information to be reported monthly, rather than annually, and would expand the data collected

(e.g., private fund advisers would report the expected impact to posted collateral in the event margin increased by one percent of the position size). Proposed Question 41 would replace current Questions 43, 44, 45 and 47, which would be deleted.

Proposed new Questions 42 and 43 would require private fund advisers to Qualified Hedge Funds to identify significant fund counterparties, similar to proposed new Questions 27 and 28 in section 1c. Proposed new Question 42 would require private fund advisers to identify counterparties to which the fund's total mark-to-market exposure (before posted collateral) is equal to or greater than, either (i) five percent of net asset value as of the data reporting date or (ii) $1 billion. In Question 42(a), the private fund adviser would identify its top five counterparties, meeting this significance test, and on a counterparty-by-counterparty basis complete an "individual counterparty exposure table," broken down into the various types of exposures. Proposed Question 42(b), on the other hand, would require the private fund adviser to identify all other significant counterparties, which also meet this same significance test, but would only require aggregate information about the total amount borrowed and the total collateral posted. Finally, proposed new Question 43 would require information about counterparties' that have the greatest exposure to the fund using a similar test (except that posted collateral would not reduce the exposures), and would have an analogous Question 43(a) with an individual counterparty exposure table for the fund's top five debtors and Question 43(b) would require aggregate information for all other significant debtors if the fund.

- *Market Factors*. The August Proposal, if adopted, would require private fund advisers to report data for all market factors that the fund's portfolio is directly exposed to, and providing such stress testing information will no longer be optional even if the private fund adviser does not regularly consider the factors in any formal testing. Private fund advisers would report data indicating how the reporting fund would be impacted, to both its long and short holdings, by certain increases or decreases in equity prices, interest rates, volatility, currency rates, commodity prices, among other market movements. The SEC believes this information would allow it to better track common market factor sensitivities, as well as correlations and trends in those market factor sensitivities, thereby giving it better insight to certain systemic risk.
- *Additional Data to be Reported*. The August Proposal also includes several other data changes and additions, which range from minor tweaks in the presentation of existing data—to new Questions seeking information that the private fund adviser are not required to report in the current version of Form PF.

What's next?

The effective date/compliance date for new Sections 5 and 6 is December 11, 2023. The effective date/compliance date for the amendments to Section 4 that affect large private equity funds is June 11, 2024.

(iv): Proposed Amendment to the Custody Rule, to be Renamed the "Safeguarding Rule", under the Advisers Act

On February 15, 2023, the SEC proposed amendments (the "Safeguarding Proposal") to Rule 206(4)-2 (the "Custody Rule") under the Advisers Act. The Safeguarding Proposal includes the redesignation of the Custody Rule as the safeguarding rule (the "Safeguarding Rule"). If passed as proposed, the Safeguarding Rule would:

- Expand the current Custody Rule to cover a broader array of client assets and advisory activities;
- Enhance the custodial protections that client assets receive under the rule; and
- Update an adviser's related recordkeeping and reporting requirements.

If adopted as proposed, the Safeguarding Rule will apply to RIAs. The SEC clarified in the related proposal release that the Safeguarding Rule would not apply to non-U.S. clients (including funds) of a registered offshore adviser. In February 2023, we published a blog post to discuss the Safeguarding Proposal's

effects on cryptocurrency. If adopted as proposed, the Safeguarding Rule would significantly impact private fund investment advisers.

Current Status and Timing

The initial comment period for the Safeguarding Rule ended on May 8, 2023. However, to give interested persons more time to understand the proposed amendments to the custody rule's audit provision in light of the private fund adviser audit rule, the SEC re-opened the comment period through October 30, 2023. This is because compliance with the private fund adviser audit rule is predicated partly on an adviser also complying with the custody rule's audit provision.

Overview

Expansion of Types of Assets under Custody

The Safeguarding Rule would expand the definition of custody to cover all client "assets", instead of only covering "funds and securities". "Assets" would include physical assets like real estate, artwork, physical commodities (e.g., wheat or lumber) and other physical commodities. "Assets" would also include crypto assets, financial contracts held for investment purposes and collateral posted in connection with a swap contract. Including crypto assets under custody would further the SEC's efforts to regulate cryptocurrency.

Discretionary Authority Resulting in Custody

Under the Safeguarding Rule, having discretionary trading authority would mean that the adviser has custody and trigger the Safeguarding Rule. The amended custody definition would specifically include any arrangements under which the adviser is permitted or authorized to withdraw or transfer beneficial ownership of client assets per the adviser's instruction (e.g., having discretionary authority or a general power of attorney). This provision would conflict with longstanding interpretations of the Custody Rule, where discretionary trading of delivery-versus-payment assets did not result in custody. This change would likely impact separately managed account ("SMA") arrangements, including those that do not trigger the current Custody Rule.

Requiring New Written Agreements

The Safeguarding Rule would require that all RIAs enter into written agreements with qualified custodians. RIAs would need to receive written reasonable assurances from the custodian regarding certain important protections of client assets. These reasonable assurances that the qualified custodian should provide to the RIAs in writing are as follows:

- The custodian must exercise due care and implement appropriate measures to safeguard the client assets;
- The custodian must indemnify an advisory client when its recklessness, negligence or willful misconduct results in that advisory client's loss;
- Sub-custodial arrangements must not relieve the custodian of its responsibilities to an advisory client;
- A custodian must clearly identify an advisory client's assets and segregate an advisory client's assets from its proprietary assets;
- The custodian must keep certain records relating to those assets;
- Unless authorized in writing by the client, the client's assets must remain free of liens in favor of a qualified custodian;
- The custodian must cooperate with an independent public accountant's efforts to evaluate its safeguarding efforts;

- Advisory clients must receive periodic custodial account statements directly from the qualified custodian;
- The custodian's internal controls relating to its custodial practices should be evaluated periodically for effectiveness; and
- The custodial agreement must mirror an investment adviser's agreed-upon level of authority to effect transactions in the advisory client's account.

Narrowing the Exception to the Rule

The Safeguarding Rule would amend the current custody rule's exception from the obligation to maintain client assets with a qualified custodian to cover advisers holding certain privately offered securities and certain physical assets.

However, the Safeguarding Rule would narrow the eligibility for the exception available for advisers to undergo a surprise examination to avoid maintaining their assets with a qualified custodian. This is because under the Safeguarding Rule, an adviser would need to determine and document that their client assets cannot be recorded and maintained in a way that a qualified custodian can maintain possession or control of the assets in order to be eligible for the surprise examination exception. To be eligible for this exception, an adviser would also need to notify an independent public accountant regarding any purchase, sale or other transfer of beneficial ownership of the assets within one business day and enter into a written agreement with the accountant so that the accountant would verify the transaction promptly upon receiving the notice. In other words, the Safeguarding Rule would enact new hurdles for advisers hoping to qualify for the surprise examination exception for its SMA arrangements.

Requiring Segregated Accounts

The Safeguarding Rule requires segregated accounts for banks and savings associations. This would result in custodians having to hold client assets in a special account to protect the assets from the creditors of banks and saving associations in the event of their insolvency or failure.

Amending Form ADV

The Safeguarding Rule would amend Form ADV. The amendments would help advisers identify when they have custody of client assets and provide information on adviser practices to safeguard client assets. The amendments would also collect new information that correspond with the Safeguarding Rule.

Requiring Recordkeeping

The Safeguarding Rule would amend the recordkeeping rule to require RIAs to maintain records of its custodial clients' trade and transaction activity and position information. The amendments would also require RIAs to: (1) maintain copies of required client notices, (2) create and maintain records documenting client account identifying information, including whether the RIA has discretionary authority, (3) create and maintain records of custodian identifying information (e.g., copies of custodial agreements and record of written reasonable assurances from the custodian), (4) create and maintain a record that shows the basis of the adviser's custody of client assets, (5) maintain copies of all account statements and (6) retain copies of any standing letters of authorization.

Commentator Feedback:

A number of trade associations have responded that, while they support ensuring investor protection and keeping client assets safe from potential misuse, the Safeguarding Rule could have numerous unintended consequences.

They noted that, among other things:

- The Safeguarding Rule would result in higher fees for custodial services. This would result in diminished investment returns for anyone who uses the services of RIAs.
- Requiring qualified custodians to hold cash client in segregated, off-the-balance sheet accounts would reduce banks' ability to provide credit. Mandatory cash deposit segregation would raise the cost of funding and credit and increase potential trade failures and operational risks.
- Requiring transaction verification for assets that cannot be custodied would essentially restrict advisory clients from investing in assets like physical commodities. In addition, this prohibition would disrupt the orderly functioning of commodities markets and increase the costs of agricultural and energy products.
- Requiring individual transaction verification creates burdensome new obligations for independent accounting firms. This new requirement would disproportionately affect smaller accounting firms, increase audit costs and potentially restrict the availability of the services that the Safeguarding Rule requires.
- The Safeguarding Rule's scope and obligations would impose new burdens on investment advisers and their compliance personnel. These burdens could disproportionately impact start-up advisers and smaller advisers.
- The segregation of client assets requirement would likely restrict prime brokers from providing margin financing by rehypothecating client assets, even when the prime broker has the client's consent to do so.
- The Safeguarding Rule's range of new custodial requirements would create operational and practical challenges to the custody of real estate. These challenges would materially inhibit adviser clients' access to investment strategies relating to real estate.
- The Safeguarding Rule's expanded definitions of "custody" and "assets" conflict with state insurance laws governing annuities.
- The Safeguarding Rule's expanded definitions of "custody" and "assets" are incompatible with both the CFTC's existing regulatory framework applicable to futures commission merchants and the SEC's margin regulations for uncleared security-based swaps.
- The Safeguarding Rule's new requirements for qualified custodians could significantly decrease the availability of custodial services for futures and derivatives.

(v): Modernization of Beneficial Ownership Reporting

As we have discussed previously, on October 10, 2023, the Securities and Exchange Commission adopted amendments to the rules governing beneficial ownership reporting under Sections 13(d) and 13(g) of the Securities Exchange Act of 1934. The adopting release is available here (the "Adopting Release"). These rules require investors that beneficially own more than 5% of a public company's equity securities to publicly disclose their beneficial ownership and other related information in either a Schedule 13D or Schedule 13G. The SEC's rule changes:

- shorten the deadline for initial Schedule 13D filings from 10 calendar days to five business days, although they now can be filed until 10:00 pm Eastern Time rather than 5:30 p.m.;
- require that Schedule 13D amendments be filed within two business days of a material change rather than the former facts and circumstances approach;
- accelerate the filing deadlines for Schedule 13G beneficial ownership reports and amendments; and
- expressly require the disclosure of certain derivative securities.

The SEC initially proposed amendments to the beneficial ownership reporting rules in its proposing release published in February of 2022. The SEC's proposed changes received extensive comments, and the final rules make a number of changes from what the SEC initially proposed. Importantly, the SEC did not adopt proposed changes to its rules regarding when a "group" acquires beneficial ownership, and did not adopt a proposed rule that would have included certain cash-settled derivative securities within the definition of what securities are beneficially owned for purposes of Regulation 13D-G. Instead, the Adopting Release provides additional guidance and commentary on the parameters around what activities do and do not result in the formation of a "group," as well as when cash-settled derivatives may result in beneficial ownership of the associated reference securities.

The new rules will be effective 90 days after publication in the Federal Register, which is expected to be soon. However, the compliance timing for the revised deadlines for Schedule 13Gs will not be in effect until September of 2024.

As we have discussed previously, the revised Regulation 13D-G rules are part of the SEC's ongoing comprehensive update to its regulation of the reporting of securities ownership and the use of derivatives and short sales by private investors, including private funds, hedge funds and family offices. On Friday, October 13, 2023, the SEC continued this project by adopting both new Rule 10c-1A, regarding the reporting of loaned securities, and new Rule 13f-2, regarding the reporting of short positions and short activity. The Adopting Release also notes that proposed Rule 10B-1, which would require prompt disclosure of large security-based swap positions, including credit default swaps and total return swaps, is still pending and may create additional reporting obligations for investors if ultimately adopted.

Please see the "Derivatives" section below for an additional discussion on developments relating to Regulation 13D-G Rules for beneficial ownership reporting.

(vi): Short Position and Short Activity Reporting by Institutional Investment Managers

On October 13, 2023, the SEC adopted new Rule 13f-2 (the "Short Sale Rule") to require monthly reporting of short sale positions and activity data on new Form SHO by institutional investment managers. The new rules require monthly reporting on new Form SHO of activity related to a broad spectrum of "equity securities." An investment manager must report on activity and positions where it has investment discretion, subject to thresholds described below.

Filing Thresholds

Investment managers with discretion over accounts that exceed certain thresholds of short sale activity will be required to confidentially file Form SHO within fourteen days of any month-end in which a threshold has been exceeded. The filing thresholds are as follows:

- For any "equity security" of an issuer registered pursuant to Section 12 of the Exchange Act or required to file reports under section 15(d) of the Exchange Act, either:

a gross short position in the equity security with a U.S. dollar value of $10 million or more at the close of any settlement date, or

a monthly average gross short position as a percentage of shares that equals of 2.5 percent or more.

- For any "equity security" of any other issuer, a gross short sale position that meets or exceeds a US dollar value of $500,000 or more.

"Equity security" includes securities convertible into equity securities but would not include short positions established through derivatives, and "gross short position" is calculated without regard to any offsetting long position. The information reported must also include the investment manager's "net" activity in the reported equity security for each individual settlement date during the month.

Public Reporting of Aggregated Short Sale Data

While the filings made by investment managers will not be publicly disclosed, it would be subject to a FOIA request. The Short Sale Rule will make the following aggregated information about short positions publicly available by the end of the month following the reported month:

- The issuer's name and other identifying information related to the issuer;
- The aggregated gross short position and corresponding dollar value across all reporting investment managers in the security at the close of the last settlement date of the relevant calendar month; and
- For each reported settlement date during the calendar month reporting period, the "net" activity aggregated across all reporting investment managers.

The Short Sale Rule will be effective January 2, 2024, although the obligation to comply with the Short Sale Rule and file the new Form SHO will be delayed for 12 months following the effective date. The SEC will begin to publish aggregated short sale data three months following the delayed compliance date.

SEC Adopts New Securities Lending Reporting Rule

On October 13, 2023, the SEC adopted new Rule 10c-1a (the "Securities Lending Rule"), requiring the reporting of certain material terms of securities lending transactions relating to "reportable securities" by the end of the day on which the loan is agreed or modified. The SEC states that the purpose of the new rule is to increase the transparency and efficiency of the securities lending market. The Securities Lending Rule will provide market participants with access to pricing and other material information, with only a short delay following agreement on the lending transaction.

All loans of "reportable securities" (with a few exceptions noted below) are required to be reported to a registered national securities association ("RNSA"). Reportable securities is defined as any security or class of an issuer's securities for which information is reported or required to be reported to the consolidated audit trail (CAT) as required by Rule 613 and the CAT National Market System Plan, FINRA's Trade Reporting and Compliance Engine (TRACE), the Municipal Securities Rulemaking Board Real-Time Transaction Reporting System, or any reporting system that replaces one of these systems. Reportable securities include equity securities (both exchange traded and those traded OTC), debt securities subject to TRACE reporting, and digital asset securities that meet the definition of "reportable security" (each a "Reportable Security"). It is important to note that the definition of Reportable Securities is not limited to U.S. exchange traded securities or securities issued by U.S. public companies, and there may be overlap with EU or UK SFTR reporting requirements.

The reporting obligation generally applies to the lender of the Reportable Security except where a broker or dealer is borrowing fully paid or excess margin securities. In that case, the SEC indicated that the customer may have agreed to a general lending program with their broker and may not be aware that their securities have been borrowed. The definition of "covered person" for purposes of the rule is not limited to U.S. persons and includes any person who effects, accepts, or facilitates a loan or borrowing in a Reportable Security in the U.S. Non-U.S. residents engaged in activities in the U.S. who lend (or borrow, if a broker or dealer) a Reportable Security are required to report the transaction to an RNSA.

Covered persons, either directly or through a reporting agent, must submit the following information about each loan of a Reportable Security by the end of the day on which the loan is agreed or modified:

Loan Data

- Information about the loaned security, including the legal name of the issuer, its LEI, whether the LEI is lapsed, and the ticker symbol, ISIN, CUSIP, FIGI or other identifier
- Information about the loan, including the date and time the loan was effected, the name of

platform where the loan was effected (if applicable), the termination date of the loan (if applicable), and the amount of the loan (size, volume or both)

- Information about the borrower, including whether the borrower is a broker or dealer, a customer (if the lender is a broker or dealer), a clearing agency, a bank, a custodian, or other person
- Information about collateral, including the type of collateral and percentage of the value of the loan
- Information about rebates, securities lending fees, and other charges

Confidential Data

- The parties to the loan, including the legal names of the parties, LEIs, the Central Registration Depository or Investment Advisor Registration Depository number, market participant identifier, and whether such person is the lender, the borrower, or an intermediary between the lender and the borrower
- If the loan is from a broker or dealer to its customer, whether the loan is from the broker's or dealer's securities inventory
- If known, whether the loan is being used to close out a fail to deliver under Rule 204 of Regulation SHO, or outside Rule 204 of Regulation SHO

Any modifications to the loan terms previously reported, along with the date and time of the modification and the previously assigned unique identifier (if any), must be reported to an RNSA by the end of the day on which the modification is effected.

The RNSA is required to make the Loan Data and any modifications to the Loan Data (in each case, other than the loan amount) public by the morning of the business day after the report was submitted on a transaction-by-transaction basis. The loan amount will be made public on the 20th business day after the initial report and any modification. The Confidential Data will not be released to the public.

The requirement to report the Loan Data and Confidential Data on securities lending transactions in Reportable Securities is delayed 24 months following the effective date of the new rule, January 2, 2024. RNSAs are required to propose rules to implement the Securities Lending Rule within 4 months of the effective date and must be approved by the SEC. The Loan Data will be made public beginning 90 days after the first required reports are submitted.

Please see the "Derivatives" section below for a discussion on developments relating to the Treasury Market Clearing Rules.

(vii): Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies and Business Development Companies

As summarized in the 2022 Proskauer Annual Review and below, the SEC previously proposed cybersecurity risk management rules under the Advisers Act and the Investment Company Act. These rules are still in proposed form and have not yet been adopted.

On March 9, 2022, the SEC proposed cybersecurity risk management rules under the Advisers Act and Investment Company Act, for RIAs, registered investment companies and business development companies, as well as various amendments to existing rules governing adviser and registered fund disclosures. The main focus of the 200 plus page new rules 206(4)-9 and 204-6 under the Advisers Act ("Proposed Cyber Rules") are to strengthen existing requirements and foster upgrades to the cybersecurity risk management practices of registered funds and advisers. Cybersecurity has been front of mind for the SEC in recent years, having issued updated guidance on public company cybersecurity disclosures in 2018 and risk alerts in 2020 on credential stuffing and ransomware attacks. The comment period expired in April 2022, but no final rule has yet been issued. Proposed New Cyber Rules would affect cybersecurity practices

for RIAs in a number of key ways by requiring:

- advisers and funds to implement written cybersecurity policies and procedures reasonably designed to address cybersecurity risks, including risks of using interconnected systems and networks directly and through IT vendors;
- advisers and funds to memorialize and maintain various recordkeeping obligations surrounding cybersecurity programs and the occurrence of cybersecurity incidents;
- advisers to disclose cybersecurity risks and incidents to the adviser's clients and prospective clients; funds to provide prospective and current investors with cybersecurity-related disclosures;
- advisers to report significant cybersecurity incidents to the SEC (including on behalf of a fund or private fund client); and
- Registered fund boards to undertake additional oversight of a cybersecurity risk management program.

Given the sophistication of today's cyber threat actors and organized ransomware groups, the vast majority of financial institutions, including RIAs and funds have in place some cybersecurity protections and technical measures under existing regulatory frameworks. However, if the Proposed Cyber Rule is approved, such entities would be obligated to take new, affirmative steps that would undoubtedly add to their compliance cost and time. For example, RIAs and funds would be required to review the design and efficacy of their cybersecurity policies and procedures annually and prepare a written report. Moreover, registered funds' board of directors would be tasked with approving cybersecurity policies and procedures, reviewing the annual cybersecurity program report, and taking oversight and accountability for the program.

Cybersecurity Policies and Procedures and Annual Review

The Proposed Cyber Rules would require all RIAs to "adopt and implement written policies and procedures that are reasonably designed to address cybersecurity risks", and calls for such policies to include five components:

- *Risk assessment*: The Proposed Cyber Rule would require RIAs and funds periodically to assess and draft written risk assessments of the particular threats (and potential ramifications of a significant cyberattack) to their systems, all based on an inventory of the network and its stored data and the presence of service providers that are permitted access to the network (and what cyber risks might be associated with these service providers). Such a program, according to the Proposed Cyber Rule, should be "reasonably designed to ensure its operational capability, including resiliency and capacity of information systems," in the face of a cyberattack. Given the evolving nature of threats, the Proposed Cyber Rule states that advisers and funds should reassess risks "as they arise" in order to prompt internal changes.
- *User security and access*: The Proposed Cyber Rule would require controls designed to minimize user-related risks and prevent unauthorized access to the network by mandating policies that echo cybersecurity protections already practiced by many companies (e.g., robust user authentication procedures and employee information access practices akin to the "principle of least privilege" (including protections that take into account the realities of remote working).
- *Information protection*. Registered funds and RIAs would be required to assess the sensitivity of data on its network and thereafter monitor IT systems to identify suspicious activity (including the regular testing of systems, including penetration tests). Such obligations, which undoubtedly are already firmly in place at covered entities, would also require certain third party vendor security oversight practices.
- *Threat and Vulnerability Management*. The Proposed Cyber Rule would require RIAs and funds to detect, mitigate, and remediate cybersecurity threats and vulnerabilities with respect to adviser or fund information and systems through ongoing monitoring of systems and industry

or government cyber threat information.

- *Cybersecurity Incident Response and Recovery*. The Proposed Cyber Rule would require RIAs and funds to have measures to detect, respond to, and recover from a cybersecurity incident; such entities would thus be able to continue to provide services to their clients and investors when facing cyber-related disruptions.

The Proposed Cyber Rules, if adopted, would also require RIAs to conduct reviews, at least annually, of their cybersecurity policies and procedures and produce a written report that details (i) the scope and nature of review conducted, (ii) any findings, (iii) any cybersecurity events that occurred during the period, and (iv) any material changes made to the policies and procedures.

Reporting Cybersecurity Incidents to the SEC

Under the Proposed Cyber Rule, RIAs would be required to report "significant cybersecurity incidents" confidentially to the Commission on proposed Form ADV-C. Such reporting would be required "promptly, but in no event more than 48 hours" after concluding that a significant cybersecurity incident had occurred or is occurring. Notably, this obligation would require RIAs to report significant cybersecurity incidents to the Commission, including on behalf of a registered fund, or a private fund client that "experiences a significant cybersecurity incident." Additionally, RIAs would also be required to amend any previously filed Form ADV-C promptly, if new material information about an incident is discovered and upon resolution of any reported incident. This reporting timeline would be one of the strictest in the industry, and follows the SEC's recent trend of seeking certain information within days versus the current reporting environment which is often weeks or months.

The Proposed Cyber Rule would define a significant cybersecurity incident as on that (i) "significantly disrupts or degrades the adviser's ability, or the ability of a private fund client of the adviser, to maintain critical operations", or (ii) leads to the unauthorized access or use of adviser information that causes substantial harm to the adviser, a client, or an investor in a private fund.

In addition to the above notification requirements, an adviser would also have to report "significant fund cybersecurity incidents" on Form ADV-C for its registered fund clients. Similar to a significant adviser cybersecurity incident, a "significant fund cybersecurity incident" has two prongs:

- significantly disrupts or degrades the fund's ability to maintain critical operations, or
- leads to the unauthorized access or use of fund information, which results in substantial harm to the fund, or to the investor whose information was accessed.

In all, according to the Proposed Cyber Rule, an RIA would have to report within 48 hours after having a reasonable basis to conclude that any significant adviser or fund cybersecurity incident has occurred or is occurring with respect to itself or any of its clients that are covered clients.

Annual Review

The proposed rule would require RIAs and funds to review their cybersecurity policies and procedures, at minimum, annually and produce a written report detailing security assessments, documenting security incidents and expounding on any material changes to policies and procedures since the last report. The text of the proposed rule hints at the expectation that security experts might handle the bulk of report preparation, but the SEC advises that personnel overseeing the cybersecurity program should also provide an organizational perspective.

Registered Fund Board Oversight

Under the Proposed Cyber Rule, the SEC would require a registered fund's board of directors, including a majority of its independent directors, to initially approve the fund's cybersecurity program, as well as to review the annual written report. The Proposed Cyber Rule states that boards should also consider what

level of cybersecurity oversight of the fund's service providers is appropriate.

Recordkeeping

The Proposed Cyber Rule would amend both the Advisers Act and Investment Company Act to add additional recordkeeping requirements, namely maintaining five years of cybersecurity policies, annual written cybersecurity reports, risk assessments, breach notification notices, and records documenting "any cybersecurity incidents," including incident response (e.g., incident logs, longer descriptions).

Disclosure of Cybersecurity Risks and Incidents

The SEC is also proposing amendments to certain forms used by RIAs and funds to provide a more fulsome disclosure of cybersecurity risks and incidents to their investors and other market participants. The proposed amendments would add a new Item 20 entitled "Cybersecurity Risks and Incidents" to Form ADV's narrative brochure, or Part 2A, a publicly available disclosure about an RIA's business practices for clients and prospective clients. Under the amended form, RIAs would be required to describe cybersecurity risks that could materially affect the services they offer as well as how they assess, prioritize, and address cybersecurity risks created by the nature and scope of their business. Of particular note, the amended form would require RIAs to describe any cybersecurity incidents that occurred within the last two fiscal years that have "significantly disrupted or degraded the adviser's ability to maintain critical operations," or that have led to the unauthorized access that resulted in substantial harm to the adviser or its clients. This proposed new reporting requirement would also obligate RIAs to deliver interim brochure amendments "swiftly" to existing clients in the event of material revisions.

Proposed Amendments to Registered Fund Registration Statements

The Proposed Cyber Rule also would require amendments to registered funds' registration forms that would require a description of any "significant fund cybersecurity incident" that has occurred in its last two fiscal years affecting the registered fund or its service providers. The requirements for disclosure describing the incident would be similar to the information required in new Form ADV-C. Similarly, as registered funds are currently required to disclose "principal risks" of investing in the fund, the Proposed Cyber Rule would require amendments to a registered fund's prospectus if a fund determines that a cybersecurity risk is a principal risk of investing in the fund. In addition, as stated in the Proposed Cyber Rule, registered funds should generally include in their annual reports to shareholders a discussion of cybersecurity risks and significant fund cybersecurity incidents, to the extent that these were factors that materially affected performance of the fund over the past fiscal year.

(viii): Rule 10b5-1 and Insider Trading

Please see the "Insider Trading" section below for a discussion on developments relating to SEC Rule 10b5-1.

(ix): Further Definition of "As Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer

Please see "FINRA/Broker-Dealer Updates for a discussion on the proposed rule on the definition of "dealer" and "government securities dealer" under Sections 3(a)(5) and 3(a)(44), respectively, of Exchange Act.

(x): Special Purpose Acquisition Companies, Shell Companies, and Projections

As summarized in the 2022 Proskauer Annual Review and below, the SEC previously proposed a set of rules and amendments governing SPACs. These rules are still in proposed form and have not yet been adopted.

On March 30, 2022, the SEC proposed a set of rules and amendments governing SPACs that will, if adopted, impose significant new regulatory hurdles for SPAC-related transactions, as well as expand potential bases for liability. The SEC states that the new rules are intended to increase the regulatory parity between traditional initial public offerings ("IPOs") and SPAC IPOs and business combinations with SPACs ("de-SPACs"), as well as to provide greater transparency and protections to investors.

While the changes would be sweeping, the proposed rules cover roughly six distinct areas:

1. Specialized SPAC Disclosure Requirements

The SEC is proposing a new subpart of Regulation S-K setting forth specialized disclosure requirements for SPAC IPOs and de-SPAC transactions. Among other things, the new subpart would:

- Define "SPAC sponsor" as the entity/or person(s) primarily responsible for organizing, directing or managing the business and affairs of a SPAC;
- Require disclosures in a de-SPAC transaction regarding the Sponsor, its affiliates and any promoters of the SPAC;
- Require disclosure of actual or potential material conflicts of interest relevant to public investors;
- Require additional disclosure describing the potential for dilution;
- Require a statement from the SPAC as to whether it reasonably believes that the de-SPAC transaction and any related transactions are fair or unfair to public investors and whether it has received any independent report or opinion relating to the fairness of the de-SPAC.

2. Align De-SPAC Transactions with Traditional IPOs

Based on the SEC's proposal and prior comments made by the Commission, the SEC is seeking to impose many of the same obligations and liabilities applicable to a traditional IPO to de-SPAC transactions. This proposed set of changes can be divided into the following parts:

- *PSLRA Safe Harbor*. The definition of "blank check company" would be amended to make the safe harbor for forward-looking statements afforded by the Private Securities Litigation Reform Act of 1995 (the "PSLRA") unavailable during the de-SPAC process.
- *Underwriter Status and Liability*. Proposed rule 140a would deem any party that acted as an underwriter in a SPAC IPO and that facilitates or otherwise participates in the de-SPAC transaction, a statutory underwriter in the de-SPAC for Securities Act liability purposes.
- *Aligning Non-Financial Disclosures in de-SPAC Disclosures*. The SEC has also proposed rules that would require additional disclosures regarding the target company in filings related to de-SPAC transactions, including: description of the target's business, property and legal proceedings of the target; changes in and disagreements with accountants on accounting and financial disclosures; beneficial ownership disclosures and recent sales of unregistered securities. The foregoing would be subject to the liability regime of Sections 11 and 12(a) of the Securities Act in connection with the registration statement used for the de-SPAC transaction.
- *Minimum Dissemination Period*. The SEC proposes that a prospectus, proxy statement or information statement filed in connection with a de-SPAC transaction be distributed to shareholders at least 20 calendar days in advance of a shareholder meeting or earliest date of an action by written consent. Currently, there is no federally-mandated minimum period of time, and it can be as short as 10 calendar days depending on the structure of the de-SPAC and the state of incorporation of the SPAC.
- *Target Company Becoming Co-Registrant on S-4/F-4*. The SEC has also proposed to amend Form S-4 and Form F-4 to require the target company to sign on as a co-registrant on these

registration forms when filed by the SPAC pursuant to a de-SPAC transaction. The foregoing would make certain target company executives subject to liability for any material misstatements or omissions in the registration statement under Section 11 of the Securities Act.

- *Re-Determination of Smaller Reporting Company Status*. Currently, most SPACs qualify as smaller reporting companies and the surviving entity of a de-SPAC is typically permitted to retain this status, with less onerous disclosures requirements, until its next annual determination date at the end of the fiscal year. The proposal, however, would require re-determination of smaller reporting company status following the completion of the de-SPAC transaction.

3. Business Combinations Involving Shell Companies

Proposed new Rule 145a would subject de-SPAC transactions and other reverse mergers involving a public shell company to the Securities Act and may require registration, even if now the transaction could be completed without registration.

The Proposal, if adopted, would also align the financial statement reporting requirements of business combinations involving shell companies to include certain additional requirements of traditional IPOs. However, it would also eliminate the need to include financial statements of the SPAC for the period prior to the de-SPAC, if certain conditions are met.

4. Enhanced Projections Disclosure

The SEC has also proposed two new rules regarding use of projections:

- Proposed amendments to Item 10(b) of Regulation S-K would require projections not based on historical financial results or operational history be clearly distinguished from those that are; projections based on financial results and operational history be presented with equal or greater prominence compared to those that are not, and that projections including a non-GAAP financial measure include additional disclosures.
- Proposed a new Item 1609 of Regulation S-K would require additional enhanced disclosures related to projections to allow investors to better asses the basis of such projections.

5. Proposed Investment Company Act Safe Harbor

Proposed Rule 3a-10 would provide SPACs with a safe harbor from the definition of "investment company" under the Investment Company Act, where the SPAC (i) has assets consisting of only government securities, government money market funds and cash; (ii) seeks only a single de-SPAC transaction with a surviving entity will be primarily engaged in the business of the target company; (ii) announces a business combination agreement within 18 months and completes the de-SPAC within 24 months of the SPAC's IPO; (iii) liquidates if it does not meet either of the 18- or 24-month deadlines; and is solely engaged in the business of seeking to complete a de-SPAC transaction.

6. Fairness of the de-SPAC Transaction

Proposed Item 1606 would require additional disclosure regarding potential conflicts of interest and incentives in the de-SPAC process. The proposed rule would require a statement from the SPAC itself as to whether it believes the de-SPAC and any related financing transactions (i.e., a PIPE) are fair to public investors, as well as the bases for this determination. The proposed item would also require the SPAC to disclose whether any director voted against, or abstained from voting on, approval of the de-SPAC transaction/related financing transactions, and the reasons for the dissent of any director.

Item 1606 would further require SPACs to discuss in "reasonable detail" the material factors upon which their reasonable belief of fairness is based. As part of their proposal, the SEC suggested such factors to

include, non-exhaustively: the valuation of the target; the consideration of financial projections; any fairness report or opinion issued by a third party and the dilutive effects of the de-SPAC on non-redeeming shareholders. We anticipate that this rule, if adopted, would drive more SPACs to request a fairness opinion from a financial adviser.

(xi): Prohibition against Fraud, Manipulation or Deception in Connection with Security-Based Swaps; Prohibitions against Undue Influence over Chief Compliance Officers; Position Reporting of Large Security-Based Swap Positions

Please see the "Derivatives" section below for a discussion on developments relating to Security-Based Swaps.

(xii): Proxy Voting Advice: Amendments to Form N-PX

As previously discussed, on November 2, 2022, the SEC adopted amendments to Form N-PX requiring institutional investment managers that file Form 13F to file Form N-PX annually reporting how they vote certain proxies on behalf of clients. The first reporting period for the new Form N-PX will cover the 12 months from July 1, 2023 to June 30, 2024, and the first report must be filed by August 31, 2024.

Form N-PX previously applied only to registered investment companies (*e.g.*, mutual funds and exchange-traded funds). The amendments do not require that managers report how they voted all proxies, but only require that managers report how they voted proxies with regards to certain executive compensation matters ("say-on-pay").

Although the obligation to file Form N-PX is triggered by a manager's obligation to file Form 13F, the report is not limited to voting in connection with securities listed on a manager's Form 13F, but instead applies to any say-on-pay vote under the Exchange Act. Joint filings are permitted in certain cases to avoid duplicative filings.

In preparation for the first filing due in August 2024, managers should ensure they are maintaining comprehensive records of how they cast any proxy votes beginning on July 1, 2023.

(xiii): The SEC and *Kirschner*: Does the SEC's Silence Mean that Syndicated Term Loans Are Not Securities?

In July 2023, the SEC declined to file the amicus brief requested by the Second Circuit Court of Appeals in *Kirschner v. JP Morgan Chase Bank*. By doing so, the SEC chose not to give its opinion on whether the involved syndicated term loans are securities. In a July 18, 2023 letter to the court, the SEC explained that "despite the best efforts to respond to the court's request, the Staff was not in a position to file a brief on behalf of the Commission." *Id.* While the Second Circuit ultimately held that the loans were not securities, the SEC's decision to not file the amicus brief left the Second Circuit panel without the agency's views, and to theorize over the agency's reasons for its decision to not act.

Background

The dispute in *Kirschner* came from a $1.775 billion syndicated loan to Millennium Laboratories LLC ("Millennium") that closed nineteen months before Millennium filed for bankruptcy. As part of that transaction, the defendant banks sold Millennium debt obligations to approximately 70 institutional investor groups. The trustee for the bankruptcy's litigation trust sued the banks asserting various claims, including that the loans should be treated as "securities". The district court had granted the defendants' motion to dismiss and held that the syndicated terms loans were not securities under "family resemblance" test adopted by the U.S. Supreme Court in *Reves v. Ernst & Young*[36] ("Reves"). The plaintiff appealed the

[36] 494 U.S. 56 (1990).

district court's dismissal to the Second Circuit.

The Second Circuit's Request and the SEC's Response

During its proceedings, the Second Circuit court issued an order soliciting the SEC's views as to "whether the syndicated term loan notes at issue in this appeal are securities under *Reves* . . . given the importance of the issue, the parties' diverging positions, and the policy implications that would result from our resolution of this case." However, the SEC declined to do so.

While the SEC has not publicly given a reason for its decision to decline the request to file its *amicus* brief, the submissions filed with the court indicate that the SEC considered this to be an important issue.

It has been over thirty years since the last time the SEC filed an *amicus* brief to weigh in on the status of similar instruments as "securities." Since that time, however, the syndicated loan market has expanded to $2.5 trillion, and the instruments and practices within that market have evolved. By taking a pass on *Kirschner* and leaving it the Second Circuit to decide on its own how to apply the *Reves* test, the SEC gave up any chance of influencing the Second Circuit's decision.

Second Circuit Ruling

On August 24, 2023, the Second Circuit ultimately agreed with the district court's decision and held that the syndicated loans at issue were not securities. In affirming the district court's dismissal of the plaintiff's state-law securities claims, the court applied the four-factor "family resemblance" test previously established by the Second Circuit and later adopted by the U.S. Supreme Court in *Reves.* While the court recognized that the lenders' motivation was investment given their expectation of profit from their purchase of the notes (a factor weighing in favor of the notes being a securities), the court was persuaded by the other three factors under *Reves* that weighed against concluding that the notes were securities.

What's next?

Since the Second Circuit decision, Kirschner has filed a petition for a writ of cert of certiorari, asking for the U.S. Supreme Court to hear the case. According to the petition, the SEC intended to file a brief arguing that syndicated loans were securities but "reportedly backed down following industry lobbying and resistance from banking regulators." In addition, the petition pointed to a recent speech titled "In-Securities: What Happens When Investors in an Important Market Are Not Protected? Remarks to the Center for American Progress", where SEC Commissioner Crenshaw said that, "much of this market is not subject to meaningful regulation and investors are being put at risk."

If the U.S. Supreme Court decides to hear this case, the SEC has not indicated whether it would then file a brief to express its views. Depending on if the U.S. Supreme Court decides to grant certiorari and how it rules, the outcome could curtail the agency's ability to regulate the term loan market in the future.

(xiv): Proposed Amendments to Regulation S-P

As previously discussed, on March 15, 2023 the SEC released its proposal to amend Regulation S-P: Privacy of Consumer Financial Information and Safeguarding Customer Information (the "Proposed Amendments"), while simultaneously issuing two additional cybersecurity-related rule proposals[37] and re-opening the comment period for its previously-proposed cybersecurity risk management rule released in February 2022.[38] This set of sweeping reforms makes it clear, if not already, that the SEC is serious about

[37] Cybersecurity Risk Management Proposed Rule for Broker-Dealers, Clearing Agencies, Major Security-Based Swap Participants, the Municipal Securities Rulemaking Board, National Securities Associations, National Securities Exchanges, Security-Based Swap Data Repositories, Security-Based Swap Dealers, and Transfer Agents, Exchange Act Release No. 34-97142 (Mar. 15, 2023) ("Exchange Act Cybersecurity Proposal"), and Regulation Systems Compliance and Integrity, Exchange Act Rel. No. 34-97143 (Mar. 15, 2023) ("Regulation SCI Proposal").

[38] Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development

implementing comprehensive cybersecurity and privacy standards across its regulated entity population—including investment advisers. However, the Proposed Amendments are already subject to criticism, most notably by Commissioner Pierce in her accompanying Statement,[39] due to the likely burdens and costs of implementation, as well as the potential for conflicts with existing state privacy laws. Moreover, the Proposed Amendments would create additional exam and enforcement risk where disclosure of certain cyber-events is deemed—after the fact—not to have been prompt or accurate enough.

Background

Regulation S-P ("Reg. S-P") requires, among other things, covered firms to adopt written policies and procedures designed to protect the personally identifiable information of such firms' natural person customers contained in its records (the "Safeguards Rule"). Reg. S-P applies to SEC registered investment advisers, investment companies, broker dealers and transfer agents ("covered firms");[40] it does not apply to unregistered advisers (e.g., exempt reporting advisers) or private funds relying on sections 3(c)(1) or 3(c)(7) under the Investment Company Act.[41] Reg. S-P was adopted in 2000, before widespread use of mobile devices, remote work and the "cloud." In the early years following Reg. S-P's adoption, compliance efforts often amounted to adopting policies and procedures that were focused on the physical security of paper files containing covered customer information (e.g., by requiring the use of locked file cabinets). It has since evolved, however, into a framework for the protection and safeguarding of covered information largely stored electronically.

In recognition of the significant changes to business operations and the extensive reliance on (and vulnerabilities posed by) electronic storage and communications, the Proposed Amendments would amend the Safeguards Rule to enhance required procedures by mandating an incident response plan to address security breaches. The Proposed Amendments would also expand the scope of information and customers covered by these requirements. Additionally, if the Proposed Amendments are adopted, the privacy notice requirement of Reg. S-P would be simplified through the implement of a 2015 legislative change, which limits the need for annual delivery of the privacy notice in certain cases.

Adoption of an Incident Response Plan

The centerpiece of the Proposed Amendments is a new requirement for covered firms to adopt a written incident response program ("IRP") as part of its written Reg. S-P policies that is "reasonably designed to detect, respond to, and recover from unauthorized access to or use of customer information." IRPs would be required to provide for:

- Assessment of the scope and scale of a breach, including the systems, customers, and information accessed or used without authorization;
- Steps to contain and control further unauthorized access or use; and
- Notification protocols for those customers whose "sensitive information" was, or was likely to have been, involved in the breach.

The Proposed Amendments would also require covered firms to enter into a written agreement with each service provider that requires the service provider to (i) take appropriate measures to safeguard customer information, and (ii) notify the covered firm in the event of unauthorized access to a customer information system maintained by the service provider (no later than 48 hours after becoming aware of the breach).

Companies, Securities Act Rel. No. 11028 (Feb. 9, 2022) ("Cybersecurity Proposal").

[39] Commissioner Hester M. Peirce, Statement on Regulation SP: Privacy of Consumer Financial Information and Safeguarding Customer Information, March 15, 2023 ("Pierce Statement").

[40] The Proposed Amendments define "covered institution" as "any broker or dealer, any investment company, and any investment adviser or transfer agent registered with the Commission or another appropriate regulatory agency ("ARA") as defined in Section 3(a)(34)(B) of the Securities Exchange Act of 1934." Rule 248.30(e)(3).

[41] Exempt reporting advisers and private funds are subject to the Consumer Financial Protection Bureau's Regulation P, 12 CFR Part 1016, and the Federal Trade Commission's Standards for Safeguarding Customer Information, 16 CFR Part 314.

This would encompass a very broad universe of service providers, including e-mail, CRM system, cloud-based and other technology vendors. As noted by Commissioner Peirce, however, renegotiating existing contracts with service providers may prove to be expensive and time consuming, and may not be feasible in all cases.[42]

Establishing a Federal Minimum Standard for Notification of an Information Breach

Covered firms are currently subject to a patchwork of state privacy laws across all 50 states, ranging in degree of compliance burden depending on where they and their clients or investors are located. The SEC intends to create a federal minimum standard for notification requirements of covered firms that experience an information breach. Such notification would be required where the information breach is likely to result in "sensitive customer information"[43] being used in a manner that would result in substantial harm or inconvenience. The Proposed Amendments call for the notification:

- To be made to each affected individual or, if the specific individual(s) is not ascertainable, all individuals for which the covered firm possesses sensitive customer information;
- To be made within 30 days of becoming aware of such unauthorized access or use (with a limited 30-day extension for matters of national security);[44]
- To include the following: (i) a description of the incident in general terms and information to have been accessed or used, (ii) a description of any remedial action and preventative measures, (iii) the date or estimated date of the incident, (iv) a point of contact at the covered firm for the individual to inquire into the matter, (v) a recommendation for the individual to review their account statements (if applicable), (vi) an explanation of what a fraud alert is and information to assist the individual in establishing a fraud alert in their credit report, (vii) recommend the individual periodically obtain and review a credit report and have any fraudulent transaction deleted, (viii) explain how the individual may obtain a free credit report, (ix) how to obtain additional online guidance from the Federal Trade Commission ("FTC") and usa.gov, and (x) a statement encouraging the individual to report incidents of identity theft to the FTC.

While the Proposed Amendments are intended to establish a minimum set of standards that would be consistent with (or at least more stringent than) applicable state laws, and while the SEC appears to have extensively reviewed state privacy laws in connection with these proposals, the SEC has nevertheless requested comments as to whether the Proposed Amendments would conflict with any specific state laws.[45]

Annual Privacy Notice Requirements

Reg. S-P requires covered firms to deliver an annual privacy notice to its customers. The Proposed

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[42] Pierce Statement ("How much will it cost to renegotiate all of those contracts? Will it even be possible to do so? What happens to a covered institution whose service provider chooses not to play ball?").

[43] The Proposed Amendments add the new term "sensitive customer information," and defines it as customer information that could create a substantial harm or inconvenience in the event of an information breach. Sensitive customer information would include, for example, a customer's: social security number; official State or government issued driver's license or identification number; alien registration number; government passport number; employer or taxpayer identification number; a biometric record; a unique electronic identification number; address; or routing code.

[44] Notably, the Proposed Amendments do not provide for exceptions where delay is needed for other law enforcement-related reasons beyond national security. However, the SEC has requested comments as to whether to include such exceptions. Proposed Amendments, request for comment 56 at p. 63. See also Pierce Statement ("While I support customer notification, the rule should include a law enforcement exception permitting covered institutions to delay alerting customers about an unauthorized incursion when there is a valid law enforcement or national security need for doing so. We are making the small concession of allowing the Attorney General to obtain a delay of up to 30 days, if he can cite a substantial risk to national security in writing.").

[45] Proposed Amendments, request for comment 34 at p. 46 ("Under what scenarios would a covered institution be unable to comply with both the proposed rules and applicable state laws? Please explain."). See also Pierce Statement ("What is a firm that finds itself pinched between competing state and federal notification rules supposed to do? Rather than preempting or deferring to state law, we dance around the problem we are creating and provide no workable strategy for firms to manage the conflict.").

Amendments would implement a 2015 legislative change, which created an exception to the annual privacy notice requirements where the covered firm's policies and practices regarding customer information are unchanged.

Intersection with the SEC's Investment Management Cybersecurity Proposal

There is significant overlap between the Proposed Amendments and the SEC's Cybersecurity Proposal issued in February 2022, applicable to registered investment advisers and other regulated entities, which is summarized in our previous Client Alert. The Cybersecurity Proposal requires the adoption of a cybersecurity incident response program, which is similar to the incident response plan called for by the Proposed Amendments. Additionally, the Cybersecurity Proposal creates an obligation to report "significant cybersecurity incidents" to the SEC. Under the Proposed Amendments, an information breach that triggers mandatory customer notification (within 30 days), would also amount to a significant cybersecurity incident that triggers an SEC reporting requirement (within 48 hours). The SEC acknowledges this overlap in the Proposed Amendments and offers assurances that entities required to comply with both rules, if adopted, would be able to avoid duplicative efforts by adopting one set of policies or providing a single notice, where applicable.

Intersection with the SEC's Examination and Enforcement Efforts

The SEC has long been focused on the risks that cybersecurity incidents pose to covered firms and, by extension, to their investors, clients and customers and other participants in the U.S. securities markets. That focus extends beyond rulemaking and includes significant devotion of resources to examination and enforcement. The Division of Examinations has made information security and resilience an examination priority every year since 2014, and it did so again in 2023.[46] Similarly, the Division of Enforcement has repeatedly brought enforcement actions in this area, including fourteen relating to cybersecurity controls and safeguarding customer information since 2015,[47] pursuing these actions through its dedicated Crypto Assets and Cyber Unit which recently almost doubled in size to fifty professionals.[48] In addition to pursuing violations uncovered during the course of routine compliance examinations, the Examinations and Enforcement Divisions also proactively investigate potential violations of which they become aware, either through whistleblowers or public news reports of prominent security breaches, such as the late 2020 SolarWinds cyber breach.[49] SEC examination and enforcement focus in this area can therefore be expected to continue—and possibly even increase—creating more risk for firms as compliance obligations expand.

Timing and Applicability

The comment period on the Proposed Amendments ended on June 5, 2023, which coincides with the re-opening of the comment period for the Cybersecurity Proposal. There would be a 12-month transition period if the Proposed Amendments were to be adopted.

(xv): What's Next: The SEC Spring 2023 Regulatory Agenda

On December 6, 2023, the SEC published its Fall 2023 Unified Agenda of Regulatory and Deregulatory Actions (the "Reg-Flex Agenda). The Reg-Flex Agenda lists the SEC regulatory actions that are at either the proposed rule or final rule stage. The Reg-Flex Agenda is a valuable source for indicating what the SEC will likely be focusing on in the upcoming year.

.[46] SEC Division of Examinations, 2023 Examination Priorities, at pp. 13-14.

[47] SEC Website, Crypto Assets and Cyber Enforcement Actions — Regulated Entities – Cybersecurity Controls and Safeguarding Customer Information.

[48] SEC Press Release, SEC Nearly Doubles Size of Enforcement's Crypto Assets and Cyber Unit, May 3, 2022.

[49] Reuters, U.S. SEC probing SolarWinds clients over cyber breach disclosures -sources, June 22, 2021.

Upcoming Proposed Rules

This SEC's latest Reg-Flex Agenda included the following upcoming rule proposals of interest to private fund advisers, which have yet to be formally proposed:

- *Rule 144*. The SEC is considering recommending whether to re-propose Rule 144, which was previously proposed in January 2021.
- *Regulation D and Form D Improvements*. Although the SEC has not indicated exactly what it is proposing, the SEC Investor Advisory Committee meetings and the Small Business Capital Formation Advisory Committee meetings included discussions of Regulation D and whether to update the definition of an accredited investor. At an Annual Securities Regulation Institute meeting, Commissioner Crenshaw voiced support for updating Form D to require the disclosure of more information (e.g., revenue, net asset value range, sales compensation, etc.).
- *Revisions to the Definition of Securities "Held of Record"*. The SEC is considering whether to propose amendments to the "held of record" definition for purposes of Section 12(g) of the Securities Exchange Act of 1934 (the "Exchange Act"). Section 12(g) of the Exchange Act establishes the thresholds at which an issuer is required to register a class of securities with the SEC. Many issuers are concerned at the potential impact of updating the "held of record" definition since the definition of "held of record" affects the number of shareholders a private issuer can have before it must publicly register its securities.

Additional Rules at Final Rule Stage

In addition to the many proposed rules described above, the SEC also noted the following proposed rules as being on the agenda for final adoption, which may also be of interest to private fund advisers:

- *Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers.* On August 9, 2023, the SEC proposed use of predictive data analytics rules under the Exchange Act and the Advisers Act for RIAs and broker-dealers, as well as amendments to existing rules under the Exchange Act and the Advisers Act. The proposal would require:

A firm to remove or neutralize the effect of conflicts of interest related to the firm's use of covered technologies in investor interactions that put the firm's or its associated person's interest before the investors' interests;

A firm that has any investor interaction using covered technology to have written policies and procedures reasonably designed to prevent violations of (in the case of investment advisers) or comply with (in the case of broker-dealers) the proposed rules; and

Recordkeeping in connection with the proposed rules.

(xvi): Proposed New Oversight Requirements for Advisers that Outsource Significant Functions to Service Providers

As summarized in the 2022 Proskauer Annual Review and below, the SEC previously proposed service provider oversight rules under the Advisers Act. This rule is still in proposed form and has not yet been adopted.

On October 26, 2022, the SEC proposed a new rule under the Advisers Act that would require advisers registered or required to be registered with the SEC to implement oversight programs for their outsourcing activities (the "Proposed Outsourcing Rule"). The Proposed Outsourcing Rule formulates a compliance regime based upon three main components, which are based on common industry practices:

(i) due diligence, (ii) ongoing monitoring, and (iii) recordkeeping. The SEC's Proposed Outsourcing Rule is a deliberate move toward a formal oversight structure as replacement for the current paradigm where RIAs

manage oversight of their service providers in accordance with their duty of care as a fiduciary.

In addition to the new oversight and recordkeeping requirements, discussed below, RIAs would be required to provide additional information in Part 1 of Form ADV. The updated Form ADV would call for RIAs to disclose whether they have outsourced a "Covered Function" (defined below), whether the outsourced service provider is an affiliate, and which Covered Functions — among a list predetermined functions included in the form — are outsourced.

"Covered Function"

The Proposed Outsourcing Rule is limited to service providers (affiliated or unaffiliated) that perform "Covered Functions", and would not apply to clerical, ministerial, utility, or general office functions or services. Covered functions are broadly defined as:

- those necessary for the RIA to provide its investment advisory services in compliance with the Federal securities laws; and
- those that, if not performed or performed negligently, would be reasonably likely to cause a material negative impact on the RIA's clients or on the RIA's ability to provide investment advisory services.

The policy basis of the Proposed Outsourcing Rule, as discussed in the proposal, is the need to prevent fraudulent, deceptive or manipulative acts that may be caused by outsourcing of an RIA's key function(s). Thus, the scope of the Proposed Outsourcing Rule is limited to advisory functions that could have a material negative impact on clients.

Due Diligence and Ongoing Monitoring

Before engaging a service provider to perform a Covered Function, the Proposed Outsourcing Rule would require an RIA to first conduct due diligence and determine (i) that it is appropriate to outsource the function and (ii) that it is appropriate to select the particular service provider. The rule would impose six elements for an RIA to consider as part of any due diligence under the rule:

- Identify the nature and scope of the covered function the service provider is to perform;
- Identify and determine how it would mitigate and manage the potential risks to client or to the RIA's ability to perform its advisory services, resulting from engaging a service provider;
- Determining that the service provider has the competence, capacity, and resources necessary to perform the Covered Function in a timely and effective manner;
- Determining whether the service provider has any subcontracting arrangements that would be material to the service provider's performance of the Covered Function, and identifying and determining how the RIA will mitigate and manage potential risks to clients or to the RIA's ability to perform its advisory services in light of any such subcontracting arrangement;
- Obtaining reasonable assurance from the service provider that it is able to, and will, coordinate with the RIA for purposes of the RIA's compliance with the Federal securities laws; and
- Obtaining reasonable assurance from the service provider that it is able to, and will, provide a process for orderly termination of its performance of the Covered Function.

Further, after engaging a service provider, the Proposed Outsourcing Rule would mandate that RIAs conduct periodic oversight to monitor the relationship. The frequency and manner of oversight would

depend on the facts and circumstances specific to the service provider and function being performed, with the same six elements used in the due diligence process being a component of an RIA's ongoing monitoring.

Recordkeeping

As part of the proposal, Rule 204-2 (the "Books and Records Rule") would be amended to require RIAs to maintain records related to the new service provider oversight program. RIAs would be required to keep:

- Records of Covered Functions that the RIA has outsourced, along with the factors that the RIA used to determine that the service is a Covered Function;
- Documentation of the RIA's due diligence assessment, including any policies and procedures adopted related to the Covered Function and/or service provider;
- A copy of the written agreement with the service provider, if any, along with any amendments, appendices, exhibits, and attachments; and
- Records related to oversight and monitoring of the service provider.

In addition to the new records requirements, above, Rule 204-2 would be amended to require RIAs to conduct due diligence and ongoing monitoring for all third-party service providers that perform a recordkeeping function. In addition to these due diligence and monitoring requirements, the RIA would also need to obtain from the third-party service providers, reasonable assurances that it will: (i) adopt and implement internal processes and systems for maintaining such books and records that satisfies all the requirements of Rule 204-2, (ii) allow the adviser and Commission staff to access the required records, and (iii) ensure the continued availability of the records (maintained in accordance with Rule 204-2) in the event the relationship is terminated or otherwise ceases.

CFTC / NFA Updates

Enforcement Activity

The CFTC reported that its Division of Enforcement, in its fiscal year ended September 30, 2023, filed 96 enforcement actions resulting in over $4.3 billion in penalties, restitution and disgorgement.

The CFTC was especially active in matters involving digital assets. Highlights included: bringing charges against Sam Bankman-Fried, FTX and Alameda Research for operating an alleged fraudulent scheme involving digital asset commodities; charging Binance, its founder and a former chief compliance officer with operating an illegal digital asset derivatives exchange; charging Celsius and its former CEO for unlawfully operating a digital asset lending platform as an unregistered commodity pool; and obtaining a default judgment against the Ooki DAO for operating an illegal trading platform.

CFTC Proposes Amendments to Regulation 4.7

On September 29, 2023, the CFTC approved a proposal to amend CFTC Regulation 4.7. The proposal, if adopted, would:

- update the definition of "qualified eligible person" ("QEP") to require that a QEP

own securities of issuers not affiliated with the QEP and other investments with an aggregate market value of at least $4 million,

have at least $400,000 of exchange specified initial margin, option premiums and required minimum

security deposits for retail forex trades on deposit with a futures commission merchant ("FCM") at any time during the six-month period prior to the purchase of the pool participation, or

own a portfolio comprised of a combination of the requirements in the preceding paragraphs where the QEP satisfies a portion of each test that, when combined, would be equal to or greater than 100%;

- require Commodity Pool Operators ("CPOs") and Commodity Trading Advisors ("CTAs") relying on Regulation 4.7 to provide certain minimum disclosures to potential and current participants in pools and advisory clients, including past performance information in the CFTC-required format; and
- permit CPOs of funds-of-funds operating under Regulation 4.7 to distribute monthly account statements to the pool participants within 45 days of month-end, provided that the CPO notifies its QEP pool participants that they are electing this alternative disclosure schedule.

Our client advisory can be found here.

Please see "Derivatives" below for a discussion of the CFTC proposal to amend the margin requirements for uncleared swaps.

Derivatives

In 2023 we have seen new and amended rules from the CFTC and SEC relating to reporting of swaps, securities loans and short sales. The CFTC also proposed amendments to certain regulatory margin requirements. Finally, the CFTC continues to actively use its statutory authority under the Commodity Exchange Act (the "CEA") against those unlawfully offering or engaging in derivatives in the digital asset space. In June, the CFTC took action to ensure proper risk management within the derivatives markets in relation to, among other things, digital assets.

CFTC

On July 26, 2023, the CFTC approved a proposal to amend the margin regulations for uncleared swaps (the "Proposed Amendments"). The Proposed Amendments, if finalized, would relieve registered swap dealers and major swap participants from the requirement to post and collect margin for uncleared swaps with certain eligible seeded funds for a period of three years from the date the fund begins making investments. This limited exception to the requirement to post and collect initial margin is intended to provide much needed relief to seeded funds from the drag on performance caused by tying up a large portion of their investments in posting initial margin for their uncleared swaps.

The proposal would also allow for securities issued by money market and similar funds ("Money Market Funds") to be used as eligible collateral for regulatory margin requirements. The Proposed Amendments would remove the restriction on transferring assets through repurchase or securities lending agreements, allowing for a broader range of Money Market Funds to qualify as eligible collateral with respect to margin for uncleared swaps.

Crypto

On May 30, 2023 the CFTC's Division of Clearing and Risk ("DCR") released an advisory letter to all derivatives clearing organization ("DCO") registrants and applicants. According to the CFTC, in the last few years DCOs have expressed an increased interest in expansion of the types of products cleared and business lines, clearing models, and services offered. The advisory stated that digital assets can involve higher cyber and operational risks, which DCR will monitor to ensure compliance under applicable regulations. The advisory letter also noted that DCR, working with other relevant CFTC staff, will "emphasize reviews of physical settlement arrangements" for DCOs clearing contracts that may involve physical delivery of digital assets and examine whether DCOs have "adequately identified and managed risks and obligations associated with digital assets and whether DCO rules clearly state the obligations of the DCO, if any, with respect to physical deliveries involving digital assets."

Please see “Digital Assets Updates” for a description of the CFTC and SEC enforcement actions against various crypto industry participants, including for failure to register as a swap execution facility.

FINRA

There were no material changes to the FINRA rules impacting derivatives.

SEC

As stated on page 29, On October 13, 2023, the SEC adopted a new regulation requiring reporting of securities’ lending transactions. Certain material terms of securities lending transactions relating to “reportable securities” are required to be reported to a registered national securities association (“RNSA”) by the end of the day on which the loan is agreed or modified. Reportable securities include equity securities (both exchange traded and those traded OTC), debt securities subject to TRACE reporting, and digital asset securities that meet the definition of “reportable security” (each a “Reportable Security”). The information to be reported includes information about the individual securities lending transaction, information on the collateral used to secure the loan and information about rebates, fees, and other charges.

The reporting obligation generally applies to the lender of the Reportable Security except where a broker or dealer is borrowing fully paid or excess margin securities or the trade is done through an intermediary. Covered persons subject to the reporting requirement are permitted to engage a reporting agent (through a written agreement) to submit the required information on their behalf.

The RNSA is required to make the information – other than that deemed confidential – public on the morning of the next business day. The amount of the loan is to be made public on the 20th business day following submission of the report. The names of the parties to the securities’ lending transaction will not be made public. Of note, currently the Financial Industry Regulatory Authority (“FINRA”) is the only registered RNSA and is expected to accept the securities lending reports once the Securities Lending Rule is effective.

On December 13, 2023, the SEC adopted new rules that will have the effect of requiring central clearing of a broad range of cash transactions and repurchase transactions in U.S. treasury securities (“U.S. Treasuries”). The new rules require covered clearing agencies (“CCAs”) to adopt policies and procedures requiring their direct participants to clear all “eligible secondary market transactions.” This will result in most repurchase and reverse repurchase transactions in U.S. Treasuries (collectively “repos”) entered into by funds or institutional investors being submitted to the CCA for clearing since almost all repos are done with direct participants of a CCA. Currently, FICC is the only CCA that clears cash transactions in U.S. Treasuries and repos.

All “eligible secondary market transactions” in U.S. Treasuries where one of the parties to the transaction is a member of a CCA (such as banks and broker-dealers) must be submitted for clearing. Cleared repos will be subject to CCA mandated minimum haircuts.

Eligible secondary market transactions in U.S. Treasuries include:

- Repos collateralized by U.S. Treasury securities where a CCA member is a party to the agreement.
- Cash purchases or sales between a CCA member that is an interdealer broker (someone who “brings together multiple buyers and sellers using a trading facility (such as a limit order book) and is a counterparty to both the buyer and seller in two separate transactions”) and any counterparty.
- Cash purchases or sales between a CCA member and a registered broker-dealer, government securities dealer or government securities broker.

Of note, following comments from industry participants on the original rule proposal in 2022, the final rule does not require cash purchases or sales between a CCA member and a hedge fund or leveraged account

(any account permissioned to borrow more than one-half of its value) to be cleared.

Cash market transactions in U.S. Treasuries will be required to be cleared beginning December 31, 2025 while repos will be subject to clearing beginning June 30, 2026.

Please see "SEC Policy and Rulemaking Updates" for a description of new SEC Rule 13f-2 (Short Sale Disclosure) and the amendment to Rule 13d-3 governing beneficial ownership reporting.

Alternative Data

Alternative data, or data garnered from non-traditional sources, is increasingly being used by private funds advisers and registered investment companies as part of their business and investment decision-making processes. This continues to be the case, particularly given the uncertain economic conditions of the past year.

Alternative data sources offer advisers information that can't be found in traditional reviews of company filings, conversations with management and/or in the traditional review of news articles. Examples of alternative data include geolocation (e.g., foot traffic), credit card transactions, email receipts, point-of sale transactions, website usage, mobile app or app store analytics, satellite images, social media posts, online browsing activity, shipping container receipts, product reviews, price tracking, shipping trackers, internet activity and quality data, as well as many other sources.

SEC Enforcement Focus

Over the last few years, the SEC has zeroed in on the acquisition and use of alternative data in response to its increased popularity with advisers. The Exams Division announced in its 2023 Examination Priorities that it will scrutinize whether registered investment advisors to private funds and firms are implementing appropriate policies and practices around the use of alternative data and use of potentially MNPI obtained through alternative data sources. And again in its 2024 Examination Priorities, the Exams Division stated that it "remains focused on certain services, including automated investment tools, artificial intelligence, and trading algorithms or platforms, and the risks associated with the use of emerging technologies and alternative sources of data." Although alternative data did not appear extensively in the SEC's 2024 exam priorities, we expect that alt data compliance has become a routine area of inquiry in exams, particularly for heavy users of alt data.

Given the demand for alternative data in this unsettled economy, firms are interested in new sources and analytics and vendors are continuing to launch new products that commercialize novel insights or newly-collected data. Thus, it remains important to understand how the SEC views the oversight of alternative data vendors and their datasets by advisers. Our general advice surrounding compliance remains the same:

- The Exams Division believes that an adviser should have written policies and procedures crafted to address the creation, acquisition, use and ongoing surveillance of alternative data vendors (as well as the adviser's own staff when the staff is creating its own alternative data).
- Those policies and procedures should be periodically reviewed and updated to take into account changing circumstances in both the alternative data industry in general, and with respect to how the adviser uses alternative data in particular.
- The Exams Division would expect to see written records reflecting the adviser's due diligence of alternative data vendors and the applicable data sets being acquired and that such documentation should show how any "red flags" that were identified during the due diligence process were resolved.
- The Exams Division may inquire whether advisers are conducting simple Google searches of alternative data vendors to see whether there were any issues regarding vendors that were easily identifiable.

- The Exams Division may expect to see more disclosure around alternative data in an adviser's Form ADV Part 2.

In addition, in light of the wide implementation of generative AI ("GenAI") and the well-known limitations of current GenAI models (e.g., inaccurate output, or "hallucinations," and bias), it behooves firms to conduct due diligence to find out if their alternative data vendors use generative AI. Relevant questions might include what models are being deployed, how GenAI is being used in data collection or analytics, and what guardrails or human processes are in place to ensure data quality.

SEC Proposed Predictive Data Conflicts Rule

In July 2023, the SEC proposed a new rule that would require broker-dealers and investment advisers to take certain steps to address conflicts of interest associated with their use of predictive data analytics and similar technologies to interact with investors to prevent firms from placing their interests ahead of investors' interests. The public comment period ended on October 10, 2023. The proposed rule would impose new policy and recordkeeping requirements. Under the rule, an investment adviser must:

- Evaluate any use of a covered technology to identify any conflict of interest;
- Determine if any conflict of interest places or results in placing the interest of the investment adviser, or a natural person who is a person associated with the investment adviser, ahead of the interests of investors; and
- Eliminate, or neutralize the effect of, any conflict of interest that places the interest of the investment adviser, or a natural person who is a person associated with the investment adviser, ahead of the interests of investors.

Under the proposed rule, a conflict of interest exists when an investment adviser uses a covered technology that takes into consideration an interest of the investment adviser, or a natural person who is a person associated with the investment adviser, and firms would be required to determine whether any such conflict of interest places or results in placing the firm's or its associated person's interest ahead of investors' interests.

Some firms and investors in financial markets now use new technologies such as AI, machine learning, NLP, and chatbot technologies to make investment decisions and communicate between firms and investors. For example, a firm may use PDA-like technologies to automatically develop advice and recommendations that are then transmitted to investors through the firm's chatbot, push notifications on its mobile trading application, and robo-advisory platform. The concern is that if the advice or recommendation transmitted is tainted by a conflict of interest because the algorithm drifted to advising or recommending investments more profitable to the firm or because the dataset underlying the algorithm was biased toward investments more profitable to the firm, then the transmission of this conflicted advice and recommendations could spread rapidly to many investors.

Consumer advocates have expressed support for the proposed rule, while the industry, for the most part, has claimed the rule is more broad than necessary, would impose many unworkable requirements and cause harm to institutional investors and firms.

FTC Focus

General. The Federal Trade Commission ("FTC") has continued its attention to what it calls the "opaque" marketplace for mobile location data and the subsequent sharing and sale of information to data aggregators and brokers that then sell data access or data analysis products to marketers, researchers, or other businesses interested in gaining insights from alternative data sources. Back in July 2022, the FTC published on its Business Blog that the misuse of mobile location and health information, including reproductive health data, "exposes consumers to significant harm." As such, the FTC announced that it would "vigorously enforce the law if we uncover illegal conduct that exploits Americans' location, health, or other sensitive data." Moreover, in the age of AI, developers are hungry for more data for training and

testing. This past year, in a Business Blog post, the FTC pointed out that given this reality, the agency "will hold companies accountable for how they obtain, retain, and use the consumer data that powers their algorithms." The blog post noted numerous prior settlements requiring companies to delete data or refrain from generating data products, like algorithms, models, and other tools derived from ill-gotten data, and also pointed to two recent enforcements against Amazon and Ring regarding data collection, deletion and use practices.

Kochava Case. On August 29, 2022, the FTC announced that it had filed a complaint against Kochava, Inc. ("Kochava"), a digital marketing and analytics firm, seeking an order halting Kochava's alleged acquisition and downstream sale of "massive amounts" of precise geolocation data collected from consumers' mobile devices. The complaint alleges that the data is collected in a format that would allow third parties to track consumers' movements to and from sensitive locations, including those related to reproductive health, places of worship, homeless and domestic violence shelters, addiction recovery centers, and their private residences, among others. The FTC alleged that "consumers have no insight into how this data is used" and that they do not typically know that inferences about them and their behaviors will be drawn from this information. The FTC also alleged that the location data provided by Kochava to its customers was not anonymized and that the data may be used to track consumers to sensitive locations and poses an unwarranted privacy risk likely to cause substantial injury to consumers, thus constituting an unfair business practice.

The FTC claimed that the sale or license of this sensitive data was an unfair business practice under Section 5 of the Federal Trade Commission Act (the "FTC Act"). Section 5(a) of the FTC Act prohibits "unfair or deceptive acts or practices in or affecting commerce." An act or practice is unfair under the FTC Act if it causes or is likely to cause substantial injury to consumers that consumers cannot reasonably avoid themselves and that is not outweighed by countervailing benefits to consumers or competition.

In May 2023, an Idaho district court granted Kochava's motion to dismiss the FTC's complaint, with leave to amend, finding that although the FTC's theories of consumer injury were legally plausible, the FTC's allegations did not adequately allege a likelihood of substantial consumer injury. Subsequently, the FTC filed an amended complaint, and Kochava requested that the court keep the amended complaint under seal, which it did until it could rule on the merits of the parties' arguments. On November 3, 2023, the court granted the FTC's motion to unseal the amended complaint, finding no "compelling reason" to keep the amended complaint under seal and rejecting Kochava's arguments that the amended complaint's allegations were "knowingly false" or "misleading." As a result, the FTC's amended complaint has been unsealed to the public.

The unsealed complaint includes additional details about Kochava's alleged unlawful practices surrounding location data and amplifies the FTC's allegations about Kochava's collection of consumers' precise mobile geolocation data. The amended complaint also asserts that in addition to precise location data, Kochava allegedly "amasses and discloses a staggering amount of sensitive and identifying information about consumers," including "names, MAIDs, addresses, phone numbers, email addresses, gender, age, ethnicity, yearly income, 'economic stability,' marital status, education level, political affiliation, 'app affinity' (i.e. what apps consumers have installed on their phones), app usage, and "interests and behaviors" – what the complaint calls Kochava's marketed "360-degree perspective" on consumers. All of this is done, according to the FTC, "without consumers' knowledge or consent." Not surprisingly, Kochava, in its opposition to the unsealing of the amended complaint, claimed that many of the allegations in the amended complaint are misleading (or that the FTC's claims do not sufficiently describe how its data products are packaged or how customers use discrete Kochava datasets) or are otherwise foreclosed by Kochava's subsequent implementation of a Privacy Block feature following the FTC's initial investigation. The case is ongoing, so discovery and further proceedings will presumably clarify the parties' positions.

This case signals that there will be more FTC scrutiny of the collection and use of location data in general. Until a comprehensive federal data privacy law is passed. the federal lead in regulation over data privacy will sit with the FTC under its existing authority. Regardless of the outcome, for companies that acquire geolocation data or related data analytics, due diligence about how and where the data was collected remains important to ensure that the information being offered by outside data analytics firms complies with

applicable laws and regulations.

[It should be noted that Kochava also faces a civil putative class action suit over its alleged sale of users' geolocation data in a format that could enable third parties to track them "to and from sensitive locations." In October 2023, a court trimmed claims in one case, but refused to dismiss the privacy suit (Murphy v. Kochava)].

State Enforcement Efforts Regarding Location Data

State attorneys general were also active about data privacy enforcement. In September 2023 California reached a $93 million settlement with Google resolving allegations that its location-privacy practices violated state consumer protection laws by allegedly misleading users by collecting, storing, and using consumers' mobile location data for consumer profiling and advertising purposes without informed consent. In addition to a monetary penalty, Google agreed to accept injunctive terms to deter future misconduct, including providing more transparency about location tracking and disclosing to users that their location information may be used for ad personalization. [Note: Google reached a $62 million settlement in a parallel civil suit over its location data practices on the same day of its settlement with the California attorney general (In Re: Google Location History Litigation)]. And in what was billed the largest attorney general-led consumer privacy settlement ever, Google reached a $391.5 million settlement with over three dozen state attorneys general in November 2023 over its location tracking practices relating to Google Account settings, with the states claiming that Google sowed confusion about the extent to which consumers who use Google products and services could limit Google's location tracking by adjusting their account and device settings. The attorneys general opened the Google investigation following a 2018 Associated Press article that revealed Google "records your movements even when you explicitly tell it not to."

Data Privacy Legislation Efforts - Federal

Public awareness and general scrutiny over the collection, selling and packaging of geolocation and other sensitive data has heightened in recent years, earning the attention of both federal and state regulators and legislatures. Several bills have been introduced in Congress in recent years addressing the use of personal locational data (see e.g., the "Digital Consumer Protection Commission Act of 2023," S.2597, which would establish a new federal commission to regulate digital platforms, including with respect to transparency, competition, privacy, consumer protection, and national security; the "DATA Act," S.688, which would require certain large online social media platforms to obtain user consent to sell, share, or convey user data to a third-party and allow users to revoke prior consent to data collection; and the "Health and Location Data Protection Act of 2022," S.4408, which, subject to a few exceptions, would, among other things, prohibit the selling, sharing or transferring of location data and health data). These are not the first bills that have attempted to generally limit the sale and use of locational and other sensitive data. In addition, Congress continues to work on reaching consensus on comprehensive data privacy legislation (see e.g., the "American Data Privacy and Protection Act," H.R. 8152), but has failed to overcome various issues, such as the extent such a law would preempt existing state data privacy laws and the availability of a private right of action, among other issues. Congressman Patrick McHenry also introduced the "Data Privacy Act of 2023", H.R.1165, which would modernize financial data privacy laws.

Data Privacy Legislation Efforts – State

On the state level, the Massachusetts legislature became the first state in the nation to consider proposals that would restrict the practice of collecting and selling cellular location data drawn from mobile phones used within its borders. The legislature held a hearing in June 2023 on a bill called the Location Shield Act (S.148). One of the more striking provisions of the bill would ban covered entities and service providers that collect or process location data across Massachusetts from "selling, leasing, trading, or renting" location data to third parties (absent certain exceptions).

On a related front, following passage of the California Consumer Privacy Act (CCPA) in 2018 (and approval by voters of the California Privacy Rights Act of 2020), at least twelve other states have passed their own consumer data privacy laws, many during 2023. The state data privacy laws specify how data controllers

must fulfill duties regarding consumers' assertion of their new data privacy rights, as well as on issues of transparency, data minimization, processing of opt-out and deletion requests and limitations surrounding the processing of sensitive data (such as precise geolocation data) without adequate consumer consent. With regard to consumer data privacy rights, California also passed notable legislation, the "Delete Act," S.362, which, among other things, would require the California Privacy Protection Agency to establish, by January 1, 2026, an accessible deletion mechanism that, among other things, allows a consumer, through a single verifiable consumer request, to request that every data broker that maintains any personal information delete any personal information related to that consumer held by the data broker or associated service provider or contractor. Beginning August 1, 2026, after a consumer has submitted a deletion request and a data broker has deleted the consumer's data pursuant to the bill's provisions, the law would require the data broker to delete all personal information of the consumer at least once every 45 days, as specified, and would prohibit the data broker from selling or sharing new personal information of the consumer, as specified.

In addition, in 2023 two states passed data broker registration laws (note: Vermont and California have existing laws). Oregon passed HB 2052, which provides that a data broker may not collect, sell or license "brokered personal data" within the state unless the data broker first registers with Department of Consumer and Business Services. Under the law "brokered personal data" means various listed computerized data elements (e.g., name, address, SSN, DOB, and other identifying information) about a resident individual, if categorized or organized for sale or licensing to another person. Texas recently enacted SB 2105, which requires data brokers, as defined, to register with the state in order to conduct business in the state. Under the Texas law, data brokers must develop and maintain a comprehensive information security program to protect the personal data held by that data broker.

Scraping Litigation Developments

Due to the focus on the training of generative AI models in the past year, scraping – and the legal issues around scraping – have become a subject of great interest. For example, we've seen a handful of lawsuits against OpenAI and other GenAI providers alleging unauthorized scraping of and improper use of plaintiffs' proprietary data as GAI model training material, with claims variously based on copyright, contract, and privacy law. The array of decisions in the well-reported hiQ-LinkedIn litigation (which was settled in December 2022) give a green light, at least in some circumstances, to scraping publicly available websites without fear of liability under the CFAA; however, even removing the CFAA from the liability equation for access to public website data, we've seen that there are still potential state law claims that a site operator may bring against an unwanted data scraper. This point has been explored in some ongoing scraping disputes from the past year. For example:

- Air Canada filed a suit alleging that Localhost LLC, operator of the Seats.aero website, unlawfully bypassed technical measures and violated Air Canada's website terms when it scraped "vast amounts" of flight data without permission and purportedly caused slowdowns to Air Canada's site and other problems. Air Canada also alleged that in addition to scraping its website, Localhost engaged in "API scraping" by impersonating authorized requests to Air Canada's API. Among other claims, Air Canada advanced breach of contract, as automated scraping activities are prohibited by the website terms; "unauthorized access" violations under the CFAA; and trespass to chattels, or the common law interference with Air Canada's use and possession of its servers and infrastructure. Air Canada's breach of contract claims are based on alleged violations of its site terms that prohibit scraping. The terms are presented as a "browsewrap" agreement, whereby the website operator claims that users are presumed to be bound by a website's terms by mere use of the site, without the need for any outward manifestation of assent. The enforceability of browsewrap terms remains unsettled. The complaint states that Air Canada also sent a cease-and-desist letter that purportedly gave Defendant actual notice of the terms and its supposed violation. Air Canada also advanced a CFAA claim against Localhost for its alleged "unauthorized access" to its systems. Air Canada's site seems to allow users to search flights and awards travel opportunities without signing in, raising a question of whether such flight data is "public" data. Still, another Delaware federal district court previously allowed scraping-related CFAA claims brought by an airline to

go forward against an online booking site. (Air Canada v. Localhost LLC).

- Jobiak LLC, an AI-based recruitment platform, filed two nearly-identical scraping suits in California district court alleging that competitors unlawfully scraped its database and copied its optimized job listings without authorization. Copyright issues are front and center in the recent flurry of complaints filed relating to the training of generative AI models. However, copyright is not often found in complaints that focus on data scraping, where the data being scraped may not be protectable be copyright. So in what is a rather unusual twist for these types of data scraping complaints, Jobiak asserts that the defendants infringed its registered copyright for its database, "Group Registration for Automated Database Entitled ALL JOBS by Jobiak" As is common in scraping actions, Jobiak also advanced CFAA claims, alleging multiple theories of liability related to the defendants' alleged "unauthorized access" via scraping to Jobiak's systems and circumvention of technical blocking measures (e.g., IP address analysis, rate limits) that caused various harms. (Jobiak LLC v. Botmakers LLC; Jobiak LLC v. Aspen Technology Labs, Inc.).
- Chegg Inc., an online learning platform, obtained a preliminary injunction based on allegations of violation of the CFAA asserted against the various operators of Homeworkify website. In addition to finding a likelihood of success on relatively novel CFAA claims (at least for a scraping dispute) that involved alleged stolen user credentials and a retaliatory denial-of-service (DDos) attack, the court granted Chegg's request to transfer the Defendants' Homeworkify domain to Chegg for thirty days to prevent what the court called Defendants' "continued harmful conduct." The court's opinion sheds some light about what a website operator must show to bring a viable CFAA claim against an unwanted web scraper, and how perseverance is sometimes required to carry the evidentiary burden and craft legally sufficient claims to obtain equitable relief against an unscrupulous online operator – indeed, the district court had previously rebuffed Chegg's earlier motion for a preliminary injunction against the Defendants back in July 2023, compelling Chegg to bolster its claims and try again. (Chegg Inc. v. Doe).

CFPB Open Banking Proposal

The Consumer Financial Protection Bureau (CFPB) has proposed a rule that would accelerate a shift toward open banking, where consumers would have more control over personal financial data and would gain new protections against companies sharing or misusing their data. The proposed rule was published on October 31, 2023, and open to public comment until December 29, 2023. Given that the CFPB has made open banking a priority and has been working on this rule for years means that it is likely to be enacted in some form, perhaps in fall 2024. Compliance dates for financial institutions would be staggered based on size and other factors.

Most consumers are enrolled in digital banking through online banking or mobile applications, and with it, open banking emerged in the early 2000s, along with the development of interfaces designed for fintech-related products or services that required access to consumer financial information, and related industry standard-setting activity. These mobile financial or payment apps often hired third party providers to access consumer financial data, with such providers often relying on scraping, which involved using previously-collected consumer credentials to log into consumer accounts at financial institutions to retrieve data. However, these scraping practices created tension between providers and banks due to the inherent risks, such as the proliferation of shared consumer credentials and overcollection of consumer financial data that might be packaged into data products unrelated to the underlying consumer transactions, and because such providers often did not seek bank permission before engaging in such scraping to enable the app's functionalities. Moreover, some methods providers and fintech platforms used to obtain login credentials and other practices surrounding the supposed collection and sharing of banking data without adequate consumer consent led to litigation (See, e.g., the Plaid settlement). The CFPB open banking proposal is essentially the last push away from scraping into a standardized, credential-free application programming interface (API) data access environment that is expected to reduce the likelihood that a data breach of a fintech provider would result in leaked account credentials.

Generally speaking, the proposed rule would require depository and non-depository entities to make available to consumers and authorized third parties certain data relating to consumers' transactions and accounts; establish obligations for third parties accessing a consumer's data, including important privacy protections for that data; provide basic standards for data access. In addition to ensuring consumers can access covered data in an electronic form from data providers, the proposed regulations would delineate the scope of data that third parties can access on a consumer's behalf, the terms on which data are made available, and the mechanics of data access. According to the CFPB, the rule would foster a data access framework that is (1) safe, by ensuring third parties are acting on behalf of consumers when accessing their data, including with respect to consumers' privacy choices and interests; (2) secure, by applying a consistent set of security standards; (3) reliable, by promoting the accurate and consistent transmission of data that are usable by consumers and authorized third parties; and (4) competitive, by promoting standardization and not entrenching the roles of incumbent data providers, intermediaries, and third parties whose commercial interests may differ the interests of consumers. Specifically, the proposed rule, in establishing the creation of standard interfaces, would encourage the market to shift away from scraping and the sharing of consumer banking credentials into APIs and require data providers to establish and maintain a developer interface for third parties to access consumer-authorized data; such interfaces would need to make available covered data in a standardized format, in a commercially reasonable manner, without unreasonable access caps, and pursuant to certain security specifications. The CFPB stated that the proposed rule would generally increase third party access to financial data and thus diminish data providers' informational advantages from its holding of so-called "first party" account data. Moreover, the proposed rule would generally prohibit a financial data provider from unreasonably restricting the frequency with which it receives and responds to requests for covered data from an authorized third party through its API – the CFPB predicts that this might result in more requests on financial institutions' system (thereby increasing infrastructure costs), but that such expenses would be mostly offset by the rapid decrease in scraping, which can realize higher traffic loads on a system.

One offshoot of the rule is that the CFPB projects that costs are likely to decrease under the proposed rule relative to fintech operators and aggregators negotiating data access agreements with financial data providers since many provisions and requirements would be standardized by regulation, including requirements for interface reliability, the scope of data accessible via the interface, authorization procedures, and the duration of access to consumers' covered data, leaving issues of third party risk management standards and other issues for further negotiation. Another expected outcome is an increase in competition for financial services because the proposed rule is expected to open up third party access to financial institution "first party" account data, thereby increasing the quality of data available to fintech applications and services that use consumer-authorized financial data (including those that compare or recommend financial products or services to consumers).

Digital Assets

As outlined in President Biden's March 9, 2022 executive order on the responsible development of digital assets, the term "digital assets" means: "All central bank digital currencies ("CBDCs"), regardless of the technology used, and other representations of value, financial assets and instruments, or claims that are used to make payments or investments, or to transmit or exchange funds or the equivalent thereof, that are issued or represented in digital form through the use of distributed ledger technology." Examples of digital assets include cryptocurrencies, CBDCs, non-fungible tokens ("NFTs"), Ordinals, fan tokens and in-game tokens, as well as stablecoins, which refer to a category of cryptocurrencies with mechanisms that are aimed at maintaining a stable value, such as by pegging the value of the coin to a specific currency, asset, or pool of assets or by algorithmically controlling supply in response to changes in demand in order to stabilize value. Stablecoins are mainly used as means to participate in, or as so-called settlement tokens inside of, decentralized finance (or "DeFi") platforms.

Regardless of the label used, a digital asset may be, among other things, a security, a commodity, a derivative, or other financial product. Digital assets may be exchanged across digital asset trading platforms, including centralized and decentralized finance platforms, or through peer-to-peer technologies.

The term “Web3” generally refers to a new iteration of web technologies that feature a technology stack that uses blockchains, cryptocurrencies, NFTs, new decentralized governance models (e.g., decentralized autonomous organizations (“DAOs”)) and related concepts and mechanisms enabling a new wave of innovation in financial assets and shared value creation. Web3 is a dynamic space that evolves on a daily basis, with new business models and strategies continuously emerging and the prospect of complex legal issues to consider on many fronts. There are many big legal questions facing the industry, such as: When is a digital asset a security and what are the implications? What is the right degree of decentralization and asset portability? How should due diligence be conducted differently in the blockchain and digital asset spaces? What does (or should) it mean to “own” a digital asset?

Now more than a decade from the release of the Bitcoin whitepaper by the pseudonymous Satoshi Nakamoto about a new peer-to-peer electronic cash system using distributed ledger technology, digital currency and related assets are no longer in their infancy. Instead, they are constantly evolving, creating both challenges and opportunities. One important aspect of capitalizing on such opportunities is, among other things, understanding and recalibrating, if necessary, in response to new legal developments.

Indeed, a new type of diligence is required to mitigate risk and succeed in the digital asset space (particularly in this current “crypto winter” and period of regulatory uncertainty) and lawyers and financial advisors can add a tremendous amount of value when it comes to designing a platform, or setting up the governance structure and legal wrapper of a DAO.

Some noteworthy developments in the digital assets industry from the past year are as follows.

Regulatory Uncertainty Continues

In recent years, federal regulators have struggled with questions over which agency has jurisdiction over the emerging cryptocurrency market. At the same time, the crypto industry has called for greater guidance regarding digital tokens from the SEC and the CFTC. In 2022, SEC Chair Gensler made some comments indicating he wanted the SEC to engage in rulemaking to regulate crypto, though to date, the SEC’s jurisdiction has been largely based on one-off enforcement actions. One crypto exchange, Coinbase, has even sought to compel the SEC to write clearer rules regarding the status of digital assets and to act on Coinbase’s July 2022 rulemaking petition requesting the agency create a comprehensive new regulatory regime for trading crypto assets that are securities (“The U.S. does not currently have a functioning market in digital asset securities due to the lack of a clear and workable regulatory regime. […] Yet the Commission still has not engaged in any rulemaking to set forth its view on which digital assets must be registered as securities or how the registration and other requirements designed decades ago for traditional securities apply to digital assets”). (In re Coinbase, Inc., No. 23-1779 (3rd Cir. Filed April 24, 2023)). In that proceeding, the Third Circuit has declined to rule on the merits of Coinbase’s petition in light of statements submitted by the SEC indicating that commission staff provided a recommendation to the commission for its consideration regarding Coinbase's rulemaking petition.

Moreover, in the wake of the FTX collapse, regulators started to zero in on insolvency risks to customer assets. Several high-profile bankruptcies highlighted custodial issues, leading to questions surrounding the ownership of customer assets and proposed SEC action. To that end, in February 2023, the SEC proposed amendments to the Custody Rule under the Investment Advisers Act of 1940, as amended, which, among other changes, expands the current custody rule’s application to a broader array of client assets under the rule managed by registered investment advisers and clarifies certain aspects of the existing rule. The SEC’s proposed amendments are aimed at reducing the risk of loss of client assets by expanding the types of assets covered by the rule beyond “funds and securities” that will be subject to custodial safeguards and helping ensure assets are properly segregated. The proposed amendment would also impose certain reporting and compliance requirements on investment advisers, including requiring them to provide information about their practices in safeguarding client assets. After the initial comment period ended in May, the SEC announced a reopened 60-day comment period on August 23, 2023.

The SEC also in 2023 reopened the comment period and provided supplemental information on proposed amendments to the definition of “exchange” under Exchange Act Rule 3b-16. The reopening release

reiterated the applicability of existing rules to platforms that trade crypto asset securities, including so-called "DeFi" systems, and provided supplemental information and economic analysis for systems that would be included in the new, proposed exchange definition.

In general, regulatory agencies would strongly prefer that their jurisdiction over the industry be made explicit via direct congressional action instead of through rulemaking. On that front, Congress has held multiple hearings on digital asset regulation and has introduced a handful of bills. For example, U.S. Senators Cynthia Lummis (R-WY) and Kirsten Gillibrand (D-N.Y.) proposed a revised version of their previously introduced crypto regulation bill to create better safeguards for the crypto industry generally while adding new, stronger consumer protection provisions and AML provisions. The proposal addresses this need, in part, by creating clearly defined regulatory roles for the SEC and CFTC, the two leading regulatory bodies currently engaged in regulating the U.S. crypto market. In the wake of the revised RFIA's introduction to the Senate floor, a similar bipartisan effort was launched in the House of Representatives on July 26, 2023. The House Financial Services Committee approved a plan to advance the Financial Innovation and Technology for the 21st Century Act, a bill that also attempts to define when a digital asset is a security or a commodity while clarifying the regulatory jurisdiction of the CFTC and the SEC in the U.S. crypto market. Despite some support for digital asset legislation from both sides of the aisle, the momentum for passage of some compromise bill may have faded in the latter half of 2023.

In the short term, in the absence of Congressional action or SEC rulemaking, existing financial laws are the main source of law governing crypto, as federal agencies defend their turf and jurisdiction over these emerging markets. This has been echoed by statements by SEC Chair Gensler in written testimony submitted in advance of a September 27, 2023 hearing before the House Financial Services Committee, where Gensler noted the industry's "wide-ranging noncompliance with the securities laws" and that "given that most crypto tokens are subject to the securities laws, it follows that most crypto intermediaries have to comply with securities laws as well."

The Crypto Wars Escalate

The SEC's recent enforcement actions against leading crypto exchanges (see here, e.g.) suggest a new push against what the agency deems a non-compliant industry. After spending years urging industry participants to come in and register, the SEC has made clear, by going after some of the biggest players in the space in 2023, that it does not intend to tolerate exchange operators' offering of unregistered crypto trading in the United States, at least as to retail investors where the tokens are securities. From the SEC's perspective, most crypto tokens are securities, so, if a company wants to provide the securities-like infrastructure to trade those tokens, it must be registered with the SEC – whether as an exchange (matching buyers and sellers), a broker-dealer (trading crypto on behalf of others), or a clearing agency (facilitating trade settlement).

The SEC seems to have lost patience and concluded that the simpler path is to go after the exchanges and limit retail crypto trading, rather than to undertake the more laborious (and perhaps fruitless) task of identifying unregistered tokens or fraudulent vaporware projects one by one. The SEC does not want to allow another FTX to happen. The regulators may be acknowledging (however reluctantly) that they might end up stamping out some innovation while justifying doing so in the interest of preventing further violations.

In addition to SEC enforcement actions against major exchanges, the CFTC announced that it had filed a civil enforcement action against Binance Holdings Limited (and related legal entities and officers for violating the Commodity Exchange Act and CFTC regulations). (CFTC v. Zhao). The CFTC, among other things, alleged that Binance allowed U.S. customers to make use of their centralized digital asset trading platform without Binance first properly registering with the CFTC, among other things. Binance eventually reached a coordinated resolution with several agencies (including the DOJ and CFTC) over the various charges.

SEC Losses

As the crypto wars escalated during 2023, the definition of a "security" remained one of the hotly contested

issues in those matters, particularly the debate over whether tokens sold on secondary markets could be deemed "securities" under the SEC's jurisdiction.

In a closely-watched action, we received one court's answer to these questions when the SEC suffered a significant loss in July 2023 in its ongoing legal battle with Ripple over the XRP digital token. (*SEC v. Ripple Labs, Inc.*). While the New York district court held that Ripple's initial sales of XRP to institutional investors constituted the sale of unregistered securities, it was a Pyrrhic victory as the court held that all other ways in which Ripple sold or distributed XRP did not involve the sale of unregistered securities. In particular, the court held that Ripple's program to sell XRP to public buyers on digital asset exchanges, as well as its distribution of XRP as compensation to employees and third parties, did not constitute the offer or sale of securities. The court ruled that Ripple's Programmatic Sales of XRP to buyers on digital asset exchanges – in which Ripple was anonymously selling the tokens to unknown buyers – did not constitute an investment contract, because the buyers there had no expectation that the performance of the seller would impact the value of the token. The court also rejected the SEC's arguments that Ripple used the institutional buyers as underwriters to sell XRP to the public. Subsequently, the district court denied the SEC's request to certify an interlocutory appeal of the ruling and the SEC voluntarily dismissed claims against two Ripple executives for aiding and abetting Ripple's alleged securities law violations with respect to Ripple's offers and sales of XRP in "Institutional Sales."

Looking ahead, the district court's *Ripple* opinion, if followed by other courts in pending litigation with the SEC, could have a far-reaching impact on the cryptocurrency markets, especially with respect to secondary market crypto trades on digital asset exchanges (though, it should be noted that at least one other New York district court, in denying a motion to dismiss an separate SEC action against a cryptoassets company, rejected the *Ripple* court's approach and stated that "*Howey* makes no such distinction between purchasers").

It should also be noted that in a subsequent decision denying the SEC's request for an interlocutory appeal in the *Ripple* case, the judge stated that: "The Court did not hold that offers and sales on a digital asset exchange cannot create a reasonable expectation of profits based on the efforts of others. The Court held that based on the totality of the circumstances in this case…Ripple's Programmatic Sales could not lead investors to reasonably expect profits from Ripple's efforts." Thus, it appears that the SEC will likely argue that the *Ripple* decision should be cabined to its specific facts and will likely point to other *Howey* precedent and prior successful enforcements in future actions that more closely match a particular complaint and set of facts.

In another notable defeat, the D.C. Circuit Court of Appeals ruled that the SEC's previous denial of cryptocurrency fund Grayscale Investments' application for its proposed bitcoin exchange-traded product (ETP) to trade on NYSE Arca was arbitrary and capricious because the Commission failed to explain its different treatment of similar products. (*Grayscale Investments, LLC v. SEC*). The agency was ordered to review the application again. The SEC has not appealed the order, prompting speculation that it may eventually approve Grayscale's ETP. Subsequently, the SEC announced that it had postponed its decision on Grayscale's proposal until January 1, 2024.

Selected Enforcement Actions Involving Digital Assets

The SEC's push to regulate the next generation of blockchain-based applications has given rise to disputes and enforcement actions, including in the developing DeFi space. Although DeFi has the potential to enhance or replace traditional financial products by speeding execution and reducing transaction costs using blockchain technology, it appears that the SEC presumes that actors in this space are generally offering "securities" subject to its jurisdiction.

Some other noteworthy enforcement actions in the digital assets industry include:

- In a first-of-its-kind action, the DOJ secured a wire fraud guilty plea against the former manager of Coinbase who improperly provided, or "tipped," material nonpublic information about the timing and content of Coinbase's "listing announcements" to his brother and a close friend.

These individuals then allegedly used the information to trade ahead of multiple listing announcements and earn at least $1.1 million. Meanwhile, the SEC pursued a parallel civil case against the defendants based on the same scheme (claiming that nine of the cryptoassets traded were securities), a suit that raised some controversy in the industry and prompted a motion to dismiss. Before a ruling, the defendants agreed to settle the SEC insider trading charges and be permanently enjoined from violating Section 10(b) of the Securities Exchange Act and Rule 10b-5 and to pay disgorgement of ill-gotten gains (if not already satisfied by orders of forfeiture in the criminal action). (U.S. v. Wahi).

- The CFTC announced settled charges against three DeFi protocols for various registration and related violations under the Commodity Exchange Act (CEA) during the relevant period of investigation. As a result, each entity paid a civil monetary penalty and agreed to cease violations of the CEA. (See e.g., In re Opyn, Inc.)
- The CFTC announced that it had obtained a default judgment against the Ooki DAO (which the CFTC alleged was operating a decentralized blockchain-based software protocol that functioned in a manner similar to a trading platform) for violating the CEA. For example, the complaint asserted that Ooki DAO was operating as an unregistered futures commission merchant by soliciting and accepting orders from customers, accepting money or property as margin, and extending credit.

  Unlike traditional corporate entities with a typical hierarchical structure, a DAO – a management structure that uses blockchain technology – functions as a leaderless entity. Without a formal corporate structure, DAOs instead operate by distributing governance rights among persons who hold a specific governance token. Consequently, federal and state courts have been grappling with how to consider a DAO under existing laws that were traditionally interpreted against long-standing corporate entities.

  In the instant case, the CFTC was particularly concerned that the Ooki DAO token holders have been attempting to circumvent the law and erect serious obstacles to service of process by implementing a DAO structure that takes advantages of its decentralized nature. In the case, the court reaffirmed that service of process was proper against the DAO based on a finding that the CFTC sufficiently showed that Ooki DAO is an unincorporated association under California law, a ruling that was pivotal to the litigation. With regard to Ooki DAO's alleged CEA violations, the CFTC asserted that anyone who participated in a blockchain vote using a governance token was considered part of the unincorporated association and therefore liable for a judgment against it. The CFTC's action against the Ooki DAO thus implicitly argued that because token holders participated in the DAO's governance, they could be personally liable for its actions. (CFTC v. Ooki DAO).

- The DOJ secured the conviction of a former product manager at NFT marketplace OpenSea on wire fraud and money laundering charges. The Defendant was sentenced to three months in prison in connection with a scheme to commit insider trading in non-fungible tokens (NFTs) by using confidential information about which NFTs were going to be featured on OpenSea's homepage for his personal financial gain (OpenSea kept these special NFT selections confidential until they went live, as a main page listing often translated to a jump in prices for the featured NFTs and others by the same creator). To conceal the alleged fraud, the DOJ claimed Defendant conducted these transactions using anonymous digital cryptocurrency wallets and OpenSea accounts; Defendant's prior efforts to dismiss the indictment were rejected. (U.S. v. Chastain).

New York Financial Regulator Publishes Guidance on Cryptoasset Custody, Virtual-Currency Business Activity, and "Updated Expectations" on Coin-Listing and Delisting Practices

The New York State Department of Financial Services (NYDFS) is no stranger to regulating the virtual currency industry. In 2015, it released its final "BitLicense" rules, becoming the first state to promulgate a comprehensive framework for regulating virtual currency-related businesses. Since 2018, NYDFS has also imposed requirements and controls on the stablecoins issued by its regulated entities. As noted in the

guidance, the agency carefully reviews a company's product offerings (including any stablecoin-related products) when evaluating a BitLicense application, and going forward, BitLicensees and New York State limited purpose trust companies that engage in virtual currency business activity must obtain NYDFS's written approval before introducing a materially new product, service, or activity (including issuance of stablecoins).

NYDFS continued its close oversight of virtual currencies and has worked to fill its self-proclaimed role as "the leading regulator of virtual currency in the nation." During the past year, the NYDFS issued multiple guidance to covered entities and banks, particularly in response to the notable bankruptcies involving crypto companies that have led to allegations of fraud and mismanagement in connection with custodial services.

- At the close of 2022, DFS released its final Guidance to banking organizations seeking to engage in "new or significantly different" virtual currency-related activities. As stated in the Guidance, "virtual currency-related activity" includes all "virtual currency business activity," as defined under the BitLicense regulation, as well as "the direct or indirect offering or performance of any other product, service, or activity involving virtual currency that may raise safety and soundness concerns for the Covered Institution or that may expose New York customers of the Covered Institution or other users of the product or service to risk of harm." At a high level, the Guidance reminds state-regulated banks that, as a "matter of safety and soundness," they must apply for approval before engaging in digital asset-related activities and outlines the types of information the NYDFS deems most relevant in assessing a proposal and the potential risks that such virtual currency-related activities may pose for the institution, consumers and the market in general. The Guidance highlights a number of activities that the NYDFS would consider to fall under the expanded definition. To receive approval, NYDFS stated that it must receive "sufficient information" to assess the virtual currency-related activity and the potential impact on safety and soundness, including implications for New York customers and other users of the product or service.
- In January 2023, DFS issued industry guidance to Virtual Currency Entities ("VCEs") who act as custodians ("VCE Custodians"). Entitled "Guidance on Custodial Structures for Customer Protection in the Event of Insolvency," the Department emphasized the "paramount importance of equitable and beneficial interests always remaining with the customer" and reminded covered institutions of their obligations in connection with "sound custody and disclosure practices in the event of an insolvency" or similar proceeding. The Guidance arrived on the heels of developments in two high-profile insolvency proceedings, the FTX proceedings and the Celsius proceedings. The DFS highlighted that in order to maintain appropriate books and records, VCE Custodians must separately account for and segregate customer virtual currency from the corporate assets of the VCE Custodian and its affiliated entities, both on-chain and on the VCE Custodian's internal ledger accounts. The Guidance also stated that VCE Custodians should only take possession of assets for the limited purpose of custody and safekeeping services and should not thereby establish a debtor-creditor relationship. To preserve customers' equitable and beneficial interest in the virtual currency, the Guidance advises a VCE Custodian to treat customer virtual currency as belonging "solely to customers" and refrain from employing it for its use by securing or guaranteeing an obligation against the virtual currency or acquiring general discretion beyond the terms expressly described in the customer agreement (whether that be for marketing, investing, or other spend).
- In September 2023, DFS issued a proposed guidance for coin-listing and a guidance on the "General Framework for Greenlisted Coins." Generally speaking, the proposed guidance for coin-listing clarifies DFS' expectations with respect to the coin-listing of DFS-regulated entities by heightening risk assessment standards for coin-listing policies and tailoring enhanced requirements for retail consumer-facing businesses and requiring licensees to develop and submit to DFS for approval a compliant coin-delisting policy. The proposed guidance also states that in the event a listed coin is identified as presenting newly elevated risk, whether through a VC Entity's monitoring process, a DFS-identified weakness or vulnerability, or otherwise, virtual currency entities must be able to discontinue support of that coin in a manner that is consistent with safety and soundness and with protection of customers and the public.

The separate guidance for the Greenlist process updates the DFS Greenlist, or the list of coins and tokens approved for all licensees to list or custody. The guidance clarifies that DFS may, at any time and in its sole discretion, add any coin to the Greenlist; remove any coin from the Greenlist; refrain from placing any coin on the Greenlist; discontinue the Greenlist process entirely; prohibit or otherwise limit a coin's use before or after a VC Entity begins using a coin; or require that any VC Entity delist, halt, or otherwise limit or curtail activity with respect to any coin.

UK Financial Conduct Authority (FCA) Publishes Financial Promotion Rules for Cryptoassets

From October 8, 2023, new rules (PS23/6) for the marketing of cryptoassets came into force in the UK. The new requirements include the need for marketing materials to be "clear, fair and not misleading", labelled with prominent risk warnings, and to not inappropriately incentivize people to invest. These rules apply to firms wherever they are based globally. The FCA has signaled that, in response to industry readiness, it will consider giving cryptoasset firms until January 8, 2024 to implement the features that require greater technical development, with the core rules still coming into effect after October 8, 2023. In November 2023, the FCA issued a Guidance to provide information on, and set out its expectations of, the communication and approval of financial promotions relating to qualifying cryptoassets.

Insider Trading Update

Insider-Trading Developments

The period since our last annual review saw a number of developments involving insider trading, including the following:

- A reversal of the mid-trial dismissal of the SEC insider-trading case on which we reported last year;
- Developments in litigation involving SEC Regulation FD, which prohibits selective disclosures of nonpublic information;
- "Insider-trading" cases that do not involve securities or commodities;
- Questions about the use of the criminal insider-trading statute without proof of receipt of a personal benefit, as is required for insider-trading actions brought under the Securities Exchange Act;
- A potential setback for use of the wire-fraud statute to prosecute insider trading;
- Developments involving "shadow trading";
- The dismissal of a private action for insider trading against private-equity firms;
- The CFTC's continued interest in insider trading;
- The continued governmental focus on insider trading and data analytics;
- The SEC's tightened requirements for Rule 10b5-1 trading plans;
- The SEC's suit against a broker-dealer for lack of information barriers and misleading disclosures; and
- The status of proposed legislation on insider trading.

Fourth Circuit Reverses Mid-Trial Dismissal of SEC Insider-Trading Case

We reported last year on the somewhat surprising dismissal of an SEC enforcement action after the SEC had put on its case in chief to a jury and before any presentation from the defense. The court ruled from the bench that the SEC had not established insider trading based merely on a statistical analysis of the defendant's allegedly suspicious trades and a relationship between the defendant and a corporate insider

who had material nonpublic information ("MNPI"). *SEC v. Clark*, 2021 WL 6932689 (E.D. Va. Dec. 13, 2021).

The victory did not last. The U.S. Court of Appeals for the Fourth Circuit reversed the decision earlier this year. *SEC v. Clark*, 60 F.4th 807 (4th Cir. 2023). The Fourth Circuit's ruling is a reminder that the SEC can meet its burden of proof by presenting merely circumstantial, rather than direct, evidence of insider trading and that a trial court must not weigh evidence, determine witnesses' credibility, or substitute its judgment for the jury's in ruling on a motion for judgment as a matter of law.

Background

The defendant in *Clark* allegedly had traded on MNPI from his brother-in-law about a merger involving the company where the brother-in-law worked as Corporate Controller. The SEC relied on what it deemed suspicious trading: the defendant had bought speculative out-of-the-money call options on the company's stock; the transactions had been unusual for the defendant; the defendant had borrowed money to pay for some of his trades; and he allegedly had told his son to buy some of the same options. The brother-in-law settled with the SEC and paid $240,000, but the defendant proceeded to trial.

The District Court dismissed the action after the close of the SEC's case at trial, finding no testimony, documents, or other evidence showing that, despite the defendant's seemingly anomalous trading pattern, the brother-in-law had obtained MNPI about the proposed merger and had passed it to the defendant. The court concluded that there was "'no circumstantial evidence here that gives rise to an inference that [the defendant] received the insider information." The SEC appealed, and the Fourth Circuit reversed and remanded for further proceedings.

Fourth Circuit's Decision

The Fourth Circuit framed its ruling by stressing the standard for a motion for judgment as a matter of law under Fed. R. Civ. P. 50(a). Judgment is appropriate only when "'a party has been fully heard . . . and the court finds that a reasonable jury would not have a legally sufficient evidentiary basis to find for the party.'" The nonmovant "must present more than a scintilla of evidence" to defeat a Rule 50(a) motion, but the court "must not weigh evidence, determine witness credibility, or substitute [its] judgment of the facts for that of the jury."

Applying that standard, the Fourth Circuit held that the trial court had "failed to consider the evidence in the light most favorable to" the nonmoving party (the SEC) and had improperly taken the case from the jury. The evidence could have enabled a reasonable jury to conclude that the defendant's brother-in-law had learned about the potential merger before the defendant began trading the issuer's call options. For example:

- The brother-in-law had communicated with the company's Chief Accounting Officer – a close personal friend, with whom he was in constant contact – about the potential impact of a transaction like a merger on the company's unvested stock, which both of them had. The pair had exchanged those emails just one day after the company's Board had responded to the prospective buyer's initial merger offer.
- When the proposed merger price had reached a level acceptable to the company, the brother-in-law began emailing employment recruiters, and he later told recruiters that he had been working on the merger the day before the defendant began to trade.
- The Chief Accounting Officer testified that he had known about the merger negotiations before the defendant began trading.

The court also found sufficient evidence for a reasonable jury to conclude that the brother-in-law had conveyed MNPI about the merger to the defendant before the defendant began trading. For example:

- The defendant started trading on the very day that the company accepted the buyer's merger

offer.

- Until that trade, the defendant had not traded the company's call options except on one occasion, nearly a decade earlier. The defendant had actively traded the company's put options, all of which had expired the month following the release of the company's quarterly financial reports. The trial court viewed those trades as evidence that the defendant had a history of speculating in call/put-type transactions, thereby supposedly undermining any inference of suspicious trading here. But the Fourth Circuit observed that "[a]nother way [of viewing those trades] is that the evidence shows an opportunity and pattern of trading [company securities] with inside information from [the brother-in-law]."
- The defendant had taken "extraordinary measures to buy the call options": he had "emptied his wife's retirement account, borrowed money at a 9% interest rate, and [taken] out a loan on his car" to fund the purchases.
- The defendant had advised his son to make similar purchases and had later "lied to the FBI about whether he had done so."
- The trades had proven "remarkably lucrative," yielding a return of more than 70% in a short period of time.

The Fourth Circuit noted that, despite this evidence, a jury could reasonably decide that the brother-in-law had not had any MNPI when the defendant began trading. But the court emphasized that, in reviewing a grant of judgment as a matter of law, "our task is only to decide whether there is evidence from which a reasonable jury could have decided that [the defendant] was liable."

Clark settled with the SEC in November 2023, shortly before a second trial was scheduled to begin. The settlement terms were not yet public as of this writing.

Implications

The *Clark* decision is fact-bound, and it does not make new law on insider trading or on motions for judgment as a matter of law. But it does illustrate that trial courts must not take too narrow or rigid a view of circumstantial evidence and its sufficiency to prove a case. As the Fourth Circuit observed: "because a defendant or interested party rarely makes a statement or reveals information that amounts to direct evidence of impermissible trading based on confidential insider information, the Commission may present circumstantial evidence to meet its burden of proof." The court noted that "[c]ircumstantial evidence, if it meets all the other criteria of admissibility, is not only sufficient, but may also be more certain, satisfying and persuasive than direct evidence."

Regulation FD's Prohibition Against Selective Disclosure Is Still Alive

Recent Decision on Regulation FD

In a rare judicial decision on Regulation FD, a federal court in New York denied the SEC's and the defendants' cross-motions for summary judgment in an enforcement action arising from the defendants' alleged conversations with analysts to try to get them to reduce their quarterly earnings estimates. *SEC v. AT&T, Inc.*, 2022 WL 4110466 (S.D.N.Y. Sept. 8, 2022).

The SEC alleged that, in March and April 2016, AT&T and three members of its investor-relations department had selectively disclosed MNPI to analysts at twenty Wall Street firms to "manage" those analysts and convince them to reduce their estimates of AT&T's first-quarter 2016 revenue so that AT&T could beat the consensus revenue estimate. By March 2016, the analysts' consensus revenue estimate for the first quarter had exceeded AT&T's internal estimates by more than $1 billion, and AT&T allegedly did not want another revenue miss, after having fallen below the consensus revenue estimate in two of the three preceding quarters.

To reduce the analysts' expectations, the individual defendants allegedly told the analysts about AT&T's

projected or actual total revenue and internal financial metrics relating to revenue (including wireless-equipment revenue and wireless upgrade rates). Those disclosures allegedly violated AT&T's internal policies and practices, which prohibited employees from disclosing internal or actual projected results. And the training that the individual defendants had received instructed them that "no metric or number may be discussed with analysts unless the metric was already public, regardless of whether it was material."

In response to the calls from the IR personnel, the analysts allegedly reduced their earnings estimates. AT&T's announced total revenue ultimately exceeded the analysts' final consensus revenue estimate by 0.1%.

The SEC sued the company and the three IR executives under Section 13 of the Securities Exchange Act and Regulation FD. The defendants and the SEC cross-moved for summary judgment, and the court denied both motions, holding that disputed issues of material fact existed at least as to whether the defendants had acted with scienter and that, accordingly, neither side was entitled to summary judgment.

The court found "formidable" evidence that the individual defendants had selectively disclosed MNPI to the analysts. The court saw "overwhelming evidence . . . on which a jury could find that in March and April 2016, AT&T undertook a campaign, choreographed at high levels of the company, to walk down analysts' estimates." The court also cited accounting literature and case law holding that information about an issuer's ability to meet analysts' consensus estimates is material. And although "the balance of the evidence on the scienter element is closer," the court found "sufficient evidence" to allow a reasonable jury to conclude that the defendants had acted with scienter: they had known that, or had been at least reckless about whether, the information they were selectively disclosing was both material and nonpublic, in violation of Regulation FD. But the court also ruled that a reasonable jury "could find for the individual defendants, at a minimum, on the element of scienter." Because both sides' summary judgment motions failed on the scienter element, the court did not decide whether summary judgment was appropriate on the other two elements of the alleged violation (the materiality and nonpublic nature of the disclosures).

In addition, the court rejected the defendants' legal argument that Regulation FD is invalid under the First and Fifth Amendments of the U.S. Constitution and outside the SEC's regulatory authority to promulgate. The court held that the Regulation does not improperly compel an issuer to speak; it simply requires an issuer to disclose publicly whatever it has chosen to disclose privately. Moreover, the SEC had a substantial and legitimate reason for adopting the Regulation: to combat selective disclosure and protect market integrity and investors. The court also held that Section 13(a) of the Exchange Act empowered the SEC to adopt Regulation FD.

On December 2, 2022, the parties informed the court that the defendants had consented to a final judgment pursuant to which AT&T would pay a $6.25 million penalty and the three individuals would each pay a $25,000 penalty. The judgment also permanently enjoined AT&T from violating Section 13(a) of the Exchange Act and Regulation FD and permanently enjoined the individuals from aiding and abetting violations of those provisions.

Selective Disclosure in Canada

It might be interesting to compare the *AT&T* decision and the SEC's Regulation FD with treatment of selective disclosure under Ontario's Securities Act (the "OSA"). The Ontario statute provides that "[n]o issuer and no person or company in a special relationship with an issuer shall inform, *other than in the necessary course of business*, another person or company of a material fact or material change with respect to the issuer before the material fact or material change has been generally disclosed." OSA § 76(2) (emphasis added). A recent ruling by Ontario's Capital Markets Tribunal (the "Tribunal") in *In the Matter of Kraft and Stein*, 2023 ONCMT 36 (Oct. 20, 2023), provides guidance on the circumstances in which the OSA will permit selective disclosure of MNPI.

The *Kraft* proceeding arose when the chair (Kraft) of a company allegedly tipped his long-time friend and business associate (Stein) about the company's expansion plans. Stein had previously entered into a consulting agreement with the company, but that agreement was no longer in effect at the relevant time.

Nevertheless, Kraft allegedly discussed the proposed expansion plans with Stein and sent him near-final drafts of documents through which the company would lease more space. Kraft claimed to have done so because he considered Stein his "'go-to guy'" for real-estate and financial matters and wanted to tap Stein's supposed expertise in commercial real estate. On the day before the transaction was announced, Stein bought shares of the company and sold them at a profit during the two trading days after the announcement.

The Tribunal concluded that Kraft had violated the OSA by tipping MNPI to Stein and that Stein had violated the OSA by trading on the tip. In so ruling, the Tribunal rejected the defendants' reliance on the OSA's exception for disclosures "necessary in the course of business" (the "NCOB exception").

- The Tribunal stressed that "necessary course of business" means more than "ordinary course of business." A selective disclosure must go beyond "a mere business purpose or business rationale"; it must "import[] a level of importance, including that something is 'essential,' 'indispensable,' or 'requisite.'" The Tribunal found that Kraft's disclosures to Stein were not necessary because Kraft had not suggested that the company hire an outside advisor to advise on commercial real estate and because the company's management and counsel had already negotiated the relevant documents.
- The Tribunal noted that the phrase "necessary course of business" does not say "necessary course of *the issuer's* business," so it conceivably could apply to a business necessity involving a person or entity other than the issuer. However, in this case, the chair effectively was acting for the issuer, so the Tribunal and the parties accepted that the NCOB exception should be analyzed from the issuer's perspective.
- The Tribunal provided a nonexclusive list of factors that could be important in determining whether a selective disclosure was made in the necessary course of business: the issuer's business, the relationship between the tipper and the issuer, the relationship between the tipper and the tippee, the nature of the MNPI disclosed, the MNPI's relevance to the issuer/tippee relationship, the tipper's reason for making the disclosure, and the tipper's credibility in seeking to establish the NCOB exception.
- The Tribunal observed that a tipper need not necessarily have thought through the NCOB exception before tipping MNPI, but evidence of such forethought could "certainly be helpful" to establishing the exception's availability. Such evidence could include board or management discussions "considering the advisability or need for the selective disclosure," documents specifying the disclosure's purpose, and confidentiality agreements with or instructions to the recipient of the selective disclosure.
- The Tribunal concluded that the NCOB exception must be determined on an objective basis, rather than on the tipper's subjective belief about necessity, and that the tipper bears the burden of establishing the exception's applicability to the facts presented.

The Tribunal's decision thus appears to suggest that anyone who feels a need to make selective disclosures under the OSA's NCOB exception should. among other things, (*i*) evaluate whether the disclosures serve a truly necessary business purpose, rather than merely a convenient or desirable one, (*ii*) obtain a confidentiality agreement from the recipient of the disclosures, and (*iii*) document those steps.

"Insider Trading" Without Securities or Commodities

In the age of crypto, "insider trading" (colloquially defined) can occur even in the absence of a security or a commodity, as several recent proceedings illustrate.

The Chastain Case

In *United States v. Chastain*, 2022 WL 13833637 (S.D.N.Y. Oct. 21, 2022), the court denied a motion to dismiss an indictment alleging wire fraud based on misappropriation of and trading on confidential information *not* alleged to have involved a security or commodity.

Chastain was a product manager for an online marketplace for nonfungible tokens ("NFTs") and was responsible for selecting certain NFTs for the marketplace's homepage, a product placement that could boost the prices of the chosen NFTs and of other NFTs by the same artists. The government alleged that Chastain had purchased dozens of NFTs shortly before they were featured on the homepage and that, after the postings occurred, he sold the NFTs for a profit. The government did not allege that the NFTs at issue were securities, and it did not charge Chastain with securities fraud. Instead, it charged wire fraud: misappropriation of the employer's confidential business information (a concept similar to the securities-law misappropriation theory of insider trading).

Chastain moved to dismiss the indictment, contending that the misappropriation theory even under the wire-fraud statute requires trading in securities or commodities. The court found the contention "wholly without merit" because, in contrast to the securities statute, the wire-fraud statute "makes no reference to securities or commodities." Wire fraud could occur based solely on the employee's misappropriation of his employer's confidential business information for his own use even in the absence of a security or commodity.

A jury convicted Chastain of wire fraud and money laundering in May 2023. On August 22, 2023, the court sentenced Chastain to three months in prison, a fine of $50,000, and forfeiture of approximately $26,000 worth of cryptocurrency. The judge stated that he found the sentence to be "unusually difficult": although he considered the jury to have been reasonable in determining that Chastain had misused his employer's confidential business information, and although Chastain had taken steps to conceal his conduct, the judge "genuinely wonder[ed], but for the fact that this case arose in the new and slightly sexy arena of NFTs, whether it would have been charged [at all]."

Chastain appealed his conviction in September 2023. *United States v. Chastain*, No. 23-7038 (2d Cir. Sept. 5, 2023).

The Wahi Litigation

We reported last year on the criminal and civil litigation involving Ishan and Nikhil Wahi. Those proceedings have now ended with guilty pleas in the criminal cases and settlements in the SEC enforcement action.

In July 2022, the DOJ and the SEC brought parallel insider-trading actions against a now-former Coinbase product manager (Ishan), his brother (Nikhil), and a close friend for trading in certain crypto assets based on nonpublic information that the assets would be listed for trading on Coinbase, a large crypto-trading platform. The government alleged that the Coinbase employee had tipped his brother and friend about the listing plans, and the latter two defendants had then purchased at least 25 crypto assets. The alleged tipping violated Coinbase's policies that prohibited employees from disclosing MNPI to any other person and defined MNPI to include decisions about whether to list crypto assets.

The SEC's enforcement action – *SEC v. Wahi*, No. 2:22-cv-1009 (W.D. Wash.) – was a fairly straightforward misappropriation-theory claim: the employee allegedly misappropriated his employer's MNPI about listing decisions and disclosed it to his brother and close friend, who used it to buy soon-to-be-listed crypto assets, which then generated more than $1.1 million in profits. But the SEC's claims depended on whether the crypto assets at issue were securities. The SEC contended that nine of the 25 crypto assets were securities under the well-known test articulated in *SEC v. Howey*, 328 U.S. 293 (1946): they allegedly were "investment contracts" – an investment of money in a common enterprise with a reasonable expectation of profit derived from the efforts of others.

The DOJ, however, did not charge the defendants with criminal securities-law violations, but with wire fraud and wire-fraud conspiracy. The DOJ's case – *United States v. Wahi*, No. 1:22-cr-00392 (S.D.N.Y.) – thus did not depend on whether any of the crypto assets were securities under *Howey*. Nor would the DOJ have needed to prove other key elements of a securities-fraud claim: whether the tipper (the employee) had received any kind of personal benefit when he allegedly tipped his brother and close friend and whether the tippees had known about any such benefit.

In September 2022, the Coinbase employee's brother pled guilty to wire-fraud conspiracy. The Assistant U.S. Attorney handling the case noted during the brother's allocution that the wire-fraud charge did not involve questions about whether the cryptocurrencies at issue were securities. The Coinbase employee himself pled guilty to two counts of wire-fraud conspiracy in February 2023. And in May 2023, the brothers entered into settlements with the SEC. The SEC decided not to seek civil penalties in light of the brothers' prison sentences.

Second Circuit Panel Questions Use of Criminal Insider-Trading Statute Without Proof of Receipt of Personal Benefit

Our prior updates reported on the long-running *Blaszczak* litigation (involving alleged hedge-fund tippees' trading on information provided by an alleged government tipper) and on prosecutors' efforts to use the criminal insider-trading statute to avoid having to prove that a tipper of MNPI received a personal benefit in exchange for providing MNPI to a tippee.

In December 2022, the Second Circuit held that a government agency's nonpublic, pre-decisional regulatory information does not constitute "property" for purposes of the federal insider-trading and wire-fraud statutes. The decision in *United States v. Blaszczak*, 56 F.4th 230 (2d Cir. 2022) ("*Blaszczak II*") effectively vacated convictions under those statutes for defendants who had traded on nonpublic, market-moving information that had been obtained from a government agency.

In a separate "concurrence" having potentially broader legal ramifications, two members of the panel also expressed concerns (in *dicta*) about the government's use of the criminal insider-trading statute to prosecute tipper-tippee insider trading without needing to prove that the tipper received a "personal benefit," as required under the federal securities laws. The concurring judges' views, if ultimately adopted by the courts or Congress, could curtail an approach that the government has been using to avoid the potentially complicated "personal benefit" issue, which has generated much litigation in recent years.

Background

Blaszczak II marked the case's second appearance in the Second Circuit. When the court issued its first decision in *Blaszczak I* in December 2019, most of the attention had focused on the court's upholding the government's use of the criminal statute prohibiting insider trading (18 U.S.C. § 1348) as a way to avoid having to prove that the provider of MNPI had received a personal benefit in exchange for that information or that a tippee had known of the tipper's receipt of a personal benefit.

Insider-trading cases have traditionally been brought under the general securities-law statute prohibiting securities fraud, 15 U.S.C. § 10(b) ("Title 15"). An insider or other tipper cannot be held liable for securities fraud under Title 15 unless he or she breached a duty of trust or confidence by using or disclosing MNPI in exchange for a personal benefit. Similarly, a tippee cannot be held liable for Title 15 securities fraud unless he or she used or conveyed the MNPI knowing that it had been obtained in breach of the tipper's duty (a standard that includes the tippee's knowledge of the tipper's receipt of a personal benefit).

Because the personal-benefit requirement sometimes creates potential difficulties of proof, some prosecutors began to prosecute insider trading under 18 U.S.C. § 1348, which (according to those prosecutors) does not require proof of a personal benefit. 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.

The Blaszczak Case

Blaszczak involved prosecutions of four individuals in connection with alleged schemes to obtain nonpublic

information from the federal Centers for Medicare and Medicaid Services (the "CMS") about reimbursement rates for certain medical treatments. A CMS employee had allegedly given MNPI to a friend (Blaszczak), a former CMS employee who was then working as a consultant; Blaszczak then passed the information to persons at two hedge funds, who traded on it. The CMS employee allegedly had received benefits from Blaszczak in the form of free meals, tickets to sporting events, and an offer to join Blaszczak's firm.

The government charged all defendants with traditional securities fraud under Title 15 and also with violations of § 1348 and the wire-fraud and conversion statutes. The court's jury instructions on the Title 15 charge addressed the standard elements – including whether the tipper (the CMS employee) had owed and breached any duty of trust or confidence to his agency, whether he had received a personal benefit for doing so, and whether the tippee defendants had known of the tipper's breach of duty and receipt of a benefit. The defendants asked the court to include those same elements in its charge under § 1348, but the court denied the request, requiring the jury to find only that the defendants had knowingly and willfully engaged in "an illegal scheme or artifice" by providing confidential CMS information "to another person for the purpose of buying or selling securities on the basis of that information." The charge did not say anything about the tipper's duty to the agency, his alleged receipt of a personal benefit, or the tippees' knowledge of either of those things.

The jury acquitted the defendants of Title 15 securities fraud but convicted them of some combination of violating § 1348 and/or the wire-fraud and conversion statutes.

Second Circuit's First Decision (Blaszczak I)

The Second Circuit, in a 2-1 decision by Judge Sullivan, affirmed the convictions, holding that the personal-benefit test required for Title 15 securities fraud does not apply to Title 18 securities fraud under § 1348 – or to wire fraud under 18 U.S.C. § 1343. *United States v. Blaszczak*, 947 F.3d 19 (2d Cir. 2019). The court rejected the defendants' contention that eliminating the personal-benefit requirement from Title 18 securities fraud (and wire fraud) would give the government "a different – and broader – enforcement mechanism to address securities fraud than what had previously been provided in the Title 15 fraud provisions." The court concluded that § 1348 was designed to achieve that result.

The court also held that, "in general, confidential government information may constitute government 'property' for purposes of" the Title 18 securities-fraud and wire-fraud statutes. "[G]overnment agencies have strong interests – both regulatory and economic – in controlling whether, when, and how to disclose confidential information relating to their contemplated rules" (here, CMS's rules about reimbursement rates). In addition, the court upheld the convictions under the statute prohibiting conversion of federal property (18 U.S.C. § 641), ruling that the government's confidential information constituted a "thing of value."

Judge Kearse dissented because she did not consider the agency's pre-decisional regulatory information to be "property" or a "thing of value" under Title 18.

The Supreme Court's Kelly Decision and Its Aftermath

While *Blaszczak* was working its way through the courts, a separate prosecution arising from the "Bridgegate" scandal was also proceeding. Bridgegate involved alleged political retaliation by the Governor of New Jersey's Deputy Chief of Staff and the Deputy Executive Director of the Port Authority of New York and New Jersey (whom the Governor had appointed) against a local mayor who allegedly had thwarted the Governor's wishes.

According to the government's allegations, the Governor – a Republican – was up for reelection and wanted to win a large bipartisan victory to promote his presidential aspirations. The Deputy Chief of Staff sought endorsements from Democratic mayors, including the Mayor of Fort Lee, but the Mayor declined to endorse the Governor. Supposedly in retaliation for the Mayor's refusal to cooperate, the Deputy Chief of Staff worked with the Port Authority's Deputy Executive Director and others to fabricate a "traffic study" that involved closing critical Fort Lee access lanes on the George Washington Bridge, thereby causing traffic to

back up and create chaos in Fort Lee.

The government prosecuted the Deputy Chief of Staff and the Port Authority's Deputy Executive Director on charges of wire fraud, fraud on a federally funded program or entity (the Port Authority), and conspiracy to commit those two crimes. The jury found the defendants guilty on all counts, and the Court of Appeals for the Third Circuit affirmed.

The Supreme Court unanimously reversed the convictions in May 2020. *Kelly v. United States*, 140 S. Ct. 1565 (2020). The Court held that the statutes at issue prohibited deceptive conduct to deprive the victim of "money or property," so the government needed to prove not only that the defendants had engaged in deception, but also that *property* had been an object of their deception. The realignment of the bridge's traffic lanes, however, was "a quintessential exercise of regulatory power," rather than an appropriation of the Port Authority's property. And although the scheme had required the use of a public employee's paid time (which could be considered governmental property), the defendants "never had that as an object." "The use of Port Authority employees was incidental to – the mere cost of implementing – the sought-after regulation of the Bridge's toll lanes," rather than an effort to deprive the government of its property.

Kelly revitalized the issue that the *Blaszczak* defendants had raised and on which Judge Kearse had based her dissent: whether CMS's confidential, pre-decisional regulatory information was "property" under 18 U.S.C. § 1348 and the wire-fraud statute. Accordingly, the Supreme Court vacated and remanded the *Blaszczak* convictions for reconsideration in light of *Kelly*.

In briefing on remand, the government agreed with the defendants' argument that the convictions could not stand under *Kelly*. The government's brief stated that the Department of Justice "now" takes the position that "in a case involving confidential government information, that information typically must have economic value in the hands of the relevant government entity to constitute 'property' for purposes of 18 U.S.C. §§ 1343 and 1348" and that CMS's "confidential information at issue in this case does not constitute 'property' or a 'thing of value' under the relevant statutes after *Kelly*."

Second Circuit's Decision on Remand (Blaszczak II)

The Second Circuit, in a 2-1 decision written by Judge Kearse (who had dissented in *Blaszczak I*), held that *Kelly* and "the prosecutorial discretion to which the Executive Branch is entitled" required remanding the Title 18 securities-fraud, wire-fraud, and conversion convictions to the District Court for dismissal. The majority explained that "broad discretion" rests with the government to prosecute or not prosecute under federal criminal statutes, but it acknowledged that the judiciary ultimately must decide whether to accept the government's confession of error. The majority concluded that, in light of *Kelly*, the relevant statutes did not apply to the conduct at issue.

The majority stressed that federal fraud statutes such as § 1348 and the wire-fraud statute "are limited in scope to the protection of property rights," so the government must prove that "the object of the defendants' fraudulent scheme was money or property." Those statutes prohibit "only deceptive schemes to deprive [*the victim*] of money or property." Inasmuch as CMS was the purported victim of its employee's leak, "defendants could not properly be convicted of violating §§ 1343, 1348, or 641 unless the objective of their schemes and conduct was the money or property of CMS."

The majority held that CMS's confidential, pre-decisional regulatory information was not CMS's "property" here because "CMS is not a commercial entity; it does not sell, or offer for sale, a service or a product." Moreover, the planned regulation, even if prematurely disclosed to outsiders, remained "within the exclusive control of CMS"; its disclosure thus had "no direct impact on the government's fisc," even if the leak "might well impact CMS's subsequent regulatory choices." The court therefore ruled that "merely obtaining advance information as to what the agency's preferred regulation would be, and when it would be announced, cannot properly be considered the agency's money or property or a thing of value that could be 'convert[ed].'"

The overturning of the convictions underlying *Blaszczak I* led Judge Walker (joined by Judge Kearse) to write a separate "concurrence" to discuss the fate of another part of the holding of that case: that criminal liability for tipper-tippee insider trading under § 1348 does not require proof that the tipper received a personal benefit, even though criminal and civil liability for Title 15 securities fraud would require such proof. That difference struck Judges Walker and Kearse as "odd" because "traditional notions of fair play are offended by the present incongruence in this circuit between civil and criminal deterrence." "It should not require fewer elements to prove a criminal conviction than to impose civil penalties for the same conduct. This asymmetry deserves the further attention of our court, the Supreme Court, and Congress."

According to Judges Walker and Kearse, the personal-benefit test for Title 15 securities fraud "creates at least some legal distinction between those who gave and obtained tips fraudulently and those who appropriately engaged in the honest disclosure and collection of corporate information." Without that limiting principle, "corporate insiders may be more reticent to share information with analysts in the ordinary course of business and analysts who do receive company information may be less likely to act on it for fear of running afoul of § 1348."

Judge Sullivan, who had written the majority decision in *Blaszczak I*, dissented on both points. First, he did not read *Kelly* as altering the conclusion that nonpublic CMS information was "property" for purposes of § 1348 and the wire-fraud statute. Second, he objected to the concurrence's "gratuitous advisory opinion" on whether § 1348 requires a "personal benefit." Judge Sullivan opined that the personal-benefit test under Title 15 "is a judge-made rule premised on the statutory purpose of the Securities Exchange Act," and he saw "no obvious reason to extend that rule to a different statutory provision under Title 18." He also observed that § 1348 had been enacted in the wake of the 2008 financial crisis to provide new tools to federal investigators and prosecutors, so "[t]he history and purpose of section 1348 therefore make it far more plausible that Congress did not intend for it to be a mere carbon copy of the Title 15 securities-fraud statute."

In July 2023, the government agreed not to retry the remaining charges against the hedge-fund analysts and the former CMS employee, provided that the defendants comply with the terms of agreements specifying good behavior.

Implications

Blaszczak II raises a number of considerations for insider-trading claims in the future.

First, and perhaps foremost, the concurrence could lead the Second Circuit, other courts, or Congress to reevaluate whether the government can use Title 18 to avoid Title 15's breach-of-duty and personal-benefit requirements. Title 18 appears to have facilitated insider-trading prosecutions where the government could not prove (or did not want to undertake the burden of proving) that the insider had received a personal benefit in exchange for providing MNPI – or that remote tippees had known about any such benefit. *Blaszczak* itself illustrates the difference that the availability of a Title 18 count can make: the jury acquitted the defendants of Title 15 securities fraud even though it convicted them under Title 18. Several other courts have relied on *Blaszczak I*'s ruling to uphold Title 18 counts, but that ruling has now been questioned.

Second, the holding that a government agency's confidential regulatory information is not its "property" for purposes of Title 18 securities fraud and wire fraud could prevent prosecutions for insider trading under those statutes. But the decision does not address whether use of or tips about such information could give rise to civil or criminal liability under Title 15. Moreover, any such misuse of confidential governmental information might now fall within the terms of the STOCK Act (the "Stop Trading on Congressional Knowledge Act"), which Congress enacted in 2012 to clarify that the insider-trading laws apply to members of the legislative, executive, and judicial branches. The STOCK Act was not at issue in the *Blaszczak* decisions.

Third, in holding that CMS's confidential regulatory information was not CMS's "property" under Title 18, the court contrasted CMS with a commercial entity, for which confidential information might be "its stock in trade, to be gathered at the cost of enterprise, organization, skill, labor, and money, and to be distributed

and sold to those who [would] pay money for it." The court's ruling as to CMS thus would not seem to apply where, for example, an employee of a newspaper misappropriates his or her employer's confidential pre-publication information for trading or tipping purposes, as the Supreme Court held several decades ago in *Carpenter v. United States*, 484 U.S. 19 (1987). (*Carpenter* upheld wire-fraud convictions for securities trading arising from a *Wall Street Journal* reporter's leaked advance information about the contents of *Wall Street Journal* articles on specific companies.) However, defendants might now try to argue in other contexts that a particular type of MNPI is not the relevant company's "stock in trade," but is information merely ancillary to the company's core business operations – an issue to which we return below.

Another Setback for Wire-Fraud Prosecutions for Insider Trading?

In addition to using Title 15's § 10(b) and Title 18's § 1348 to prosecute alleged insider trading, the government sometimes uses the normal wire-fraud statute, as it did in *Blaszczak*. The Supreme Court's May 2023 decision in *Ciminelli v. United States*, 143 S. Ct. 1121 (2023), might narrow the availability of that option where the MNPI at issue does not constitute a "traditional property interest."

Ciminelli did not involve insider trading; it concerned bidding on government contracts for the "Buffalo Billion" initiative, designed to invest $1 billion in development projects in upstate New York. The defendants were a member of the board of the nonprofit that administered the initiative, the owner of a construction company, and a lobbyist with ties to New York's then-Governor.

The board member and the construction-company operator allegedly made payments to the lobbyist to ensure they would have "a prominent position" in Buffalo Billion. The defendants also jointly developed a set of requests for proposal that treated "unique aspects" of the construction company as qualifications for preferred-developer status. Thus, the RFPs "effectively guaranteed that [the construction company] would be (and was) selected as a preferred developer for the Buffalo projects."

The defendants were indicted for wire fraud and conspiracy to commit wire fraud. The prosecution relied on the "right to control information" theory, under which the government "could establish wire fraud by showing that the defendant[s] schemed to deprive a victim of potentially valuable economic information necessary to make discretionary decisions." Under this theory, the defendants allegedly had deprived the Buffalo Billion project administrator of information showing that they had rigged the RFP process for a billion-dollar project in their own favor. The District Court instructed the jury that the term "property" in the wire-fraud statute "'includes intangible interests such as the right to control the use of one's assets,'" so the jury could find that the defendants had harmed the project administrator if the administrator was "'deprived of potentially valuable economic information that it would consider valuable in deciding how to use its assets.'"

The jury convicted the defendants of wire fraud and conspiracy to commit wire fraud, and the Second Circuit affirmed. But the Supreme Court unanimously reversed, holding that "the wire fraud statute reaches only traditional property interests" and that "[t]he right to valuable economic information needed to make discretionary economic decisions is not a traditional property interest."

We will see whether and to what extent *Ciminelli*'s narrowing of the definition of property affects the use of the wire-fraud statute to prosecute insider trading. It is not hard to imagine that defendants will argue that certain types of MNPI are merely "valuable economic information needed [for corporations and others] to make discretionary economic decisions" and thus do not constitute the type of property interest to which the wire-fraud statute applies. And when *Ciminelli*'s holding is added to *Blaszczak*'s ruling that a government agency's confidential regulatory information is not its "property" for purposes of Title 18 securities fraud and wire fraud, prosecutors might feel increasingly compelled to rely on Title 15 securities fraud – at least where governmental information and other MNPI that does not constitute an issuer's "stock in trade" is the focus of the alleged crime.

In fact, that issue was recently litigated in the *Chastain* case (discussed above), albeit before the Supreme Court issued its ruling in *Ciminelli*. Chastain was convicted of wire fraud for having purchased (and later sold) NFTs based on advance knowledge of which NFTs would be featured on his employer's home page

– a product placement that allegedly was likely to increase the value of those NFTs and other NFTs by the same artists. During pretrial *in limine* motions, Chastain argued that the prosecution was required to prove he had defrauded his employer of "property" – and that the government could not prove that MNPI about the NFTs' placement on the home page constituted property under the wire-fraud statute unless the government could establish that the product placement itself had "inherent value" to the employer.

The court rejected the argument, holding that "the Government is not *required* to prove that the featured NFT information had inherent value to [the employer]," although "such evidence can be considered by the jury in (among other things) evaluating whether the information was 'confidential business information' and, thus, [the employer's] property." *United States v. Chastain*, 2023 WL 2966643 (S.D.N.Y. Apr. 17, 2023). To count as "property" under the wire-fraud statute, information need only "be acquired or compiled by [an employer] in the course and conduct of its business" and must be "both considered and treated by an employer in a way that maintained the employer's exclusive right to the information."

The court did not read *Blaszczak II* or *Kelly* as imposing an "inherent value" requirement on property. Although "the *Blaszczak* court did indeed invoke the 'stock in trade' quote . . . , describe the lack of 'impact on the government's fisc,' and refer to 'inherently valuable government information,' . . . that language was merely part of the court's explanation for why the information in that case was 'regulatory in character' rather than 'money or property' . . . , a critical distinction following the Supreme Court's decision in *Kelly* . . . ." The court also observed that this distinction between "regulatory" MNPI and business MNPI was particularly important "in the public corruption context" because "the Supreme Court has been careful to construe the wire and mail fraud statutes strictly so as to avoid 'a sweeping expansion of federal criminal jurisdiction' to police state and local governmental decisions." "Indeed, *Blaszczak* did not involve confidential *business* information at all."

Thus, according to the *Chastain* court, MNPI can constitute property under the wire-fraud statute if a user or tipper deprives the information's owner of "its right to exclusive use of the information" regardless of whether the MNPI had "inherent value" to the owner or whether the owner could have used the MNPI for its own economic benefit. We will see whether courts view *Chastain* as consistent with the subsequent *Ciminelli* decision and with *Blaszczak*.

"Shadow Trading" Litigation Continues

Our prior updates described the SEC's first-ever enforcement proceeding alleging "shadow trading": using alleged MNPI about one security to trade a different security whose price the trader believes will be affected by the MNPI about the first security. As we previously explained, the SEC defeated a motion to dismiss in *SEC v. Panuwat*, 2022 WL 633306 (N.D. Cal. Jan. 14, 2022), in which the SEC alleges that a corporate employee engaged in insider trading based on news about a not-yet-public corporate acquisition involving his own employer when he purchased securities of a company not involved in that transaction.

Panuwat moved for summary judgment, and the court denied his motion in November 2023. *SEC v. Panuwat*, No. 21-cv-6322 (N.D. Cal. Nov. 20, 2023). The court held that the SEC had adduced sufficient evidence to enable a reasonable jury to find that Panuwat had knowingly traded on MNPI obtained through his employment and that his use of employment-related confidential information constituted a breach of duty to his employer.

Factual Background

To recap the facts (as expanded through the summary judgment record): Panuwat was the head of business development at a biopharmaceutical company called Medivation. The SEC alleged that Panuwat had learned that Medivation was on the verge of being acquired by a large pharmaceutical firm and that, shortly before the acquisition was announced, he had purchased call options on securities issued by Incyte, another biopharmaceutical company that allegedly shared Medivation's market space.

The SEC's theory is that several potential acquirors had been interested in buying Medivation, that Incyte

was one of a "limited number of mid-cap" companies in Medivation's area of business (oncology), that Incyte would become more attractive to potential acquirors once the Medivation deal was announced, and that Incyte's stock price would increase as a result. The facts allegedly supported the SEC's theory: when the Medivation acquisition was announced, Incyte's stock price rose 7.7%, and Panuwat made more than $100,000 on his call options.

The evidence in the summary judgment record showed that:

- Analysts had been following Medivation's sales process and had discussed the potential impact that Medivation's acquisition could have on other biopharmaceutical companies, including Incyte;
- Panuwat had been involved in the search for an appropriate buyer for Medivation and in analysis of the potential impact of a sale;
- The sale process was confidential within Medivation, with code names assigned to all involved parties;
- The market had "a general idea" of how the sale process was progressing, but it did not know "the proposed sale prices and exact timing of the interested parties' bids" – although certain Medivation employees, including Panuwat, often knew those details;
- On August 18, 2016, Medivation's CEO sent an email to Panuwat and 12 other Medivation employees stating that the ultimate buyer had "reiterated [to him] how much they really want this" transaction "this weekend," and naming a specific price for the deal;
- Seven minutes later, Panuwat started buying Incyte call options at three different strike prices, each of which represented 81%, 70%, and 84% of the daily volume of those options sold in the market; and
- The Medivation acquisition was announced four days later, on August 22, and Incyte's stock price rose that day by 7.7%.

The Summary Judgment Ruling

After having lost a motion to dismiss in 2022, Panuwat moved for summary judgment, arguing that no genuine factual dispute existed on issues relating to misappropriation of MNPI, breach of duty, and scienter. The court denied the motion in all respects, holding that sufficient factual disputes existed on all points and that those disputes should go to a jury.

Materiality

The court first held that the SEC had "shown a connection between Medivation and Incyte such [that] a jury could find that a reasonable investor would view the information in [the Medivation CEO's email to Panuwat] as altering the 'total mix' of information available about Incyte." The SEC's evidence suggested that the market did not perceive Medivation and Incyte "to be undisputedly different from each other." Although the two companies "had leading drugs approved for treating different diseases and patients" and "did not share approved drug products or develop the same drugs," the SEC had shown that "analyst reports and financial news articles repeatedly linked Medivation's acquisition to Incyte's future." Panuwat had conceded that he was a sophisticated investor, so a jury could infer that he had been aware of the market reports and that they could have "influenced his perspective on the biopharmaceutical market." He also had "commented positively on Incyte months before" he bought the call options. The totality of facts thus could "support the SEC's theory that a reasonable investor such as Panuwat – who paid careful attention to the biopharmaceutical market, and specifically to Incyte – could have perceived Medivation and Incyte to be connected in the market such that pertinent information about one was material to the other."

The court also took notice that the two companies occupied a "small pool" of the market: they were two of only a "small number" of "commercial oncology focused companies" with market capitalization of $5 billion to $75 billion. Moreover, Incyte's stock price's reaction to the Medivation acquisition was "'strong evidence'

of how reasonable investors underst[oo]d the significance of th[e] information" at issue.

Nonpublic Nature of Information

The SEC also had established that the information in the Medivation CEO's email was "nonpublic and available to Panuwat because of his position with Medivation." Panuwat knew the identities of the companies that had submitted bids to buy Medivation; he knew those companies' bids; he knew that the bidding process "was pushing up the sale price"; he knew that the ultimate buyer wanted to announce a final deal on August 22; and he knew on August 18 (minutes before he bought his call options) "the expected timing and price point of the deal." While the market had been *generally* aware of the sale process, it had not known "the *final details* of the transaction – the final buyer, the final price, and the ultimate timing of the execution of the merger."

Awareness of the MNPI

The court held that a factual dispute existed as to whether Panuwat had read his CEO's email about the impending transaction. Panuwat argued that the SEC had not introduced evidence that he actually had read it, but the court held that a factual dispute existed inasmuch as the email had been sent to Panuwat's office email address, no evidence existed that Panuwat had not been in the office or had been unable to read the email, and Panuwat admittedly had been "very involved" in at least some aspects of Medivation's sale process.

Breach of Duty

Even if Panuwat had MNPI about Incyte, the SEC still needed to establish that he breached "some fiduciary, contractual, or similar obligation" to Medivation when he traded the Incyte call options. The court held that the SEC had adduced evidence of a breach of duty under three different theories, each of which sufficed to defeat summary judgment.

- Medivation's Insider Trading Policy, by which Panuwat was bound, prohibited employees from trading "'the securities of *another publicly-traded company*, including all significant collaborators, customers, partners, suppliers or competitors,'" based on inside information obtained through employment at Medivation (emphasis added). The court rejected the argument that the types of companies listed after the word "including" constituted an exclusive list of companies covered by the prohibition. Rather, "a jury could determine that the types of companies listed in the Insider Trading Policy are not necessarily the only types of companies that the Policy covers."
- Panuwat had signed a Confidentiality Agreement that required him not to use Medivation's confidential information for his own personal benefit.
- A jury could find that Panuwat had breached "a duty of trust and confidence that was created when his employer, Medivation, entrusted him with confidential information." That breach of duty did not depend on either the Insider Trading Policy or the Confidentiality Agreement. Rather, the duty arose from common-law agency principles, and Panuwat could be deemed to have breached it when he used for his personal benefit certain confidential information entrusted to him by his employer "without disclosing that fact to Medivation."

Scienter

Finally, the court held that sufficient evidence existed to allow a jury to find that Panuwat had acted with scienter. In so ruling, the court declined to address a split within the Ninth Circuit on whether "scienter requires that the defendant merely be 'aware' of the MNPI or if he must 'use' the MNPI" in trading. The SEC "has shown sufficient evidence to support a jury finding on either standard."

- A jury could find that Panuwat had received and read the Medivation's CEO email about the timing and price of the acquisition.

- The timing of Panuwat's transactions – just seven minutes after the CEO's email – could support a jury finding that Panuwat had used the information in buying the Incyte call options.
- Arguments about Panuwat's past trading history (which did not involve extensive trading in call options) could cut either way and thus created a factual dispute.

For all the above reasons, the court denied summary judgment for Panuwat, and the case will now proceed to trial unless a settlement occurs.

Implications

The court's decision, like the prior ruling denying Panuwat's motion to dismiss, appears to validate the SEC's reliance on a "shadow trading" theory where a trader breaches his or her duty by using MNPI about one company to trade another company's securities. But the court's decision again rests at least to some extent on the facts specific to this case.

For example, the materiality analysis depended on evidence that (*i*) the third-party issuer (Incyte) was one of only a limited number of companies in the acquisition target's business and financial space; (*ii*) the third party had been specifically cited as a company that could be affected by the acquisition target's transaction; and (*iii*) the trader had been directly involved in the underlying corporate discussions and presentations concerning the employer's sale. Changing these variables could conceivably produce different results. At what point does "a limited number" of comparable companies become too big a number for information about Company A to be material to Company B (or C, D, or E)? How comparable do Companies A and B need to be? Would the court have reached a different conclusion if analysts and insiders had *not* mentioned Incyte as a comparable company, or if Panuwat had *not* been aware of those references?

The summary judgment decision does potentially change – and perhaps expand – the scope of the court's prior analysis of the breach-of-duty element of insider trading. When the motion to dismiss was decided, many commentators (ourselves included) focused on the fact that Medivation's insider-trading policy had *expressly* covered "the securities of another publicly-traded company" (apart from Medivation itself), and they speculated on whether the absence of such language might have produced a different result. The summary judgment decision suggests otherwise. The court has now held that, even apart from the Insider Trading Policy and the Confidentiality Agreement, Panuwat had a duty to his employer under "traditional principles of agency law" not to use his employer's confidential information "for his own personal benefit without disclosing that fact to [the employer]." That duty does not depend on the breadth of the Insider Trading Policy.

Nevertheless, companies and traders, including private funds, should consider whether insider-trading policies and procedures, as well as any relevant nondisclosure agreements, specifically cover securities of third-party companies. The reach of those policies could be determinative – particularly if traditional principles of agency law do not apply – and could influence any trading restrictions or "walls" that companies implement.

Another interesting aspect of this decision is buried in a footnote (note 4), in which the court noted that it had granted leave to Investor Choice Advocates Network to file an amicus brief in support of Panuwat. That brief had raised two arguments, one of which was that the SEC's "shadow trading" theory violates the "major questions" doctrine, which purportedly prohibits agencies from adopting rules or pursuing enforcement positions on "major questions" without clear statutory authorization from Congress. The court did not find the amicus brief's arguments "particularly persuasive," and it observed – without further elaboration – that the summary judgment denial "is not contrary to other courts' decisions to refrain from issuing a blanket ban on trading based on nonpublic information."

Shadow Trading Through ETFs?

An interesting study published in January 2023 suggests that another form of "shadow trading" might have been occurring in recent years: investors who know about upcoming M&A transactions seem to be trading

ETFs containing stock of the target companies in those deals. The study – "Using ETFs to conceal insider trading," by Elza Eglīte and Dans Štaermans (Stockholm School of Economics in Riga), Vinay Patel (University of Technology Sydney), and Tālis J. Putniņš (Digital Finance CRC as well as the Stockholm School of Economics and the University of Technology) – observes that using ETFs to trade on M&A-related MNPI can have several advantages over trading individual securities, including that (*i*) traders might be able to reduce the risk of scrutiny from law enforcement while still obtaining the expected benefit from exposure to the M&A targets' shares when the deals are announced, (*ii*) ETFs are often more liquid than are the targets' individual shares, thereby potentially reducing the price impact of transactions by traders with MNPI, and (*iii*) traders can benefit from increases in the prices of the targets' shares as well as those of similarly situated companies – as was charged in the *Panuwat* case, in which the defendant traded shares of one company (Incyte) allegedly based on nonpublic information about an acquisition of another company (Medivation).

The study found significant levels of shadow trading in 3% to 6% of same-industry ETFs before M&A announcements, amounting to at least $212 million per year. The researchers observed that the shadow trading was most common in the healthcare, technology, and industrials sectors and occurred in 2% to 12% of the ETFs in those sectors, with more than 80% of the total dollar amount of shadow trading occurring in those sectors.

We will see whether regulators pay attention to this study and any other similar ones. But in light of the government's extensive use of "big data," scrutiny of ETF transactions is a distinct possibility. In fact, the study found little evidence of shadow trading in ETFs in the last two years of the 2009-2021 period at issue – an observation that the authors note is "consistent with increasing regulatory attention towards shadow trading," such as the *Panuwat* enforcement action, which was filed in 2021.

Private-Equity Firms Defeat Private Insider-Trader Claims

Two groups of private-equity investors prevailed on a motion to dismiss a private action for insider trading under §§ 10(b) and 20A of the Exchange Act (which allows buyers or sellers to sue contemporaneous sellers or buyers if the latter sold or purchased based on MNPI). *In re SilverLake Group, L.L.C. Sec. Litig.*, 2022 WL 4485815 (N.D. Cal. Sept. 27, 2022), 2023 WL 3134608 (N.D. Cal. Apr. 26, 2023), *appeal filed*, No. 23-15822 (9th Cir.). In the course of its ruling, the court held that a private plaintiff needs to show only that a trader *possessed* MNPI when trading, not that the trader actually *used* it – an issue that "the Ninth Circuit has not fully resolved in the context of civil insider trading cases." 2022 WL 4485815, at *8.

The *SilverLake* litigation involved a now-bankrupt satellite operator called Intelstat S.A. One of the private-equity investors in Intelstat held two seats on the company's board, and both investors had information rights under the Shareholder Agreement, although the rights did not extend to MNPI.

Intelstat was involved with other satellite broadcasters in the C-Band Alliance, which was formed to repurpose the C-band broadcasting frequency for use by cell-phone service providers. The Alliance proposed that its members would vacate the C-band and sell their rights to that spectrum through a private auction, keeping the profits (estimated at more than $60 billion) for themselves. That plan, however, required approval from the Federal Communications Commission (the "FCC"), which was considering its own proposal to conduct a public auction for C-band licenses and remit all or most of the profits to the U.S. Treasury.

Intelstat allegedly believed at first that the FCC would adopt the C-Band Alliance's proposal. However, public and political opposition to a private auction began to grow, and, in late October 2019, Congress introduced a bill requiring a private auction. On November 5, 2019, Intelstat met with the FCC's Chairman. The meeting allegedly did not go well for Intelstat: the FCC purportedly sent signals that it was leaning toward a public auction.

The plaintiffs alleged that, immediately after the November 5 FCC meeting, the two private-equity funds and Intelstat's Chairman sold $246 million of Intelstat stock through a private block trade. On November 18, the FCC announced that it would hold a public auction, and Intelstat's stock price dropped by 40%.

Plaintiffs, who claimed to have purchased contemporaneously with defendants' sales, contended that defendants had avoided a loss by selling based on MNPI about the FCC's disinclination to approve the proposed private auction. But the court granted defendants' motions to dismiss.

The court first held that plaintiffs had standing to sue as contemporaneous traders. The court acknowledged that the Ninth Circuit has not adopted a "clear definition of the term 'contemporaneous,'" but it noted that other courts had found sufficient contemporaneity when trades occurred within "a few days" of an alleged insider trade. The court did not require plaintiffs to allege they had purchased Intelstat stock on the other side of defendants' block sale. Rather, the court was satisfied that plaintiffs' purchases on November 5 and 6, "at the very least," were sufficient to plead trading contemporaneous with defendants' sales.

The court also rejected defendants' contention that plaintiffs needed to show that defendants had actually *used* MNPI in connection with their sales. The court acknowledged a Ninth Circuit holding that, in a *criminal* case, the government must prove actual *use* for insider trading. (That case, however – *United States v. Smith*, 155 F.3d 1051, 1067-69 (9th Cir. 1988) – predated the SEC's adoption of Rule 10b5-1(b), which requires only that "the person making the purchase or sale [have been] *aware* of the" MNPI – a potential issue that the court did not note.) But the court observed that "[d]istrict courts within the Ninth Circuit are divided about whether actual use is required to state a civil claim." The court chose to follow the line of cases holding that *possession* of MNPI can be enough to satisfy the scienter element of §§ 10(b) and 20A in a *civil* case.

Nevertheless, the court dismissed the insider-trading claims, holding that plaintiffs had not sufficiently pled that defendants had possessed MNPI or had acted with scienter in making the block sale. Plaintiffs were not able to plead any facts showing that the Board had been informed about the events at the FCC meeting or that the FCC had disclosed any MNPI during the meeting. And while investors had information rights under the Shareholder Agreement, that Agreement specifically excluded MNPI.

The court also noted that, even though defendants' block trade had taken place shortly after the FCC meeting, it also had occurred shortly after Intelstat's quarterly earnings announcement. Moreover, the block sale was not "dramatically out of line" with defendants' prior trading practices.

The court allowed plaintiffs to replead, but it dismissed the amended complaint because the new pleading did not overcome the deficiencies in the prior one. Plaintiffs' appeal to the Ninth Circuit is pending. Stay tuned.

CFTC's Continued Interest in Insider Trading

We reported last year on the CFTC's enforcement action against EOX Holdings (an inter-dealer broker) and one of its brokers relating to block trading. As we noted, a jury concluded in August 2022 that the defendants had not engaged in insider trading, although it also concluded that the broker had violated CFTC regulations by taking the other side of customer orders without consent and by unnecessarily disclosing customers' MNPI without permission. The court denied the defendants' post-trial motions, *CFTC v. EOX Holdings L.L.C.*, 2022 WL 16556032 (S.D. Tex. Oct. 31, 2022), and the defendants appealed. The Fifth Circuit reversed the judgment, holding that the defendants lacked fair notice that the CFTC's 39-year-old rule prohibiting commodities traders from "taking the other side of orders" could apply to a trader who was trading a customer's discretionary account, rather than acting as a counterparty principal when "taking the other side." *CFTC v. EOX Holdings, L.L.C.*, 2024 WL 78512, at *7 (5th Cir. Jan. 8, 2024) ("[T]he Rule applies only to brokers and affiliated persons who 'becom[e] a counterparty with a financial interest and the possibility of profit and loss,' and not to those who merely 'make the decision to trade opposite the order and execute the trade opposite the order.'").

Another CFTC insider-trading case – *CFTC v. Miller*, No. 4:21-cv-4023, also in the Southern District of Texas – survived a motion to dismiss in April 2023. The CFTC there alleges that the defendant, a trader of natural gas futures, obtained MNPI through a chain of tippees starting with tipper-executives of two energy companies, and he used the MNPI to make profitable energy trades. The MNPI purportedly

consisted of information about the two energy companies' block trade orders, so the trader allegedly knew he would get the prices he needed for his trades to be profitable. The trader then allegedly shared his trading profits with the conspiring parties. The trader also was criminally charged with conspiracy to commit commodities fraud and with four counts of commodities fraud. He pled guilty to the conspiracy charge in February 2023. *U.S. v. Miller*, No. 4:21-cr-0570 (S.D. Tex.).

Continued Governmental Focus on Insider Trading and Data Analytics

Officials from the DOJ, SEC, and CFTC have reiterated on recent occasions that their agencies remain interested in uncovering instances of insider trading and are using data-analytics tools to identify suspicious trading activities. For example, at conferences in May 2023, high-ranking officials from one or more of those agencies made the following points:

- The DOJ and SEC have brought insider-trading charges against a public-company executive for trading pursuant to Rule 10b5-1 trading plans that allegedly had been established while he was in possession of MNPI.
- The agencies intend to continue focusing on trading pursuant to improperly established trading plans and will bring more prosecutions or enforcement actions.
- The agencies are using data analytics to analyze trading patterns over periods of months or years and are looking at potential instances of front-running, data breaches involving MNPI, and cherry-picking.
- The CFTC is using transaction data and order-message data to identify order cancellations that could indicate spoofing or some other type of market manipulation.
- Enforcement agencies sometimes rely on sweeps – large numbers of simultaneous indictments or enforcement actions – to send a message to market participants.
- Enforcement agencies are looking at "off-channel communications" as potential circumstantial evidence to establish insider trading and have been sanctioning firms and employees for failure to maintain and preserve electronic communications.

The DOJ and the SEC recently illustrated their commitment to insider-trading sweeps by bringing four sets of criminal and civil cases in the United States District Court for the Southern District of New York in June 2023:

- Cases against persons affiliated with a SPAC (Digital World Acquisition Corporation) concerning alleged trading based on advance information about the SPAC's not-yet-public plans to acquire Trump Media & Technology Group.
- Cases against an alleged insider-trading ring in which a Vice President at Alexion Pharmaceuticals, Inc. purportedly tipped a friend (a former police chief, who then tipped others) about Alexion's negotiations to acquire Portola Pharmaceuticals, Inc. The tipper recently pled guilty to one count of securities fraud, and several of the remote tippees have also entered guilty pleas.
- Cases against a Pfizer employee who allegedly traded on nonpublic information about Pfizer's planned new-drug application for Paxlovid.
- Cases against a Chief Compliance Officer (Steven Teixeira) who allegedly misappropriated MNPI from the laptop of his girlfriend – an employee at an investment bank – about potential transactions involving the bank's clients. Teixeira allegedly traded on that information and tipped a friend, who also traded.

The SEC's Director of Enforcement mentioned the SEC's use of "data analytics initiatives" in connection with the four enforcement actions. The cases also have been cited as targeting "gatekeepers," who are supposed to prevent misconduct of the types charged here. The "gatekeepers" in those cases included a Chief Compliance Officer, a registered broker-dealer, a corporate director, and a police chief.

SEC Tightens Requirements for 10b5-1 Trading Plans

We reported last year on the SEC's proposed amendments to Exchange Act Rule 10b5-1, which (among other things) governs trading plans that, in some circumstances, can provide a defense to charges of insider trading. Rule 10b5-1(c)(1) can establish an affirmative defense to a claim of trading "on the basis of" MNPI if the trader can demonstrate that, "before becoming aware of the information," he, she, or it had "adopted a written plan for trading securities" and that the trades at issue were made pursuant to that plan.

On December 14, 2022, the SEC amended the Rule, with some changes from the 2021 proposal. The new Rule places some new limitations on the availability of the defense:

- A waiting or "cooling-off" period for directors and Section 16 officers between the time a Rule 10b5-1 plan is made or modified and the first transaction under the plan. Directors and officers cannot trade until the later of (*i*) 90 days after adopting or modifying a trading plan or (*ii*) two business days following the issuer's disclosure of its financial results for the fiscal quarter in which the plan was adopted or modified (but not exceeding 120 days following adoption or modification of the trading plan).
- A 30-day waiting period after adoption or modification of a trading plan for persons other than directors and Section 16 officers.
- A certification requirement mandating that directors and officers provide the issuer, when adopting or modifying a trading plan, with a certification that they are not aware of MNPI about the issuer and are adopting the plan in good faith.
- A prohibition on multiple, overlapping trading plans.

The waiting periods do not immunize trading plans made while the relevant person had MNPI.

The waiting periods also do not apply to issuers – a change from the 2021 proposed amendment, which had contained a 30-day waiting period for issuers. However, the SEC noted that it is continuing to consider whether regulatory action is necessary.

The SEC also amended Item 408 of Regulation S-K and the reporting requirements for Section 16 insiders to require additional disclosures about trading plans and trading:

- Issuer disclosure in Form 10-Q or 10-K as to whether, during the last fiscal quarter, any issuer, director, or Section 16 officer had adopted, modified, or terminated any trading arrangement;
- Issuer disclosure about the issuer's adoption of any insider-trading policies and procedures for directors, officers, employees, or the issuer itself;
- Mandatory "checkbox" disclosures in Forms 4 and 5 requiring filers to note whether a reported transaction was made pursuant to a trading plan; and
- Required disclosure on Form 4 of any *bona fide* gifts of equity securities by Section 16 insiders.

SEC Sues Broker-Dealer for Lack of Information Barriers and Misleading Disclosures

On September 12, 2023, the SEC filed charges against a broker-dealer and its parent for operating two trading businesses that purportedly had been walled off from each other and for making allegedly false and misleading statements about information barriers between those two businesses. *SEC v. Virtu Financial Inc.*, Case No. 1:23-cv-8072-JGK (S.D.N.Y.).

The SEC alleges that Virtu and its affiliates operated an order-execution service for large institutional customers and a proprietary trading business through which Virtu traded securities for its own accounts. According to the SEC, Virtu told its institutional customers and the public that "information barriers" and "systemic separation" existed between the two businesses, but, in reality, no such separation existed.

The Complaint alleges that "virtually all employees" at Virtu could access transaction-level MNPI about institutional customers' trading, including customer names, securities purchased, side of the transaction (buy or sell), execution price, and execution volume. The customer information allegedly was broadly accessible throughout the organization because it was protected only by "widely known and frequently shared generic username and password." And the information allegedly was material because "a trader could observe that Virtu had executed the orders of a large institutional customer throughout the day, understand that the same customer may follow a similar trading pattern over the next day or so, and take advantage of such information by trading ahead of the customer's subsequent orders."

The SEC charges defendants with making materially misleading statements and omissions about the existence and efficacy of information barriers, failing to have those barriers, and failing "to establish, maintain, and enforce written policies and procedures designed to prevent the use of MNPI" – a particularly egregious failure because of Virtu's operating both a proprietary trading business and a trade-execution business.

We will follow this case and report further in our next annual update. But in any event, the SEC's suit illustrates the importance of erecting and maintaining robust information barriers between customers' trading services and proprietary trading businesses, protecting customer information with carefully controlled passwords and other monitoring, ensuring that disclosures about information barriers are accurate and complete, and maintaining and enforcing written MNPI policies and procedures.

Legislation on Insider Trading: Yet Again, Not Much Progress

Our 2022 update reported on several bills that had been introduced in Congress to try to codify the law of insider trading and to address related issues. None of those bills was enacted by the time the 117th Congress ended in January 2023.

Legislative efforts in the current, 118th Congress so far have been less ambitious, focusing only on trading by members of the executive and legislative branches.

- S. 58, the "Preventing Elected Leaders from Owning Securities and Investments (PELOSI) Act," was introduced in the Senate on January 24, 2023. This bill, which applies only to Members of Congress and their spouses, would generally prevent such persons from holding, purchasing, or selling covered financial instruments during a Member's term of office.
- S. 693, "Eliminating Executive Branch Insider Trading," was introduced in the Senate on March 7, 2023. The bill would prohibit specified executive-branch officials and others from holding or trading certain investments.
- S. 1171 and H.R. 2678, bicameral bills titled the "Ending Trading and Holdings in Congressional Stocks (ETHICS) Act," was introduced in the Senate on April 17, 2023 and in the House on April 18, 2023. The bills again apply only to Members of Congress and their spouses and dependent children.
- H.R. 345, the "TRUST in Congress Act," was introduced in the House on January 12, 2023. The bill would require Members of Congress, their spouses, and their dependent children to place specified investments into a qualified blind trust until 180 days after the Member's term ends.
- H.R. 1138, the "Prohibit Insider Trading Act," was introduced in the House on February 21, 2023. The bill would prohibit Members of Congress and their spouses from holding or trading in certain investments such as individual stocks and related financial instruments.

None of these bills has made much progress so far.

Private Fund Litigation

Special Purpose Acquisition Companies (SPACs)

Sponsors of SPACs should be sensitive to potential of conflicts of interest when they issue proxies informing shareholders of their choice to invest in the post-merger company or to redeem their shares. In *Laidlaw v. GigAcquisitions2, LLC*, 2023 WL 2292488, at *1 (Del. Ch. Mar. 1, 2023), the Delaware Court of Chancery denied a motion to dismiss a shareholder suit against the controlling sponsor of a SPAC which alleged that the SPAC had issued a misleading proxy statement and thus impaired the public stockholders' ability to make an informed redemption decision. The court found that it was conceivable, because the sponsor allegedly stood to gain if the shareholders did not redeem their shares, that the broad "entire fairness" standard of review—not the familiar and deferential business-judgment standard—should apply. Controlling sponsors should therefore do their utmost from a governance perspective—including create a special committee and obtaining a fairness opinion, which the sponsor did not do in *Laidlaw*—to ensure that SPAC proxy materials are not subject to heightened judicial scrutiny. The proxy materials should, of course, also fully disclose any potential conflicts.

Take Private Transactions

In "take-private" transactions, a public company is converted into a privately-held company, usually through a merger or an acquisition. Companies should be aware of litigation risks that might arise when conducting such transactions, particularly because the applicable standard of review can vastly change the outcome of the case. In *In re Mindbody, Inc. S'holder Litig.*, 2023 WL 2518149 (Del. Ch. Mar. 15, 2023), Mindbody, Inc.'s CEO, hoping for liquidity from what he referred to as Mindbody's "extremely volatile" stock, sought to take the company private by merging with a private equity buyer, Vista Equity Partners Management, LLC. However, the CEO's deal discussions with Vista took place "largely without the involvement or knowledge of the Company's board of directors." Once the Board finally learned of Vista's interest and began formally seeking offers from other bidders, the CEO then tipped Vista, who ultimately acquired the company. Because of the various factors at play, the court applied enhanced scrutiny and concluded that that the CEO, motivated by a personal need for liquidity and having "tilted the playing field in Vista's favor," breached his fiduciary duties to the company. By contrast, in *SMART Local Unions & Councils Pension Fund v. BridgeBio Pharma, Inc., et al.*, No. 2021-1030-PAF, opinion (Del. Ch. Dec. 29, 2022), the court dismissed claims brought by a minority shareholder of Eidos Therapeutics Inc. alleging that Eidos's controlling shareholder (BridgeBio Pharma) and a special committee of BridgeBio's board breached their fiduciary duties in connection with BridgeBio's acquisition of Eidos's minority shares. Plaintiff alleged that defendants breached their duty of care when they turned down a higher sale offer from a third party. Applying the business judgment standard of review, the court disagreed. Importantly, none of the nefarious actions seen in *Mindbody* were present in this case, and a fully-informed, independent special committee of the board and majority of the minority stockholders approved the transaction with no evidence of coercion. Moral of the story: if you are considering a sale to take your company private, candor is key.

FINRA / Broker-Dealer Updates

Congress Codifies Private M&A Broker Registration Exemption

As part of the Consolidated Appropriations Act of 2023, Congress created a new statutory exemption from broker-dealer registration for individuals and entities involved in the transfer of ownership of eligible privately held companies. The exemption, which went into effect on March 29, 2023, is contained in new Section 15(b)(13) of the Exchange Act. The provision essentially codifies a prior SEC staff no-action letter which provided relief for private company M&A brokers issued in 2014, which has now been withdrawn.

The no-action letter provided an exception from registration with the SEC for persons performing limited activities with respect to the sale of a privately held company. The new exemption contains essentially the same terms, except that it places a limit on the size of an "eligible privately held company" at less than $250 million in gross revenue or $25 million in earnings before interest, taxes, depreciation, and amortization

(EBITDA) in its last fiscal year.

The relief is limited to an "M&A broker", which is defined as any broker or person associated with the broker engaged in the business of effecting securities transactions solely in connection with the transfer of ownership and control of an eligible privately held company involving the purchase, sale, exchange, issuance, repurchase, or redemption of, or a business combination involving, securities or assets of an eligible privately held company.

The broker must reasonably believe that on completion of the transaction the buyer will *control* and *actively manage* the eligible privately held company or business with the assets of the eligible privately company. Control is presumed where the buyer has the right to vote or to sell or direct the sale of 25% or more of a class of voting securities, or, in the case of a partnership or limited liability company, has contributed or has the right to receive on dissolution 25% or more of the capital. Examples of active management include (1) electing executive officers, (2) approving the annual budget or (3) serving as an executive officer or manager.

In addition, the broker must reasonably believe that if any person is offered securities in exchange for securities or assets of the eligible privately held company, that person will, prior to being legally bound to the transaction, receive or have reasonable access to (1) the most recent fiscal year-end financial statements of the issuer as customarily prepared by management of the issuer in the normal course of operations and (2) if the financial statements of the issuer are audited, reviewed, or compiled (i) any related statement by the independent accountant, (ii) a balance sheet dated not more than 120 days before the date of the offer, and (iii) information pertaining to the management, business, results of operations for the period covered by the financial statements, and material loss contingencies of the issuer.

The company is privately held if it does not have a class of securities registered or required to be registered under Section 12 of the Exchange Act and is not required to report under Section 15(d) of the Exchange Act—*i.e.* it is not a public reporting company. It must be an operating company that is a going concern and not a "shell" company.

The following conditions must be met for the exemption to apply:

- Neither the broker nor any of its directors, officers or employees have been barred or suspended from association with a broker-dealer.
- The broker cannot bind any party to the transaction.
- The broker cannot directly or through an affiliate provide financing for the transaction (although it can arrange financing in compliance with Regulation T if it discloses any compensation in writing).
- The broker cannot have custody, control or possession or otherwise handle funds or securities issued or exchanged in connection with the transaction.
- The broker cannot participate in a public offering.
- The broker must provide written disclosure and obtain written consent from both parties to any joint representation.
- The broker cannot assist in forming any group of buyers.
- There is no transfer of interests to a passive buyer or group.

The securities received by the buyer or the broker are restricted within the meaning of Rule 144(a)(3) under the Securities Act.

Massachusetts Upholds Broker-Dealer Fiduciary Rule

Massachusetts' highest court, the Supreme Judicial Court, affirmed the validity of the State's fiduciary duty

rule holding broker-dealers to the same professional standards as investment advisors. The decision in Robinhood Financial LLC v. Secretary of the Commonwealth, Robinhood Financial LLC v. Secretary of the Commonwealth :: 2023 :: Massachusetts Supreme Judicial Court Decisions :: Massachusetts Case Law :: Massachusetts Law :: US Law :: Justia, unanimously upheld the authority of the Commonwealth Secretary, William Galvin, to promulgate the rule. The rule imposes on broker-dealers the same fiduciary standards applied to investment advisors to act in their client's best interest when making securities recommendations.

Broker-dealers are typically held to a lesser standard of care than principal dealers or agents with respect to the execution of their customers' orders, whereas investment advisers are fiduciaries held to a higher standard with respect to the investment advice and recommendations they make to their clients. However, the court found that the Massachusetts Uniform Securities Act authorized the Secretary to impose the same standard of care on broker-dealers as investment advisers with respect to their client recommendations. The Secretary argued that the roles of broker-dealers and investment advisors have merged over time, such that customers of broker-dealers have come to expect the same higher standards and conflict free advice from broker-dealers, and therefore the standards imposed by the SEC under Regulation BI (Best Interest) were insufficient to meet those expectations. (See our most recent client advisory and most recent update on Regulation BI and Advisers Act fiduciary standards here: Broker-Dealer and Investment Adviser Standards of Conduct - SEC Adopts Rules and Interpretations - Insights - Proskauer Rose LLP, SEC Staff Issues Bulletin on the Care Obligations of Advisers and Broker-Dealers to Retail Investors - Insights - Proskauer Rose LLP). In upholding the Secretary's authority under the State's securities laws, the court found that Regulation BI "constitutes a regulatory floor," which "does not preclude the Secretary from imposing a higher duty on broker-dealers that provide investment advice." The court also noted "the long history of State regulations . . . alongside Federal regulations" with respect to broker-dealers.

Other states, including California, Missouri, Nevada and South Carolina, have imposed or proposed similar common law fiduciary duties on broker-dealers. Massachusetts' position as a financial services hub and leading state regulator is likely to promote more general adherence to the higher standard as the Massachusetts Securities Division brings administrative cases against national firms to enforce the rule.

FINRA Proposes to Amend Rule 2210 to Permit Projected Performance and Targeted Returns in Institutional Communications

On November 13, 2023, FINRA filed with the SEC a proposal to amend FINRA Rule 2210, which amendment would create a tailored exception from the general prohibition on projections in marketing materials and other communications with institutional investors, including marketing decks and pitch books for private placements in investment funds and other securities.

FINRA Rule 2210(d)(1)(F) currently prohibits any member from including projected performance in a written communication—retail or institutional. The proposed amendment would provide a limited exception for performance projections or targeted returns in written communications distributed or made available only to "institutional investors." An "institutional investor" is defined in Rule 2210(a)(4) to include banks, insurance companies, government agencies, employee benefit plans, registered investment companies, registered investment advisers, as well as *any other person (individual or entity) with total assets of at least $50 million*.

In addition, the amendment would permit projections in marketing materials sent or made available only to Qualified Purchasers as defined in Section 2(a)(51)(A) of the Investment Company Act, including an individual, family-owned company or family-related trust with more than $5 million in investments.

FINRA noted that the current restriction is intended primarily to protect investors "who are less able to assess the risks and limitations of using projected performances in making investment decisions."

The exception would be conditioned on the member firm having or making: "(1) written policies and procedures reasonably designed to ensure that the communication is relevant to the likely financial situation and investment objectives of the investor and compliance with other applicable requirements; (2) a reasonable basis and records to support the criteria used and assumptions made in calculating the

projected performance or targeted return, and (3) prominent disclosure that the projected performance or targeted return is hypothetical in nature and stating that there is no guarantee that the projected or targeted performance will be achieved." In addition, the member must provide sufficient information to enable the investor to understand (1) the criteria used and assumptions made in calculating the projected performance or targeted return, including whether it is net of fees and expenses, and (2) the risks and limitations of using the projections or targets in making investment decisions, including reasons why they might differ from actual performance.

FINRA noted that the amendment is intended to align broker-dealers' obligations with those of investment advisers under the new IA Marketing Rule.

The proposal would not change the current prohibitions with respect to other types of retail communications.

Foreign Corrupt Practices Act

While 2023 was not a particularly notable year for FCPA enforcement resolutions, we provide the below summary of developments that may impact FCPA compliance for private fund managers.

* * *

In October 2023, U.S. Deputy Attorney General Lisa O. Monaco announced a new Mergers & Acquisitions Safe Harbor Policy to be applied Department-wide for criminal misconduct discovered in bona fide, arms-length M&A transactions. This policy may apply when FCPA or other potential criminal violations arise in the context of acquisitions, and the Deputy A.G. specifically noted examples of self-disclosed FCPA matters that resulted in declinations. Notably:

1. An acquiring company will receive a presumption of a declination if:

    a. It voluntarily discloses criminal misconduct discovered at the acquired entity within 6 months from the date of closing (regardless of when the misconduct was discovered);

    b. It cooperates with the ensuing investigation; and

    c. It engages in requisite, timely and appropriate remediation, restitution, and disgorgement, for which 1 year from the date of closing will serve as a baseline for full remediation of the misconduct.

2. The baseline time requirement for the reporting and remediation is subject to a reasonableness analysis based on the specific facts, circumstances, and complexity of a particular transaction.

3. Companies detecting misconduct threatening national security or involving ongoing or imminent harm should act promptly and not wait for a deadline.

4. Acquiring companies' ability to receive a declination will not be impacted by the presence of aggravating factors at the acquired company.

5. An acquired company may also qualify for the voluntary, self-disclosure benefits, including declination, unless aggravating factors exist at the acquired company.

6. Any misconduct disclosed under the Safe Harbor Policy will not be factored into future recidivist analysis for the acquiring company.

7. A company that does not perform effective due diligence or self-disclose misconduct at an acquired entity will be subject to full successor liability for the misconduct.

* * *

In March 2023, the U.S. Department of Justice's Criminal Division launched the Compensation Incentives and Clawbacks Pilot Program to be applicable to all corporate matters handled by the Division during a three-year pilot period. The Pilot Program provides that:

1. Every corporate resolution entered by the Division is required to include a requirement that the resolving company implement compliance criteria in its compensation and bonus system. The resolving company must also report on its implementation annually.

2. A reduction of the fine in the amount of 100% of any compensation that is recouped during the period of resolution may be provided if a company fully cooperates and timely and appropriately remediates and demonstrates it has implemented a program to recoup compensation from employees who engaged in wrongdoing in connection with the conduct under investigation, or others who both (a) had supervisory authority over the employee(s) or business area engaged in the misconduct and (b) knew of, or were willfully blind to, the misconduct, and has in good faith initiated the process to recoup such compensation before the time of resolution.

In September 2023, the Department entered into a Non-Prosecution Agreement with Albemarle Corporation applying the discount of penalty for the amount of recouped compensation in accordance with the Pilot Program for the first time in a FCPA resolution.

* * *

In February 2023, the U.S. Court of Appeals for the Fifth Circuit reversed and remanded a lower court decision in *United States v. Rafoi*, holding that the reach of a criminal FCPA prosecution over extraterritorial acts was more expansive than the trial court had determined. The defendants in this case, employees of Swiss wealth-management firms, allegedly helped launder the proceeds of a bribery scheme through various financial transactions. The Fifth Circuit first held that the court should not have dismissed the complaint based on lack of subject-matter jurisdiction, because whether a statute reaches extraterritorial acts is a merits question on the facts, not a challenge to the court's power to hear it. Furthermore, the court held that the indictment sufficiently alleged that non-U.S. defendants either acted as "agents of a domestic concern" or were liable because they committed an act in furtherance of the scheme while within the U.S. Because of these allegations, the government sufficiently alleged conduct covered by the FCPA by the defendants as either primary violators or conspirators.

Foreign Investment Review: CFIUS ad BEA Reporting

CFIUS

The Committee on Foreign Investment in the United States ("CFIUS") plays a prominent role in private fund transactions. Private funds managed or operated outside of the United States ("US") regularly need to review investment activities and the extent to which CFIUS filing requirements or risk assessment issues are implicated, especially for transactions involving critical technology. The top acquirers of US critical technology remain firms in Germany, the United Kingdom ("UK"), Japan, South Korea, the Cayman Islands, Canada, and China.

The 2022 CFIUS annual report issued in 2023 reveals several noteworthy trends concerning CFIUS filings and enforcement. According to the report, there were 154 short-form Declaration filings for the most recent reporting year. Of those, 50 were subject to mandatory filing requirements, and 14 resulted in requests for

long-form filings. Approximately two-thirds of the Declaration filings were from allied countries.

China remains the largest source of long-form filings, as Chinese investors are less likely to initiate a review by short-form Declaration filing given those investors' higher risk profile. Like 2021, in 2022 no Presidential decisions were issued (i.e., transactions blocked). There were 286 long-form filings, 162 of which were subject to subsequent investigations, including 41 that were ultimately subject to mitigation measures – a significant increase from the 26 subject to mitigation measures in 2021. In the most recent reporting year for CFIUS, mitigation measures include elements of the following:

- prohibiting or limiting the transfer or sharing of certain intellectual property, trade secrets, or technical information;
- establishing guidelines and terms for handling existing or future contracts with the US Government or its contractors, US Government customer information, and other sensitive information;
- ensuring that only authorized persons have access to certain technology, systems, facilities, or sensitive information;
- ensuring that certain facilities, equipment, data, and operations are located only in the United States;
- establishing a corporate security committee, voting trust, and other mechanisms to limit foreign influence and ensure compliance, including the appointment of a US Government-approved security officer and/or member of the board of directors and requirements for security policies, annual reports, and independent audits;
- notifying, and requiring the approval of, security officers, third-party monitors, or relevant US Government parties in advance of visits to the US business by foreign nationals;
- security protocols to ensure the integrity of products or software sold to the US Government;
- notifying customers or relevant US Government parties when there is a change of ownership in the US business;
- assurances of continuity of supply to the US Government for defined periods, notification and consultation prior to taking certain business decisions, and reserving certain rights for the US Government in the event that the company decides to exit a business line; establishing meetings to discuss business plans that might affect US Government supply or raise national security considerations;

Overall, the CFIUS oversight web continues to expand-- it should remain on the shortlist of regulatory and compliance items to address early and proactively for non-US-managed investment funds and every transaction that may involve ex-US funding sources. Additionally, CFIUS-type foreign direct investment regimes continue to proliferate globally, with nearly all the major market economies now having a formalized review and approval process. Fund managers and compliance specialists must keep abreast of development in this emerging and developing area and ensure that processes are in place to identify potential Foreign Direct Investment filing requirements outside the US.

"Reverse" CFIUS

Other expansions to maintain US technological leadership have included proposed legislation that would monitor and restrict outbound investment -- so-called "reverse CFIUS." While the proposed bills did not make it into legislation, on August 9, 2023, President Biden issued Executive Order 14105 – "Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern." The Executive Order discuss the President's finding that "countries of concern," as defined by a list of countries annexed to the Order, "are engaged in comprehensive, long-term strategies that direct, facilitate, or otherwise support advancements in sensitive technologies and products that are critical to such countries' military, intelligence, surveillance, or cyber-enabled capabilities." Such advancements in areas such as "semiconductors and microelectronics, quantum information technologies, and artificial intelligence

capabilities," the Order continues, "threaten the national security of the United States." The Executive Order aims to address "certain United States investments" that "may accelerate and increase the success of the development of sensitive technologies and products in countries that develop them to counter United States and allied capabilities."

In consultation with the Secretary of Commerce and other executive departments and agencies, the Executive Order directs the Secretary of the Treasury to issue rules that would institute an investment review regime involving notification procedures and prohibition of certain categories of outbound investment transactions.

Initially, "countries of concern" included only China (the Executive Order separately lists "The Special Administrative Region of Hong Kong" and "The Special Administrative Region of Macau"). While the Executive Order empowers the Treasury and Commerce Departments to make recommendations, including "the addition or removal of identified sectors or countries of concern," the language in several pieces of legislation that have stalled in Congress would have cast a wider net beyond the scope of the Executive Order. "Covered national security technologies" include "sensitive technologies and products in the semiconductors and microelectronics, quantum information technologies, and artificial intelligence sectors that are critical for the military, intelligence, surveillance, or cyber-enabled capabilities of a country of concern" and "may be limited by reference to certain end-uses of those technologies or products."

The ANPR sets out only broad concepts for how the program would be implemented and largely poses questions regarding how to define key terms and technologies within the scope of the regulations. Still, several key points are worth noting.

- As proposed, the restrictions would be limited to semiconductors and microelectronics; quantum information technologies; and artificial intelligence systems (to be defined), where the potential military, intelligence, surveillance and cyber-enabled applications pose risks to US national security.
- The program, as proposed, would include certain outright prohibitions on investment with respect to the most sensitive technologies with direct military applications, along with notice requirements for a secondary set of nominally less sensitive technologies.
- Covered transactions would include not only acquisitions of equity interests (e.g., mergers and acquisitions, private equity and venture capital), but also greenfield investment, joint ventures and certain debt financing transactions.
- It is not proposed or anticipated that the program would provide for retroactive application – i.e., it will not require divestment of existing investment.
- As proposed, there would be certain categories of exempted transactions, potentially including certain investments made as a limited partner into a venture capital fund, private equity fund, fund of funds or other pooled investment fund where an investor contribution is solely capital into a limited partnership and such limited partner cannot make managerial decisions, is not responsible for any debts of the fund beyond its investment and does not have the formal or informal ability to influence or participate in decision making or operations -- and where the investment is below a de minimis threshold to be determined by the Secretary. Note, though, that while certain LP investments into a fund may not be within scope of the new prohibitions, the fund itself may face restrictions on how to deploy capital. This raises potential compliance issues for investing funds and diligence issues around ensuring fund compliance for investors -- potentially changing the investment profile or thesis for certain funds.
- Other potentially exempted transactions may include investments into publicly-traded securities or index funds, mutual funds, exchange-traded funds or similar instruments (including associated derivatives); university-to-university research collaborations; contractual arrangements or the procurement of material inputs (raw materials); intellectual property licensing arrangements; bank lending; the processing, clearing or sending of payments by a bank; underwriting services; debt rating services; prime brokerage; global custody; equity

research or analysis; or other services secondary to a transaction.

Bureau of Economic Analysis Surveys and Transaction Reporting

The Bureau of Economic Analysis (the "BEA") of the US Department of Commerce conducts various benchmark surveys and requires certain transaction post-closing reporting to gather information about foreign direct investment in the US.

A "U.S. affiliate," defined as a "U.S. business enterprise in which a foreign person (foreign parent) owned or controlled, directly or indirectly, 10 percent or more of the voting securities in an incorporated U.S. business enterprise, or an equivalent interest in an unincorporated U.S. business enterprise," is potentially required to participate by filing with the BEA. Only the US affiliate at the first level of ownership must file. Entities further down the chain of ownership need not file and may refer a BEA request to the first level affiliate.

Certain private funds are not required to file. Specifically, a private fund need not file if it does not own an operating company -- defined as a company that is not a private fund or a holding company -- in which the foreign parent owns at least 10 percent of the voting interest.

US affiliates that do not get the benefit of the private fund exemption should confirm whether they are required to respond to a BEA request for survey participation. For instance, if a US ultimate beneficial owner sits atop the organizational structure, the BEA's regulations may not apply.

Hart-Scott-Rodino Antitrust Improvements Act of 1976

As antitrust enforcers continue to test the bounds of antitrust law, fund related enforcement has become a prime focus. Over the last year, rule proposals and enforcement actions directly address fund managers' business model and, at every step, seek to impede deal flow. From new Hart-Scott-Rodino Antitrust Improvements Act of 1976 ("HSR" or "HSR Act") reporting and disclosure rules, to revised merger guidelines that presume anticompetitive harm in a wider range of transactions, to enforcement actions seeking to unwind consummated transactions, fund deals are directly in the crosshairs. Proposed revisions to the Merger Guidelines, for instance, would specifically target 'serial acquisitions' or 'roll-ups' by advisers and private funds.

The HSR Act imposes filing and waiting period requirements for transactions that meet certain annually adjusted thresholds (currently $111.4 million). HSR filings provide antitrust enforcers opportunity to review transactions and investments, allowing them to investigate and address potential competitive concerns prior to completion. The HSR Act also carries monetary penalties for failure to comply — adjusted for 2023 from $46,517 to $50,120 per day. Fund managers should consider HSR filing obligations in all types of transactions, including smaller transactions, minority investments, exercises of warrants or options, and follow-on investments. Additionally, they should consider the current market value of previously acquired positions, to plan for potential HSR filing and waiting period requirements when participating in follow-on offerings and investments, review minority holdings that may have appreciated above the HSR threshold, and plan for incremental purchases that may trip the initial or subsequent notification thresholds. Subsequent notification thresholds for 2023 are: $222.7 million, $1.1137 billion, 25% (if valued at greater than $2.2274 billion), and 50% (where value exceeds $111.4 million).

The basic HSR reporting threshold increased to $111.4 million, and suspension of the HSR early termination program continues indefinitely – meaning that most HSR filings are subject to the full 30-day waiting period. The Federal Trade Commission (FTC) published a new merger filing fee schedule in accordance with the Consolidated Appropriations Act, passed in December of 2022. The latter legislation increased HSR filing fees for transactions valued at more than $5 billion to $2.25 million – up from the previous $280,000. The new fee for mergers between $1 billion and $2 billion is $400,000; for mergers between $2 billion and $5 billion, the fee is $800,000; and mergers above $5 billion face the top tier fee of $2.25 million. A schedule of lower fees is also in place for transactions valued below $1 billion. See full fee schedule below:

Size-of-Transaction*	FEE
Greater than $111.4 million to $161.4 million	$30,000
$161.5 million to $499.9 million	$100,000
$500 million to $999.9 million	$250,000
$1,000 million to $1,999.9 million	$400,000
$2,000 million to $4,999.9 million	$800,000
$5,000 million or more	$2.25 million

*Size-of-Transaction is equal to the aggregate total amount of voting securities, assets, or non-corporate interests being acquired.

In June 2023, the FTC and the Department of Justice (DOJ) posed new HSR reporting rules. If implemented, the rules would fundamentally alter the HSR reporting landscape, shifting to more of a "white paper" approach similar to that of ex-U.S. jurisdictions like the EU. The proposed rules also bring in typically 'off-limits' reporting, such as the identity of limited partners. Other notable expansions include reporting related to employees and labor issues, commercial relationships unrelated to the proposed acquisition or investment, officer and director interlocks with competitors, competition analyses and transaction rationale, prior iterations and drafts of transaction documents, ordinary course market related documents, prior acquisition history, private equity fund structure and investment vehicle reporting, creditors/debt holders, and foreign subsidies. The comment period ended on September 27, 2023. A revised final set of proposed rules would likely go into effect in 2024.

HSR enforcement remains active. The FTC unsuccessfully sued to block Louisiana Children's Medical Center's (LCMC) acquisition of three Louisiana hospitals from HCA Healthcare, Inc. (HCA) for failure to comply with the HSR Act. According to the complaint, the $150 million value of LCMC's acquisition exceeded the reporting threshold, requiring the transaction to be reported to federal antitrust agencies. LCMC and HCA consummated the transaction without reporting to the agencies under HSR. The FTC's claims of HSR Act violations were met with LCMC and HCA counterclaims that the HSR notice and waiting requirements did not apply because the Attorney General of Louisiana approved a Certificate of Public Advantage (COPA) for the acquisitions under Louisiana state law. In September 2023, a federal district judge sided with the hospitals. Though the FTC's suit was unsuccessful, it served as a reminder that the FTC strictly enforces the HSR Act.

In July 2023, the DOJ Antitrust Division joined the FTC in releasing a draft update of the Merger Guidelines. The Guidelines set forth many of the antitrust policy positions pursued by the current administration, which have been largely rejected by the courts. The draft Merger Guidelines included 13 Guidelines, notably that "[w]hen a merger is part of a series of multiple acquisitions, the agencies may examine the whole series," and "[w]hen an acquisition involves partial ownership or minority interests, the agencies examine its impact on competition."

Welsh, Carson, Anderson & Stone (Welsh Carson) is currently bearing the brunt of the FTC's campaign against private equity roll-up acquisitions. The FTC filed suit against Welsh Carson and one of its portfolio

companies, U.S. Anesthesia Partners (USAP), alleging the parties engaged in anticompetitive conduct through: a "roll-up" strategy in the market for anesthesiology services in Texas. According to the agency, over a 10-year period USAP acquired 17 anesthesiology practices in cities across Texas, entered into price-setting arrangements between USAP and at least three of its competitors, and entered into an agreement between USAP and one of its competitors to allocate markets. While Welsh Carson's stake in USAP is less than 50%, the FTC has alleged that Welsh Carson actively directs the portfolio company's strategy and decision-making. The FTC is seeking a permanent injunction, to prevent USAP and Welsh Carson from engaging in the alleged anti-competitive activities, and equitable relief, including "structural relief," which could require the unwinding of some or all of USAP's prior transactions.

The DOJ has also stepped-up enforcement relating to Clayton Act Section 8 and its prohibition on director overlaps between competitors resulting in several high-profile director resignations. Section 8 has import for advisers and private funds taking minority positions in competing companies and seeking board representation. Under the Clayton Act, no person, or representative of the same person or entity, may serve simultaneously as a director or officer of competing companies, but there are carve-outs and exceptions. The prohibitions of Section 8 are limited to cases in which each of the companies has, under the revised thresholds for 2023, capital, surplus, and undivided profits of more than $45,257,000. Even where the threshold is met, the restrictions do not apply where the competitive sales of either company represent less than 2% of its total sales, are less than $4,525,700, or where the competitive sales of each company represent less than 4 percent of its total sales. The statute also permits directors and officers whose appointments were not prohibited at the time of appointment to continue to serve for up to a year after the Section 8 thresholds are exceeded.

In November 2023, KKR & Co. disclosed that the DOJ is investigating with respect to the restrictions on interlocking directorates under Section 8 of the Clayton Act. In August, two Pinterest board members resigned from Nextdoor's board in response to DOJ enforcement efforts around Clayton Act Section 8. In announcing the resignations, DOJ Antitrust Division Deputy Assistant Attorney General Andrew Forman warned that, "[e]nforcement involving interlocking directorates will continue to be one of the top priorities of the Antitrust Division." The FTC is also active here. In November, the agency finalized a settlement that prevented private equity firm Quantum Energy Partners, an investor in natural gas production, from occupying a board seat at natural gas producer EQT Corporation. The order also required Quantum to divest its EQT shares and unwind a joint venture.

In merger settlements, the FTC continued the current administration's Consent Decree policy requiring a 10-year period of prior approval of the parties' future acquisitions, which last year was extended to divestiture buyers. A recently finalized consent order approving Intercontinental Exchange, Inc.'s (ICE) acquisition of Black Knight, Inc (Black Knight) required the two mortgage technology providers to seek prior approval from the FTC before reacquiring any divested asset or acquiring an interest in a loan origination system business over the next 10 years. As part of the consent order, Black Knight divested Empower and Optimal Blue, two businesses in the mortgage origination process, to Constellation Web Solutions Inc., a provider of mortgage-related tools and software.

In the settlement, ICE and Black Knight were also required to accept employment related provisions. For one year, ICE and Black Knight are required to facilitate Constellation's hiring of certain employees not already included in the divestitures, specifically employees who have responsibilities for the divested products and businesses. ICE and Black Knight are also prohibited from enforcing any noncompete or non-solicit agreement against any employee seeking a position in the divested businesses. This is in line with other efforts by the FTC to impose labor and employment related provisions in settlements.

Corporate Transparency Act

In 2021, the United States enacted the Corporate Transparency Act ("CTA") as part of a multi-national effort to rein in the use of entities to mask illegal activity. The CTA directs the United States Department of the Treasury's Financial Crimes Enforcement Network ("FinCEN") to propose rules requiring certain types of entities to file a report identifying the entities' beneficial owners and the persons who formed the entity.

FinCEN issued the final rule on Beneficial Ownership Information Reporting Requirements (the "Reporting Rule") on September 29, 2022. The Reporting Rule applies to any entity that is created by filing with a Secretary of State or any similar office under the law of a State or Indian tribe, as well as foreign entities registered to do business in any State or tribal jurisdiction (each a "Reporting Company").

Each Reporting Company is required to report the entity name (and any alternative trade or d/b/a names), business street address, jurisdiction of formation and, for foreign entities, the State or Tribal jurisdiction of registration, and a unique identification number (such as Taxpayer Identification Number, Employer Identification Number, Legal Entity Identifier, etc.). The Reporting Rule also requires Reporting Companies to identify their beneficial owners - defined as anyone who owns more than 25% of the Reporting Company or who has substantial control over the Reporting Company. Additionally, Reporting Companies that are created or registered to do business in the United States on or after January 1, 2024 are also required to report the "company applicants" who directly file, and who are primarily responsible for filing, or directing or controlling the filing of, the entity's formation documents (the "Company Applicants"). It is important to note that the reporting obligation lies with the Reporting Company and not the beneficial owner or Company Applicant.

The Reporting Rule lists 23 types of entities that are exempt from the definition of Reporting Company and consequently are not required to file reports under the Reporting Rule. These include large operating companies, public companies, registered investment companies, and certain pooled investment vehicles, among others. Of note, although the Reporting Rule exempts directly or indirectly wholly owned subsidiaries of a number of entity types, including registered investment companies, there is no such blanket exemption for subsidiaries of exempt pooled investment vehicles. Some feeder fund vehicles, alternative investment vehicles, other subsidiaries of private funds, and holding company entities that are not otherwise eligible for an exemption are likely to be subject to the Reporting Rule. Certain kinds of pooled investment vehicles, such as real estate vehicles relying on the Section 3(c)(5)(c) exemption under the Investment Company Act of 1940, certain commodity pools (even if advised by a registered commodity trading advisor and operated by a registered commodity pool operator), and certain foreign pooled investment vehicles are not exempt from the Reporting Rule.

The CTA authorizes FinCEN to disclose beneficial ownership information to United States government agencies, certain foreign agencies and authorized persons, and financial institutions using the information for certain KYC purposes. The information reported to FinCEN under the Reporting Rule will not be accessible to the public and is not subject to Freedom of Information Act requests.

Companies created before January 1, 2024 will have one year (until January 1, 2025) to file the required information. These companies are required to submit information about their beneficial owners but are not required to report information about their Company Applicants.

Reporting Companies created on or after January 1, 2024, but before January 1, 2025, must file the required information within 90 days after receiving notice of an effective formation or registration. Reporting Companies created on or after January 1, 2025, will be required to file the required information within 30 days after receiving notice of an effective formation or registration. Companies formed or registered after the effective date of the Reporting Rule are required to include information on both Company Applicants and beneficial owners.

U.S. Tax

Proposed Regulations Would Impact the Determination of Domestically Controlled REIT and Structures for Sovereign Wealth Funds' U.S. Real Estate Investments

On December 28, 2022, the Internal Revenue Service (the "IRS) and the Treasury Department released proposed regulations (the "Proposed Regulations") under sections 892 and 897 of the Internal Revenue Code (the "Code"). If finalized as proposed, the Proposed Regulations would prevent a non-U.S. person from investing through a wholly-owned U.S. corporation or a U.S. corporation owned by one or more non-

U.S. persons in order to cause a real estate investment trust ("REIT") to be "domestically controlled". The ability of a non-U.S. person to invest through a U.S. corporation to cause a REIT to be domestically controlled had been approved in a private letter ruling, and is a structure that is widely used. The Proposed Regulations would also apply to existing REITs that rely on a non-U.S. owned U.S. corporation for their domestically-controlled status (due to a look-back rule that requires the REIT to have been domestically controlled for a period of five year prior to a sale transaction), and suggest that the IRS could attack such a structure under current law (i.e., even if the Proposed Regulations are not finalized). The Proposed Regulations clarify that in determining a REIT's domestically controlled status, a foreign partnership would be looked through and "qualified foreign pension funds" ("QFPFs") and entities that are wholly owned by one or more QFPFs ("QCEs") would be treated as foreign persons.

More specifically, the Proposed Regulations provide a set of look-through rules in determining whether a REIT is domestically controlled under section 897. These rules have the effect of looking through domestic C corporation owners of a REIT that are 25%-or greater owned by non-U.S. owners (such corporations, "foreign-owned domestic corporations"). Under the Proposed Regulations, a direct or indirect shareholder of a REIT is categorized as either a "look-through person" or a "non-look-through person". To determine whether a REIT is domestically controlled, a taxpayer must look through each look-through person and determine the ultimate ownership of the REIT by non-look-through persons.

A non-look-through person is an individual, a domestic C corporation (other than a foreign-owned domestic corporation), a publicly traded REIT, a nontaxable holder, a foreign corporation (including a foreign government), a publicly traded partnership (domestic or foreign), an estate (domestic or foreign), an international organization, a QFPF, and a QCE, while a look-through person is simply any person that is not a non-look-through person.

Our January 13, 2023 blog post discusses these Proposed Regulations at length.

Final Regulations affecting Qualified Foreign Pension Plans ("QFPF")

Under section 897 of the Code, nonresident aliens and foreign corporations are taxed on the gain from the disposition of any United States real property interests ("USRPI"), those gains being considered income effectively connected with a U.S. trade or business. Distributions from certain REITs and regulated investment companies can also be treated as gain from the disposition of USRPIs. Under section 897(l) of the Code, QFPFs are generally not considered nonresident aliens or foreign corporations, exempting them from this tax. On December 29, 2022, the Department of Treasury published final regulations addressing this exemption from taxation for QFPFs under section 897(l) of the Code. Though the final regulations offer some clarifications, they retained the basic structure of the proposed regulations that were issued in 2019, including the eligibility criteria for QFPFs. That is, QFPFs are generally trusts, corporations, or other entities that meet five statutory requirements, including being organized under the laws of a foreign country, having been established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees, and not having a single participant that has the right to more than 5% of the entity's assets. The final regulations do not affect the core criteria for determining whether an entity has status as a QFPF but instead provide some adjustments. For example, the term "retirement or pension benefits" is defined more broadly (to include additional benefits). Additionally, the proposed regulations would have required that a pension fund measure the present value of qualified benefits that it expects to be provided during the entire period of the fund's life and provide that valuation on an annual basis. The final regulations offer an alternate test and also clarifies that the fund may use any "reasonable method for determining present value."

IRS Initiates Audits of Large Partnerships

In 2021, the IRS launched a pilot program to facilitate the identification of large partnerships and assessment of certain compliance risks. As a continuation of this program and with the help of the resources developed during the pilot program, the IRS began auditing the tax returns of 75 of the largest United States partnerships in the fall of 2023. In the past, the IRS has been criticized for its focus on auditing low-income taxpayers and its partnership audit rate, which up until this point had remained quite low despite a

substantial increase in the number of large partnerships in the last several years.

On September 8, 2023, the IRS released certain information related to its plan to focus on the tax compliance of wealthy taxpayers (IR-2023-166). Not all of its plans have been made public, but it has been speculated that the IRS is looking to focus on areas where there may be covert movement of wealth (e.g. estate planning, digital assets). Part of this strategy includes a large-scale audit of the country's largest partnerships. The agency has employed artificial intelligence to identify the returns of the partnerships with average assets exceeding $10 billion, which include hedge funds, real estate partnerships, and law firms. Finally, in October of 2023, the IRS began mailing out compliance letters to around 500 partnerships with over $10 million in assets after identifying discrepancies on balance sheets.

IRS Guidance on Digital Assets

The following is a summary of guidance relating to digital assets released by the IRS over the last year:

Form 1040 Instructions

On January 20, 2023, the IRS released updated instructions for Form 1040, which switch the term "virtual currency' to "digital assets" and adopt a definition of "digital asset" that is consistent with the Infrastructure and Jobs Act (signed into law in 2021). The instructions clarify how taxpayers must report digital asset transactions. Taxpayers that have (i) received (as a reward, award, or payment for property or services); or (ii) sold, exchanged, gifted, or otherwise disposed of a digital asset (or any financial interest in any digital asset) in 2022 are required to check "Yes" in the box next to the question on digital assets on page 1 of Form 1040 or 1040-SR. Of note, the instructions provide that receiving digital assets as a result of hard forks or through mining, staking or similar activities must be reported on the Form 1040.

However, the following transactions, without more, do not need to be reported on the Form 1040: (i) holding a digital asset in a wallet or account; (ii) transferring a digital asset from one wallet or account owned by the taxpayer to another wallet or account of the taxpayer; (iii) or purchasing digital assets using U.S. or real currency, including through electronic platforms such as PayPal and Venmo.

Announcement 2023-2

On December 23, 2022, the IRS released Announcement 2023-2, which provides interim guidance on digital asset broker requirements and states that the IRS and Treasury intend to issue new regulations pursuant to section 80603 of the Infrastructure Investment and Jobs Act on the application of sections 6045 and 6045A of the Code to digital asset transactions.

Notice 2023-27

On March 21, 2023, the IRS released Notice 2023-27, which provides preliminary guidance on the treatment of NFTs as collectibles under section 408(m) of the Code and states that the IRS and Treasury intend to issue guidance to that effect.

Section 1(h)(4) and (5) provide that the sale or exchange of a collectible (as defined in section 408(m) of the Code, but including coins and bullion), that is a capital asset held for more than a year is subject to tax at a 28% rate rather than the 20% rate. For these purposes, "collectible" means any work of art, rug or antique, metal or gem, stamp or coin, alcoholic beverage or any other tangible personal property specified by the Treasury. However, section 408(m)(3) of the Code excludes certain coins and bullion from this definition (but, as mentioned above, section 1(h)(4) and (5) includes them).

Section 408(m)(1) of the Code provides that, if an individual retirement account (an "IRA") acquires a collectible, the acquisition is treated as a distribution from the IRA equal to the IRA's cost of that collectible. In addition, if an individually directed account under a qualified section 401(a) plan acquires a collectible, the acquisition is treated as a distribution from the account equal to the account's cost of that collectible.

Until further guidance is issued, the IRS intends to apply a look-through test to determine whether an NFT is a collectible under section 408(m) of the Code. Under this test, an NFT is a section 408(m) collectible if its associated right or asset constitutes a section 408(m) collectible. For instance, an NFT that certifies ownership of a gem would be considered a section 408(m) collectible because the underlying gem is a collectible. Furthermore, Notice 2023-27 states it is unclear whether applying the look-through test to an NFT whose associated right or asset is a digital file, which the IRS and Treasury consider treating as a "work of art", would result in that NFT being treated as a section 408(m) collectible.

Notice 2023-34

On April 24, 2023, the IRS released Notice 2023-34, which revises Notice 2014-21 to acknowledge that "certain foreign jurisdictions" (i.e., El Salvador) treat Bitcoin as legal tender, but otherwise reaffirms the conclusions in Notice 2014-21. Notice 2014-21 was the Notice that treated convertible virtual currency (i.e., cryptocurrency) as property for U.S. federal income tax purposes. For more information about Notice 2014-21, read our blog post here.

In describing virtual currencies, Notice 2014-21 provided that "In some environments, it operates like "real" currency — i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance — but it does not have legal tender status in any jurisdiction."

For further information of proposed guidance regarding the federal tax treatment of digital assets, please see our May 2, 2023 blog post.

Tax Court Decision Interprets Profits Interest "Safe Harbor" under IRS Rev. Proc. 93-27

The Tax Court's May 3, 2023, decision in ES NPA Holding, LLC v. Commissioner (T.C. Memo 2023-55), upholding a taxpayer's position to characterize a partnership interest as a profits interest under the "safe harbor" of IRS Revenue Procedure 93-27 (as clarified by IRS Revenue Procedure 2001-43), provides helpful guidance to issuers of profits interests, including private equity funds and other investment partnerships and their portfolio companies.

As background, Revenue Procedure 93-27 provides a "safe harbor" definition of a profits interest. Specifically, it defines a "profits interest" as a partnership interest other than a "capital interest," meaning "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation" at the time of receipt of the partnership interest. It further provides that the receipt of a profits interest in exchange for services "to or for the benefit of" a partnership in the recipient's capacity of a partner or in anticipation of becoming a partner is not a taxable event to the recipient so long as the profits interest (1) does not relate to a "substantially certain and predictable stream of income," (2) is held for at least two years prior to disposition, and (3) and is not granted by a "publicly traded partnership."

In this case, the IRS took the position that (a) the partnership interest received by the taxpayer did not qualify for the Revenue Procedure 93-27 "safe harbor" and further did not qualify as a "profits interest" because the taxpayer did not directly provide services to the issuing partnership of the partnership interest and (b) the partnership interest was a capital interest rather than a profits interest because the taxpayer would be entitled to a share of the partnership's proceeds in a hypothetical liquidation on the day the taxpayer received the partnership interest.

In its decision, the Tax Court—interpreting Revenue Procedure 93-27 expansively rather than literally—held in favor of the taxpayer with respect to both of the IRS's positions and provided that (1) a taxpayer who receives a profits interest issued out of one partnership in consideration of services that were, among other things, to or for the benefit of another related partnership—may, under the appropriate facts, qualify for the "safe harbor" and (2) a contemporaneous arm's-length transaction was acceptable evidence of value for purposes of determining that the profits interest entitled the taxpayer to distributions out of post-grant profits

only, and the partnership interest was therefore a profits interest rather than a capital interest.

While the Tax Court's decision can be interpreted as being generally consistent with market practice, there are meaningful nuances to the Tax Court's decision. In light of these nuances, and the general lack of interpretive guidance regarding profits interests, it remains important for issuers of profits interests to discuss their specific circumstances with their legal and tax advisors.

This guidance was discussed in our May 23, 2023 blog post.

Gain on Inventory Items May Be Considered U.S.-Source Income

Non-U.S. persons, including non-U.S. partners in a partnership, are generally taxed on any income that is "effectively connected with the conduct of a trade or business within the United States" ("ECI"). A Tax Court case discussed whether gain attributable to inventory is considered U.S. source income.

In *Rawat v. Commissioner*, No. 15340-16 (U.S.T.C. February 2023), the taxpayer, a non-U.S. person, filed U.S. federal income tax returns as a nonresident alien for tax years 2000 through 2007. The taxpayer acquired an interest in a U.S. partnership that manufactured and sold popular consumer products. In 2008, the taxpayer sold her interest in the partnership for over $400 million, at which point the partnership held inventory items for future sale in the United States. The partnership later sold those inventory items for a profit.

The IRS conducted an audit of the partnership for the 2007 and 2008 tax years. The IRS concluded that part of Rawat's income resulting from her sale of the partnership interest should include the portion attributable to inventory and issued a notice of deficiency. The taxpayer challenged this assessment in the Tax Court.

The taxpayer filed a motion for summary judgment and, citing *Grecian Magnesite Mining, Industrial & Shipping Co.*, SA, 149 T.C. 63 (2017), aff 'd, 926 F.3d 819 (D.C. Cir. 2019), argued that non-U.S. individuals are not subject to U.S. income tax on a sale of their interest in a U.S. partnership, as those gains would be sourced outside of the U.S. The Tax Court opined that Congress effectively overruled this precedent by adding section 864(c)(8) to the Code effective for transactions after November 27, 2017. Under section 864(c)(8), if a nonresident alien individual or foreign corporation owns an interest in a partnership which is engaged in any trade or business within the United States, gain or loss on the sale or exchange of all (or any portion of) such interest may be treated as effectively connected with the conduct of such trade or business.

The Court held that because part of the taxpayers' gain on the sale of her partnership interest was allocable to inventory for purposes of section 751(a)(2), it is excepted from the general rule treating such gain as gain from a capital asset under section 741. Because the partner's gain was treated as attributable to inventory under section 751(a)(2), for purposes of the sourcing rules, it was also considered "income derived from the sale of inventory property" under the exception of section 865(b), and therefore, may be considered U.S.-source income. As such, the Tax Court denied the partner's motion for summary judgment.

Hedge Fund was Engaged in a U.S. Trade or Business Through Its Fund Manager

On November 15, 2023, the U.S. Tax Court held in *YA Global Investments v. Commissioner* 161 T.C. No. 11 (2023) that a non-U.S. private equity fund (YA Global) with a U.S. asset manager that bought equity and convertible debt of U.S. portfolio companies was engaged in the conduct of a trade or business within the United States for U.S. federal income tax purposes, all of its income was "effectively connected" to that trade or business, and the fund (which was treated as a partnership for U.S. federal income tax purposes) was liable for penalties and interest for failing to withhold with respect to its non-U.S. corporate feeder. YA Global made loans and convertible loans and entered into standby equity distribution agreements ("SEDAs") to purchase equity. It entered into hundreds of these transactions over the years in question. YA Global described itself as providing underwriting services, its manager received structuring fees and

banker's fees, and YA Global itself received commitment fees. The Tax Court held that YA Global provided services, and therefore was engaged in a trade or business in the United States for tax purposes.

Background

YA Global was a Cayman Islands partnership. Yorkville Advisors ("Yorkville" or the "manager") was YA Global's sole general partner and investment manager. Yorkville's employees worked from within the United States. Yorkville received a 2% management fee and a 20% incentive fee based on YA Global's profits. However, Yorkville was also entitled to retain any fees it received directly from the portfolio companies to the extent of its overhead. Any excess fees received by Yorkville were offset against management fees owed to Yorkville, or paid to YA Global.

YA Global purchased convertible debt and equity from thinly publicly-traded U.S. corporate portfolio companies. YA Global's equity purchases were pursuant to SEDAs, which required the fund to purchase up to a specified dollar value of a portfolio company's stock over a fixed period (typically two years) at a discounted price (e.g., 97%) of the weighted average of the stock's trading price. The SEDAs and convertible debentures generally required the portfolio company to pay "structuring fees" and "banker's fees" to Yorkville and "commitment fees" to YA Global. The SEDAs were structured to provide substantial fee income to be paid to Yorkville, which it was entitled to retain (up to its overhead costs) under the agreement with YA Global.

An executive of one of the portfolio companies testified that his company did not receive any services and that the fees were merely a cost of issuing shares. However, in pitchbooks to the portfolio companies, YA Global described itself as an underwriter and, on its website, it described itself as providing portfolio companies with a service.

YA Global held many of its investments for 12-24 months before selling the shares into the public markets or converting the debt into shares and selling those shares into the public markets. YA Global told its investors that it sought "capital appreciation". An expert testified that YA Global's returns were comparable to a venture capital firm (i.e., that YA Global took market risk) and had a few big winners and lots of losers. However, YA Global told portfolio companies that it was functioning as an underwriter, providing portfolio companies with a service, and Yorkville received structuring fees and banker's fees.

The Tax Court's Opinion

As a threshold matter, the court found that Yorkville was YA Global's agent, but the analysis is convoluted and presents funds with an argument that their managers are not agents.

The IRS argued that Yorkville should be treated as YA Global's agent merely because Yorkville was acting on behalf of YA Global. However, the court declined to adopt a standard so broad. Instead, the court held that, it was YA Global's power to give interim instructions to Yorkville that caused Yorkville to be YA Global's agent. In fact, the court held that it is the "power to give interim instructions [that] distinguishes principals in agency relationships from those who receive services provided by persons who are not agents." The investment management agreement between YA Global and Yorkville required YA Global to promptly advise Yorkville of any specific investment restrictions relating to the investment account. This, the court concluded, meant that YA Global had the power to give interim instructions.

Of course, if this standard were followed, an offshore fund with a U.S. manager potentially could avoid a U.S. trade or business simply by providing that the manager has full investment discretion (and that the fund may not give its manager interim instructions). Most funds do not have the power to give their managers interim instructions. While we are skeptical that subsequent courts will follow the Tax Court on this point, it will be the first defense against an IRS assertion that an offshore fund is engaged in a trade or business in the United States.

YA Global's U.S. Trade or Business

As mentioned above, YA Global referred to itself as an underwriter and described SEDAs as a "service we offer companies." Yorkville received "structuring fees" and "banker's fees" from the portfolio companies in connection with YA Global's purchase of equity and convertible debt, and YA Global received "commitment fees" from the portfolio companies for its obligation to purchase the portfolio companies' equity pursuant to the SEDAs.

We believe that it was YA Global's characterization of its business and the "fee" labels placed on the amounts it received that contributed to the court's decision.

The court's reasoning for its conclusion was questionable in parts. For example, the court said that the fact that YA Global received commitment fees upon execution of the relevant agreements was evidence that the payment of fees did not depend upon YA Global putting its capital at risk. However, when YA Global entered into the SEDAs (and received fees), it committed to purchase a specified dollar amount of the portfolio companies' equity without any guarantee that it would receive back its investment, and YA Global lost money far more often than it made money. All of the fees were in fact dependent on YA Global putting its capital at risk.

The court also reasoned that if the fees the portfolio companies paid were simply additional compensation for capital, those fees should have been paid entirely to YA Global (rather than Yorkville). However, perhaps the reason why the fees were paid to Yorkville rather than YA Global was simply because, under the deal between Yorkville and YA Global, Yorkville could keep only amounts paid to it as "fees" to the extent of its overhead. The deal between Yorkville and YA Global did not affect the nature of the transaction between YA Global and the portfolio companies.

The court also held that the commitment fees YA Global received for its agreement to purchase stock of the portfolio companies pursuant to the SEDAs were not option premiums. It reasoned that because YA Global purchased the stock at a price that was below the trading price, it was not at risk of price fluctuations.

Having concluded that YA Global received fees for the provision of financial services, the court summarily held that YA Global was not a mere investor and did not qualify for the "stock and securities" trading safe harbor of section 864(b)(2). Therefore, it held that YA Global was engaged in a trade or business in the United States.

Origination Activity

The Tax Court did not decide whether the origination of convertible debt to portfolio companies caused YA Global to be engaged in a U.S. trade or business. However, the court did say that, in order for YA Global to be engaged in a "banking, financing, or similar business" within the meaning of Regulations section 1.864-4(c)(5)(i), the Regulations "seem[] to contemplate retail operations" only and not loans to commercial borrowers. While the meaning of "public" in this context is unclear, YA Global is the first case to suggest that public means only "retail" (i.e., individual) borrowers.

Effectively Connected Income

The court held that all of YA Global's income allocable to non-U.S. partners during the tax years at issue was effectively connected with the conduct of its U.S. trade or business and, therefore, subject to withholding under section 1446. (YA Global was a partnership for U.S. federal income tax purposes and had a non-U.S. corporate feeder fund as a partner.)

There were two separate technical bases for the Tax Court to conclude that the gain from the sale of YA Global's securities was effectively connected to its U.S. trade or business. First, section 865(e)(2)(A) treats gain from sales of personal property as U.S. source if it is attributable to a U.S. office, and section 864(c)(3) treats all U.S.-source income, other than "fixed and determinable, annual and periodic income" (such as

interest and dividends), as "effectively connected" with a U.S. trade or business. The Tax Court held that YA Global's gain was attributable to YA Global's U.S. office (i.e., Yorkville's U.S. office) because the U.S. office was a material factor in the production of the income and activities of the type from which the income was derived were regularly carried on at that office. Accordingly, the court held that YA Global's sales of securities constituted U.S.-source income under section 865(e)(2)(A) and was effectively connected to YA Global's trade or business under section 864(c)(3).

Second, under section 475(d)(3)(A) (and sections 64 and 65), gains of a dealer are ordinary income and, under section 864(c)(3), this income (which is not gain from the sale of personal property or "fixed and determinable, annual and periodic income") is treated as effectively connected income. (Thus, the section 475 analysis bypasses section 865(e)(2)(A).)

For further discussion of the case, please refer to our blog post.

Tax Court Holds That Active Limited Partners of State Law Limited Partnerships May Be Subject to Self-Employment Tax

Section 1402(a)(13) of the Internal Revenue Code provides that the distributive share of "limited partners, as such" from a partnership is not subject to self-employment tax. Managers of private equity and hedge funds are routinely structured as limited partnerships to exclude management and incentive fees from self-employment taxes. On November 28, 2023, the Tax Court in *Soroban Capital Partners LP v. Commissioner* held that the phrase "limited partner, as such" means that, in order to benefit from the self-employment exclusion, a limited partner must be passive and cannot actively participate in the partnership. The Tax Court did not consider whether even de minimis participation would disqualify a limited partner from the exclusion. Accordingly, under Soroban, limited partners in private equity and hedge fund managers must pay self-employment tax if they actively participate in the manager.

The Tax Court did not set forth the specific factors that would indicate when a limited partner is actively participating in the partnership's business. Notwithstanding this continued uncertainty, under the Tax Court's reasoning, it is likely that most limited partners of investment management firms structured as limited partnerships who participate in the day-to-day activities of the firm would not be considered "limited partners, as such". And therefore, managers who take the position that their active limited partners are not subject to self-employment tax may wish to reconsider that position in light of Soroban.

For additional information and discussion, please refer to our December 8, 2023 blog post.

Proskauer Attorneys File Amicus Brief Before the U.S. Supreme Court in Connection with Moore v. United States

A pending case in the Supreme Court involves a challenge to the constitutionality of section 965 of the Code. This section of the Code imposes a transition tax on the untaxed foreign earnings of controlled foreign corporations ("CFCs"). A central question that the Court will need to consider is whether the Sixteenth Amendment, which grants Congress the power to impose income taxes without apportionment, authorizes Congress to tax unrealized gains that are not first realized by the taxpayer.

The plaintiffs in the case are Charles and Kathleen Moore, who had invested in a CFC that, year to year, had reinvested profits rather than distributing earnings to its investors. After the Tax Cuts and Jobs Act changed aspects of section 965 of the Code, the Moores began to be taxed on the undistributed profits. The Moores argue that their case centers around a definition of income and whether it must be "realized" as a prerequisite to the imposition of an income tax under the Sixteenth Amendment of the U.S. Constitution, which generally grants Congress the power to "lay and collect taxes on incomes, from whatever source derived. . ."

On October 23, 2023, Proskauer attorneys submitted an amicus brief in connection with the U.S. Supreme Court case of Moore v. United States on behalf of the American College of Tax Counsel, in which it urges

the Court to avoid ruling on the constitutionality of the realization requirement altogether.

Our November 6, 2023 blog post discusses *Moore v. United States* and the amicus brief in greater detail.

IRS incorporates temporary e-signature guidance into the Internal Revenue Manual:

As of October 30, 2023, the temporary guidance on e-signatures, which was initially formulated to allow for flexibility in filing certain tax forms and documents during the COVID-19 pandemic, has been made a permanent part of the Internal Revenue Manual (the "IRM").

The IRM wholly adopts the temporary guidance, providing that that following are certain acceptable forms of e-signature:

- A typed name that is typed within or at the end of an electronic record, such as typed into a signature block.
- A scanned or digitized image of a handwritten signature that is attached to an electronic record.
- A shared secret, such as a code, password, or PIN.
- A unique biometric-based identifier, such as a fingerprint, voice print, or a retinal scan.
- A handwritten signature input onto an electronic signature pad.
- A handwritten signature, mark, or command input on a display screen by means of a stylus device.
- A selected checkbox on an electronic device such as a computer or tablet.
- A signature created by a third party software.

E-signatures are permanently allowed on the following forms:

- Form 11-C, Occupational Tax and Registration Return for Wagering.
- Form 637, Application for Registration (For Certain Excise Tax Activities).
- Form 706, U.S. Estate Tax Return.
- Form 706-A, United States Additional Estate Tax Return.
- Form 706-GS (D), Generation-Skipping Transfer Tax Return for Distributions.
- Form 706-GS (D-1), Notification of Distribution from a Generation-Skipping Trust.
- Form 706-GS (T), Generation-Skipping Transfer Tax Return for Terminations.
- Form 706-QDT, U.S. Estate Tax Return for Qualified Domestic Trusts.
- Form 706 SCHEDULE R-1, Generation-Skipping Transfer Tax.
- Form 706-NA, U.S. Estate (and Generation-Skipping Transfer) Tax Return.
- Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return.
- Form 730, Monthly Tax Return for Wagers.
- Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons.
- Form 1066, U.S. Real Estate Mortgage Investment Conduit (REMIC) Income Tax Return.
- Form 1120-C, U.S. Income Tax Return for Cooperative Associations.
- Form 1120-FSC, U.S. Income Tax Return of a Foreign Sales Corporation.
- Form 1120-H, U.S. Income Tax Return for Homeowners Associations.
- Form 1120-IC DISC, Interest Charge Domestic International Sales – Corporation Return.

- Form 1120-L, U.S. Life Insurance Company Income Tax Return.
- Form 1120-ND, Return for Nuclear Decommissioning Funds and Certain Related Persons.
- Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return.
- Form 1120-REIT, U.S. Income Tax Return for Real Estate Investment Trusts.
- Form 1120-RIC, U.S. Income Tax Return for Regulated Investment Companies.
- Form 1120-SF, U.S. Income Tax Return for Settlement Funds (Under Section 468B).
- Form 1127, Application for Extension of Time for Payment of Tax Due to Undue Hardship.
- Form 1128, Application to Adopt, Change or Retain a Tax Year.
- Form 2678, Employer/Payer Appointment of Agent.
- Form 3115, Application for Change in Accounting Method.
- Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts.
- Form 3520-A, Annual Return of Foreign Trust with a U.S. Owner.
- Form 4421, Declaration – Executor's Commissions and Attorney's Fees.
- Form 4768, Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes.
- Form 8038, Information Return for Tax-Exempt Private Activity Bond Issues.
- Form 8038-G, Information Return for Government Purpose Tax-Exempt Bond Issues.
- Form 8038-GC; Information Return for Small Tax-Exempt Governmental Bond Issues, Leases, and Installment Sales.
- Form 8283, Noncash Charitable Contributions.
- Form 8453 series, Form 8878 series, and Form 8879 series regarding IRS e-file Signature Authorization Forms.
- Form 8802, Application for United States Residency Certification.
- Form 8832, Entity Classification Election.
- Form 8971, Information Regarding Beneficiaries Acquiring Property from a Decedent.
- Form 8973, Certified Professional Employer Organization/Customer Reporting Agreement.
- Elections made pursuant to Internal Revenue Code Section 83(b).

Notably, Form SS-4, Application for Employer Identification Number, is not included on the list of permitted forms.

ERISA

A Guide to the DOL's New Investment Advice Fiduciary Rule Proposal – What Investment Advisers and Managers Need to Know

The new "retirement security rule" package, issued by the U.S. Department of Labor (the "DOL") on October 31, 2023, is the latest chapter in an almost 15-year effort by the DOL to amend the five-part test in its 1975 regulation for determining whether a person is an ERISA "fiduciary" by reason of providing "investment advice" for a fee (the "Five-Part Test"). For more on the history, see here, here, and here. The package includes a proposed new fiduciary "investment advice" rule (the "Proposed Rule") and proposed amendments to certain prohibited transaction exemptions.

Very generally speaking, the Proposed Rule would significantly expand the circumstances under which a person could be treated as providing "investment advice" that is subject to ERISA's fiduciary standards (including the self-dealing prohibited transaction rules). In particular, the Proposed Rule would replace the Five-Part Test's requirements that advice be provided (1) on a "***regular basis***" pursuant to (2) a "***mutual agreement, arrangement or understanding***" that (3) it would serve as "***a primary basis for investment decisions***" with a much broader test that is based on the retirement investor's reasonable expectations and context. The Proposed Rule is broad enough to potentially cover certain marketing and other related activities considered common to the investment management industry (including the private investment fund industry).

Background

Under Section 3(21) of ERISA and Section 4975(e) of Title 26 of the U.S. Code (the "Code"), a person is considered a "fiduciary" with respect to an ERISA plan or an individual retirement account (an "IRA") if ***the person renders investment advice for a fee or other compensation, direct or indirect, or has any authority or responsibility to do so***. Separately, a person would be a fiduciary if it has discretionary authority or responsibility over the management or investment of the assets of an ERISA plan or IRA (or a vehicle considered to be holding "plan assets" under ERISA or Section 4975 of the Code (e.g., a private investment fund that is over the "ERISA 25% limit" but not operated as a venture capital operating company ("VCOC") or real estate operating company ("REOC"))). However, the Proposed Rule has no bearing on becoming a fiduciary by reason of having such discretionary authority or responsibility over "plan assets," nor does it change the rules for determining whether or not a private investment fund is holding "plan assets" under ERISA.

Under the Five-Part Test, a person is considered to be providing "investment advice" for these purposes only if the person: (1) renders advice to the ERISA plan or IRA as to the value of securities or other property, or makes recommendations as to investing in, purchasing or selling securities or other property, (2) on a ***regular basis***, (3) pursuant to a ***mutual agreement, arrangement, or understanding*** with the ERISA plan, the ERISA plan fiduciary or the IRA owner that, (4) the advice will serve as a ***primary basis*** for investment decisions with respect to the ERISA plan's or IRA's assets and (5) the advice will be individualized based on the particular needs of the ERISA plan or IRA. A person who meets all five prongs of the test and receives direct or indirect compensation will be considered an "investment advice" fiduciary with respect to the applicable ERISA plan or IRA.

As you may recall, in 2016, the DOL replaced the Five-Part Test with a new fiduciary regulation (the "2016 Rule") that significantly expanded the scope of "investment advice." However, the 2016 Rule was vacated by the U.S. Court of Appeals for the Fifth Circuit in 2018 and, following that decision, the DOL reinstated the Five-Part Test.

Proposed New Test

The Proposed Rule would replace the Five-Part Test with a rule that says a person provides "investment advice" if it provides a "recommendation" of "any securities transaction or other investment transaction or any investment strategy involving securities or other investment property" to a "retirement investor" (*i.e.*, an ERISA plan, a plan fiduciary, a plan participant or beneficiary, an IRA, an IRA fiduciary or an IRA owner or beneficiary) and satisfies ***any*** of the following three requirements:

- The person either directly or indirectly (through or together with an affiliate) has discretionary authority or control with respect to purchasing or selling securities or other investment property for the retirement investor;
- The person either directly or indirectly (through or together with an affiliate) makes investment recommendations to investors on a regular basis as part of its business, and the recommendation is provided under circumstances indicating that the recommendation is based on the particular needs or individual circumstances of the retirement investor and may be relied upon by the retirement investor as a basis for investment decisions that are in the retirement

investor's best interest; ***or***

- The person making the recommendation represents or acknowledges that it is acting as a fiduciary when making investment recommendations.

Key Takeaways and Implications of Proposed New Test

- **Elimination of requirement that investment advice be provided to advice recipient on a "regular basis"**. Under the Five-Part Test, an isolated one-time interaction generally would not be treated as fiduciary investment advice because the advice was required to be provided on a "regular basis" ***to the advice recipient***. The Proposed Rule would expand the fiduciary net by allowing the "regular basis" requirement to be satisfied for anyone who makes (or has an affiliate that makes) investment recommendations to ***any investors*** on a "regular basis" ***as part of its business***. This means that one-time advice can be subject to the fiduciary standard.

Practice pointer: The Proposed Rule picks up an individualized recommendation to a retirement investor by an adviser that regularly provides investment recommendations to ***any*** investors. As a result, many common "one-time" advice scenarios that historically were not covered by the fiduciary standard, such as recommendations related to a single financially significant real estate transaction, purchasing an annuity contract for a defined benefit pension plan or rolling over assets from an employer-sponsored plan to an IRA, could all be considered fiduciary investment advice under the Proposed Rule.

- **Elimination of "mutual agreement, arrangement or understanding" and "primary basis" requirements**. Under the Five-Part Test, an adviser could avoid fiduciary status by making clear (including via contract disclaimers) that there is no "***mutual agreement, arrangement or understanding***" that anything the adviser says will serve as "***a primary basis***" for an investment decision. The Proposed Rule would look instead to whether the objective circumstances surrounding the recommendation make it reasonable for the retirement investor to believe that it could rely upon the advice as "***a basis***" for an investment decision that is in the retirement investor's best interest.
- **Recommendation required**. A threshold element for fiduciary status is making a "recommendation." Although the Proposed Rule does not include a formal definition of "recommendation," the DOL notes in the preamble that it views a "recommendation" as a communication (written or oral) that, based on its ***content, context, and presentation*** (including the extent to which the communication is more individually tailored to a specific retirement investor or group of investors) would reasonably be viewed as a suggestion that the retirement investor engage in or refrain from taking a particular course of action. The DOL also noted that a series of actions or communications taken together may constitute a recommendation even if they would not have met the threshold individually. The DOL states that the determination of whether a recommendation has been made would be based on an objective, rather than subjective, analysis of the facts and circumstances. However, at the same time, the DOL describes the standard for a "recommendation" under the SEC's Regulation Best Interest as meeting the standard for a recommendation under the Proposed Rule, and that standard turns on the inherently subjective inquiry as to whether the communication reasonably could be viewed as a "call to action" that reasonably would influence an investor to trade a particular security or group of securities.

Practice pointer: The simple act of a private investment fund manager sending its fund's offering memorandum and other governing documents to a retirement investor (in and of itself) generally should not constitute a "recommendation" to invest in the fund under the Proposed Rule. However, if such document delivery is combined with individualized discussions and other related interactions between the fund manager and the prospective investor that address the particular needs or individual circumstances of the retirement investor such that the retirement investor reasonably could believe it could rely on the interactions as a basis for determining that an investment in the fund is in its best interest, those interactions could be a recommendation that would be considered fiduciary investment advice under the Proposed Rule.

- **No safe harbor for sales or sophisticated retirement investors**. The DOL rejected the

difference between a "sales" recommendation and "investment advice" in the retail market. In the DOL's view, when retirement investors talk to investment providers about the investments they should make, they commonly pay for and receive covered "investment advice." Although the vacated 2016 Rule included an exclusion for transactions with independent plan fiduciaries with financial expertise, which provided relief for many common sales and marketing practices involving institutional investors, the Proposed Rule does not include a similar exception for recommendations to "sophisticated" advice recipients.

Practice pointer: The omission of a "sales" or "sophisticated investor" safe harbor may leave a lack of clarity for many common marketing activities. Although the DOL says it is trying to protect smaller retail investors, the regulatory wording also sweeps in common interactions with institutional and other sophisticated investors—even those who have the means to engage advisers and counsel. As was the case under the 2016 Rule, fund managers would need to be careful regarding communications made to prospective and existing IRA investors if the Proposed Rule is finalized in its current form.

- **Informal advice outside the scope of a manager's engagement**. As noted above, the Proposed Rule picks up any "recommendation" by a party that directly or indirectly (through or together with an affiliate) has discretionary investment authority or control over a retirement investor's assets—even if the discretion relates to other assets that are not plan assets. Accordingly, if, for example, an adviser (or its affiliate) manages an individual's non-retirement assets, the Proposed Rule would pick up a recommendation by that adviser (or its affiliate) for the client to consider investing its IRA in the adviser's private investment fund. Another common example is if an adviser (or its affiliate) manages a company's non-retirement assets, any recommendation by that adviser (or its affiliate) to that company (in its capacity as sponsor of the company's ERISA-covered retirement plan and, therefore, a "retirement investor") regarding the investment of the ERISA plan's assets would likely be treated as covered "investment advice" under the Proposed Rule. Similarly, if an adviser (or its affiliate) manages an ERISA plan's assets within a "plan asset fund" or a separate account arrangement, any "recommendations" by that adviser (or its affiliate) to any of the ERISA plan's fiduciaries, participants or beneficiaries—even if made in a completely unrelated context that is not within the adviser's contractual mandate—could also be treated as a fiduciary investment advice.

Practice pointer: It is often the case that a discretionary investment manager is engaged to manage only a portion of the assets of a plan or a retirement investor's non-retirement assets. Under the Proposed Rule, a covered "recommendation" provided by such a manager (or its affiliate) would constitute "investment advice" ***even if the recommendation is made with respect to assets that are not managed by the manager***. This change would make it even more difficult for a manager to offer an unrelated investment product to an existing retirement investor client.

- **Acknowledgement of fiduciary status**. Under the Proposed Rule, an adviser that represents or acknowledges that it is acting as a fiduciary when making investment recommendations should be prepared to comply with ERISA's fiduciary duty and prohibited transaction rules when making such investment recommendations to a retirement investor. There is no requirement that such an adviser provide investment recommendations on a regular basis as part of its business, or on a regular basis to the retirement investor. If the adviser says it will be acting as an ERISA fiduciary when providing advice, it will be held to that standard with respect to the provision of such advice but not necessarily with respect to any other aspect of the relationship or a future relationship.
- **"Hire me" recommendations**. The DOL confirmed in the preamble that an adviser's normal activity of marketing itself would not be treated as investment advice, ***so long as the adviser does not make any investment recommendations along with*** the "hire me" pitch. However, there is no safe harbor, as the Proposed Rule requires consideration of the complete facts and circumstances surrounding each recommendation. Also, as noted above, the Proposed Rule's finding of an advisory relationship based on discretion over an investor's ***other*** assets could make it impossible to pitch for expanding an existing relationship without the pitch being subject to the fiduciary standard.

Practice pointer: It remains to be seen whether there is a practical way to make a "hire me" pitch without

discussing what the adviser would recommend if engaged. For example, when an investment manager pitches a potential retirement investor with the intention of managing the retirement plan investor's assets within the manager's private investment fund, that "hire me" pitch could be viewed as including a "recommendation" to invest in the fund. Accordingly, the "hire me" exception in the Proposed Rule will be very difficult to utilize for the purposes of marketing specific funds or preset investment strategies. Pitches could be particularly problematic for providers that already have some relationship with the retirement investor (e.g., pitching an existing client to expand the relationship).

- **"Day 1" impact on fiduciary status / ERISA compliance**. If the Proposed Rule is finalized in its current form, service providers to ERISA plans or IRAs (or vehicles holding "plan assets") who do not currently hold themselves to fiduciary standards or have not contractually agreed to comply with ERISA, could be deemed to be providing covered investment advice pursuant to an arrangement that does not comply with ERISA when the new rule becomes effective. In particular, non-compliant compensation structures might especially pose a problem. Accordingly, service providers to ERISA plans or IRAs (or vehicles holding "plan assets") should review their existing arrangements to assess the potential impact of the Proposed Rule.
- **No disclaimers**. The Proposed Rule states that disclaimers regarding fiduciary status will not control to the extent they are inconsistent with the adviser's verbal communications, marketing materials, state or federal law or other interactions with the retirement investor. Accordingly, common provisions set forth in private investment fund documentation (e.g., subscription agreements, offering materials and other governing documents) purporting to make clear that the manager is not providing investment advice to invest in the fund would not be dispositive if inconsistent with the manager's fundraising and marketing activities related to retirement investors.

Practice pointer: Although disclaimers cannot override contrary communications and materials, they can still be helpful to establish that there is no intent to provide advice. Accordingly, fiduciary investment advice disclaimers will likely continue to be common practice in the private investment fund industry. In practice, the challenge will be to avoid comments, materials, and conduct that are inconsistent with the intent not to provide advice that can be relied on by a retirement investor.

- **Valuation of securities and other investment property not covered**. Valuation and appraisal services, as well as fairness opinions, are excluded from recommendations covered by the Proposed Rule. Such services alone would not be considered fiduciary investment advice.
- **IRA rollover advice specifically covered**. The DOL emphasizes that it intends for the Proposed Rule to pick up advice on whether to take a distribution or roll over assets from a retirement plan to an IRA, even if there is no recommendation as to ***how to invest*** the assets after the rollover.
- **Fee or other compensation, direct or indirect**. As noted above, investment advice is subject to the fiduciary standard only if it is provided for "a fee or other compensation, direct or indirect." This requirement can be satisfied by indirect compensation that isn't explicitly provided for advice. If the adviser (or an affiliate) receives any fee or compensation, from any source, specifically for the advice or in connection with or as a result of the applicable recommendation, then the requirement will be satisfied. Examples include commissions, loads, finder's fees, revenue sharing payments, shareholder servicing fees, marketing or distribution fees, mark ups or mark downs, underwriting compensation, expense reimbursements, gifts and gratuities or other non-cash compensation. A fee or compensation will be treated as a paid-for recommendation if the fee or compensation would not have been paid ***but for*** the recommended transaction or the provision of advice including if eligibility for or the amount of the fee or compensation is affected by the recommended transaction or the provision of advice.

Practice pointer: Certain common private investment fund industry marketing activities could be considered fiduciary investment advice even though, in the case of a prospective investor or client, a fee will not be charged until after the investor invests in the fund or the separately managed account is established. For example, if an adviser is considered to provide "investment advice" to a prospective

retirement investor with respect to investing in the adviser's private investment fund, a typical management fee, carried interest or incentive fee paid by the fund would likely be considered to satisfy the "fee or other compensation, direct or indirect" requirement.

Proposed Prohibited Transaction Exemption Amendments

Section 406(b) of ERISA and Section 4975(c) of the Code prohibit (among other things) investment advice fiduciaries from receiving compensation that varies based on their investment advice and compensation that is paid from third parties unless the conditions of an available exemption are satisfied. The DOL has previously issued prohibited transaction class exemptions ("PTEs") covering certain common transactions that would provide relief to investment advice fiduciaries for certain otherwise prohibited compensation arrangements. In connection with the issuance of the Proposed Rule, the DOL also proposed amendments to PTEs 2020-02, 84-24, 75-1, 77-4, 80-83, 83-1 and 86-128, which essentially would require all investment advice fiduciaries to comply with "impartial conduct standards." The "impartial conduct standards" incorporate ERISA's principles of prudence and loyalty, and they are intended to be aligned with the standards of conduct for investment advice professionals established and considered by other U.S. federal and state regulators—in particular, the SEC and its Regulation Best Interest.

Proskauer's Perspective

The DOL's latest proposal would significantly expand what constitutes fiduciary "investment advice," and would affect many advice providers that currently take the position that their communications and interactions with ERISA plan and IRA clients are not subject to the fiduciary duty or prohibited transaction rules under ERISA or Section 4975 of the Code.

Importantly, certain common marketing, pitch practices, offering activities and periodic communications for private investment funds and separately managed accounts involving retirement investors could be considered investment advice if viewed as a "recommendation" to invest in a fund, to remain invested in a fund or to continue a separately managed account arrangement. If such communications or activities constitute fiduciary "investment advice" to a retirement investor to purchase or continue to hold an interest in the manager's own funds and/or establish or continue a separately managed account arrangement with the fund manager (and to pay any related management or other fees), this advice could be treated as "conflicted," resulting in a violation of fiduciary duty and/or a prohibited transaction absent compliance with an exemption.

Although the Proposed Rule and related proposed PTE amendments are simply that at this point—proposed—given the potential expansion and impact, investment advisers and managers should carefully review the proposal to determine whether and how the proposal might apply to them.

Special DOL Proxy Voting Rule Took Effect on December 1, 2023

In late 2022, the DOL issued final regulations (the "Final ESG Rules") which address the extent to which ERISA fiduciaries may consider environmental, social and governance ("ESG") factors when making investment decisions and exercising shareholder rights, such as voting proxies, on behalf of ERISA-covered clients. For a detailed discussion of the Final ESG Rules, see here.

Although the Final ESG Rules generally became effective on January 30, 2023, a special investment policy rule applicable to ERISA fiduciaries of pooled investment vehicles holding "plan assets" of more than one ERISA plan (a "Pooled Plan Asset Vehicle") first took effect on December 1, 2023. Importantly, this special rule does not apply to pooled investment vehicles or accounts that are not subject to ERISA (e.g., a private investment fund that is under the "ERISA 25% limit" or that is operated as a VCOC). It also generally does not apply to ERISA-covered separately managed accounts or "funds-of-one," other than with respect to such an entity's investment into a Pooled Plan Asset Vehicle.

The special rule portion of the Final ESG Rules provides (in relevant part) as follows:

- To the extent an investment manager of a Pooled Plan Asset Vehicle is subject to an investment policy statement ("IPS") (which includes any proxy voting policy) that conflicts with another ERISA plan's IPS, the investment manager must reconcile, insofar as possible, those conflicting policies (assuming compliance with each policy would be consistent with ERISA);
- In the case of proxy voting, to the extent permitted by applicable law, the investment manager must vote (or abstain from voting) the relevant proxies to reflect such policies in proportion to each ERISA plan's economic interest in the Pooled Plan Asset Vehicle; and
- Such an investment manager may, however, develop its own ERISA-compliant IPS and require participating ERISA plans to accept such IPS, including any proxy voting policy, before they are allowed to invest. In such cases, an independent ERISA plan fiduciary must assess whether such IPS and proxy voting policy are consistent with applicable ERISA requirements before deciding to retain the investment manager.

Accordingly, investment managers of potential Pooled Plan Asset Vehicles should ensure that their fund documentation includes language sufficient to get comfortable that either (i) investing ERISA plans are not subject to an IPS or proxy voting policy that conflicts with the IPS or proxy voting policy of the Pooled Plan Asset Vehicle or (ii) to the extent an investing ERISA plan is or may be subject to such a conflicting IPS or proxy voting policy, the ERISA plan expressly or effectively agrees that its conflicting IPS or proxy voting policy will not apply and that instead the IPS and proxy voting policy of the Pooled Plan Asset Vehicle will apply.

Similarly, investment managers of ERISA plan investors (e.g., ERISA plan trusts or separately managed accounts or "funds-of-one" for such trusts) that are considering investing in a Pooled Plan Asset Vehicle, should consider reviewing the Pooled Plan Asset Vehicle's IPS and proxy voting policy (to the extent applicable) to ensure they comply with the requirements of the Final ESG Rules and to determine whether any action is necessary in regards to any conflicting or non-compliant policies. In addition, such investment managers should assess whether their own proxy voting policies (if any) comply with the requirements of ERISA and the Final ESG Rules. In particular, although the Final ESG Rules provide that an ERISA fiduciary investment manager may (but is not required to) adopt and follow prudently designed proxy voting policies, as of December 1, 2023, any such policy must not (i) prohibit voting on matters that the fiduciary prudently determines are expected to have a significant effect on the value of the investment or investment performance after taking into account the costs involved, or (ii) require the fiduciary to vote when the fiduciary prudently determines that the matter being voted upon is not expected to have such an effect after taking into account the costs involved.

* * * * *

As always, Proskauer is here to help investment managers of Pooled Plan Asset Vehicles and ERISA plans assess whether any action is required to be taken in order to comply with the Final ESG Rules.

State Regulation / Blue-Sky

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, such state may 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 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 all states, except Florida, now have a central electronic filing system for Rule 506 offerings, "The NASAA Electronic Filing Depository" usually referred to as the "EFD," which is currently required to be used for filings in many states, and possibly will be mandatory for all or most states in the not too distant future. EFD filings have become much more prevalent since the pandemic and, are in fact, a practical and convenient alternative to paper filings.

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. A handful of states also occasionally request to see copies of the offering materials provided in connection with the offering.

Employment Law

Non-Compete Legislation

Federal

On January 5, 2023, the Federal Trade Commission (the "FTC") proposed a new rule that would impose a near-complete ban on the use of non-competes by employers. This proposal comes on the heels of President Biden's 2021 Executive Order targeted toward promoting competition in the workplace. The rule proposal was the initial step in the rulemaking process, followed by a comment period. The FTC will review all comments prior to publishing a final version.

Under the Proposed Rule, the FTC asserts an authority to deem non-competition clauses to be an "unfair method of competition." The rule provides that an employer may not (1) enter into or attempt to enter into new non-compete clauses as of the Compliance Date (as defined below); (2) maintain pre-existing non-compete clauses as of the Compliance Date; or (3) represent to workers, under certain circumstances, that the worker is subject to a non-compete. The proposed rule will serve as a "regulatory floor" superseding any state law that is inconsistent with the new rule. If finalized, the rule would take effect 60 days after it is published in the Federal Register, and employers would have until 180 days after its publication (the "Compliance Date") to comply with its requirements.

Notably, the Proposed Rule provides a narrow exception for non-competes entered into by a person who is selling all or substantially all of a business entity's operating assets. The exception would only apply to an owner, member, or partner of a business who holds at least a 25% ownership interest in the business being sold. With only this narrow exception, legal challenges to test the FTC's power to issue such an expansive rule and to test the rule against judicial scrutiny under the major questions doctrine are inevitable.

As of this date, the FTC has not indicated when it might take further action to finalize the proposed rule. Follow our blog post for more information about and updates on the status of the FTC's proposed rule.

New York

After months of speculation and intense lobbying, on December 23, 2023, New York Governor Kathy

Hochul vetoed a bill that would have imposed a near-total ban on employee non-competition agreements in New York State.

Governor Hochul has long expressed her support for legislation banning non-compete agreements for "low and middle-income" employees earning $250,000 or less in total annual compensation, but generally balked at the idea of a blanket prohibition covering even highly compensated professionals and executives. The bill that passed both houses of the New York State legislature earlier in 2023 would have banned future non-compete agreements for all employees, regardless of earnings level.

In a statement explaining her veto, Governor Hochul lamented that she "attempted to work with the Legislature in good faith on a reasonable compromise," but was constrained to veto the proposed legislation with its "one-size-fits-all approach."

The Governor's veto does not necessarily signal the end for non-compete legislation in New York. The Governor's veto memo notes that she remains committed to enacting non-compete legislation protecting "middle-class and low-wage earners." The sponsors of the vetoed bill have promised to reintroduce the non-compete legislation this year. Governor Hochul could also introduce her own proposal by attaching it to the state budget.

California

Effective as of January 1, 2024, California employers are prohibited from entering, or attempting to enforce, non-compete agreements, regardless of where the agreement was signed. Previously, the Californian Business and Professional Code restricted non-competes entered within the state, but the new law amends this restriction to include contracts entered beyond the borders of California. The law allows an employee, former employee, or prospective employee to bring a private action to enforce the new law for injunctive relief, recovery of actual damages, or both. Additionally, prevailing employees, former employees, or prospective employees will be entitled to recover reasonable attorney's fees and costs.

This new law fortifies California's public policy interests against non-compete agreements and expands employees' enforcement rights for challenging these agreements in California courts. However, it remains to be seen how the law will interplay with principles of comity especially when out-of-state employers have secured judgments in other states. It is possible that employers will feel pressure to commence litigation to enforce non-competes in more favorable jurisdictions before a California court can strike down the agreement.

For more information on this amendment, see our blog post

Minnesota

Effective July 1, 2023, Minnesota enacted a near-complete ban on non-compete provisions in employment agreements. The new prohibition applies to both employees and independent contractors, regardless of the person's income. Although the prohibition went into effect on July 1, 2023, it does not apply retroactively to agreements entered into before the effective date.

The law defines non-competes as, "an agreement between an employee and employer that restricts the employee, after termination of the employment, from performing: (1) work for another employer for a specified period of time; (2) work in a specified geographical area; or (3) work for another employer in a capacity that is similar to the employee's work for the employer that is party to the agreement." The statute, however, does not clarify whether this prohibition extends to forfeiture for competition provisions linked to deferred compensation.

Where an employee primarily resides and works in Minnesota, the new law specifically prohibits employers from utilizing "choice of law" provisions to avoid Minnesota's ban. Courts may also award reasonable attorneys' fees to persons enforcing their rights under this law.

There are two key exceptions to the statute, and non-compete agreements will be valid and enforceable if: (i) they are entered into during the sale of a business; or (ii) they are entered into in anticipation of the dissolution of a business.

The law also specifically permits (i) "a nondisclosure agreement, or agreement designed to protect trade secrets or confidential information," and (ii) "a nonsolicitation agreement, or agreement restricting the ability to use client or contact lists, or solicit customers of the employer."

Confidentiality and Non-Disparagement Provisions

Federal

On February 21, 2023, in *McLaren Macomb*, 372 NLRB No. 58 (2023), the National Labor Relations Board (the "NLRB") held that employers infringe upon Section 7 rights under the National Labor Relations Act (the "NLRA") if they make offers of severance or separation payments to non-supervisory, non-managerial employees contingent upon agreement to confidentiality or non-disparagement clauses.

Following the *McLaren Macomb* decision, on March 22, 2023, NLRB General Counsel Jennifer Abruzzo issued a memorandum to Regional Directors confirming that the Board intends to take an aggressive approach when enforcing this new standard. In this memorandum, GC Abruzzo explained that confidentiality provisions in severance agreements are permissible only when (1) "narrowly tailored"; (2) targeted to proprietary or trade secret information; (3) limited in temporal scope; and (4) based on legitimate business justifications. GC Abruzzo further clarified that employers would be permitted to utilize "non-defamation" provisions in separation agreements but could not use broad non-disparagement provisions applying to all negative public statements.

For clarity, the new standard put forth by the NLRB applies to severance and separation agreements with any non-supervisory, non-managerial employee, regardless of union status. However, employers are still permitted to utilize confidentiality and non-disparagement provisions with supervisory or managerial employees, who are not afforded protections under the NLRA.

Notwithstanding *McLaren*, most private employers place a high value on the non-disparagement and non-disclosure provisions in their separation agreements and many non-unionized employers, weighing the risks, may not feel compelled to remove those provisions from their agreements in light of the NLRB's decision.

For more detailed information on this subject, see our blog posts here and here.

New York

Effective November 17, 2023, New York now prohibits any settlement or other resolution of a claim involving sexual harassment or any other form of unlawful discrimination or harassment from including any term or condition requiring the complainant to pay the defendant liquidated damages in the event the plaintiff violates a non-disclosure provision. Additionally, agreements are unenforceable if they require a forfeiture of all or part of the consideration for violation of a nondisclosure clause or require any affirmative statement, assertion, or disclaimer by the complainant that the complainant was not in fact subject to unlawful discrimination, including discriminatory harassment, or retaliation.

This new law comes as an amendment to the NY General Obligations Law. Beyond the prohibition of liquidated damages for violation of non-disclosure provisions, the amendment also eliminates the requirement that a complainant be provided a firm 21-day period to consider any confidentiality provisions of a settlement or resolution of a discrimination claim. Now, complainants must be provided "up to 21 days" to consider these terms but can decide any time within the 21-day period. However, the amendment does not change the 7-day period to revoke assent after signing a confidentiality provision.

Relatedly, a second new law, effective February 15, 2024, will extend the statute of limitations for any claim of unlawful discriminatory practice under the New York State Human Rights Law to three years. This new law comes as New York's Adult Survivors Act expired on November 24, 2023, which provided for a one-year period in which complainants could file civil suits for certain sexual offenses regardless of whether the statute of limitations on the claim had ended.

Virginia

Effective as of July 1, 2023, Virginia expanded its restrictions on the use of confidentiality, nondisclosure and non-disparagement agreements in circumstances involving allegations of sexual harassment.

HB 1895 amended Virginia's previous "Nondisclosure Agreement Law." The law previously prohibited employers from requiring employees or prospective employees "to execute or renew any provision in a nondisclosure or confidentiality agreement that has the purpose or effect of concealing the details relating to a claim of sexual assault." The amendment expands the scope of the law by prohibiting nondisclosure or confidentiality agreements that would conceal claims of sexual harassment.

This law applies to nondisclosure agreements, confidentiality agreements, and any agreement with a "provision relating to nondisparagement." For more information on these two laws, see our blog post.

Salary Disclosure Laws

Following the lead of Colorado and New York City, which previously enacted salary transparency laws, several additional jurisdictions enacted or passed their own salary disclosure laws in 2023.

New York

Effective September 17, 2023, New York State employers with 4 or more employees are now required to include a salary or salary range in job, promotion, or transfer opportunities. The job posting must advertise the salary or salary range the employer believes, in good faith, to be true at the time of posting, to give prospective applicants a legitimate idea of the expected pay.

The law applies to advertisements for jobs that "will physically be performed, at least in part, in the state of New York," including any position that "will physically be performed outside of New York but reports to a supervisor, office, or other work site in New York." This territorial coverage represents a more exacting standard than the New York City pay transparency law, which took effect in 2022. Notably, the City law expressly excluded "[p]ositions that cannot or will not be performed, at least in part, in the city of New York." Now, New York City employers must make sure to comply with the more stringent standard demanded under the New York State legislation.

For more information about the New York State pay transparency law, see our blog post.

California

Effective January 1, 2023, employers with 15 or more employees must include the anticipated pay scale in job postings. Further, employers are required to disclose positional salary ranges upon request from a current employee. The law also imposes additional reporting obligations on pay data as well as maintenance of job title and wage rate history for each employee for a specified timeframe.

Washington

Effective January 1, 2023, Washington State employers with 15 or more employees must include the opening wage scale or salary range of the job, and a general description of all benefits and other compensation offered, in each job posting. Disclosures must be made for job postings for positions based in Washington State and for remote work positions that could potentially be performed by an employee

residing in Washington State.

Rhode Island:

Effective January 1, 2023, employers with at least one employee in Rhode Island must disclose salary ranges for job applicants' and current employees' positions, if the applicant or employee requests it; for applicants, before discussing an offer of compensation; and for current employees, at the time of hire or before they move to a new position.

To find out more about the California, Washington, and Rhode Island pay transparency laws, click here.

Hawaii

Effective January 1, 2024, Hawaiian employers with at least 50 employees must disclose an hourly rate or salary range in job listings that reasonably reflects the actual "expected compensation." Unlike most other jurisdictions, the Hawaiian law's disclosure requirements do not apply to job listings for internal transfers or promotions. Public employee positions for which salary, benefits, or other compensation are determined under a collective bargaining agreement are also excluded from the pay transparency law. For more information, read our blog.

Illinois

Effective January 1, 2025, Illinois employers with at least 15 employees will be required to include "pay scale and benefits" in all job postings. This means employers must disclose the wage, salary, or wage or salary range that employers reasonably believe they will pay for the position, as well as a general description as well as the benefits and other compensation (including bonuses, stock options, or other incentives) that the employer expects to offer for the position. The law will apply to jobs performed at least in part in Illinois as well as jobs where the employee will report to a supervisor, office, or other work site in Illinois. Read our blog for more details on the Illinois law.

Massachusetts

The Massachusetts House and Senate are currently consolidating their similar, but not identical, pay transparency bills, with the expectation that a consolidated bill will eventually be signed by Governor Maura Healey. In the current versions of both bills, covered employers would be required to disclose the pay range for a particular position when posting the job opening. Employers also would be required to disclose the pay range when a current employee is offered a promotion or transfer to a new position with different job responsibilities, or when requested by a current employee or applicant.

Under both bills, "covered employers" are defined are those with 25 or more employees in Massachusetts. Similarly, out-of-state employers with 25 or more Massachusetts employees also would be subject to the law. These disclosure requirements also apply to "agents" of covered employers, such as placement agencies and recruiters. Pay range includes the "annual salary range or hourly wage range that the covered employer reasonably and in good faith expects to pay for such position at that time." Currently, the drafts do not mention bonus or incentives under pay range.

If a consolidated bill is agreed upon and signed by Governor Healey, it would go into effect one year from the date of signing. For more details on the proposed legislation, click here.

Temporary Workers and Independent Contractors

Federal

On January 2, 2024, the U.S. Office of Information and Regulatory Affairs completed its review of the Department of Labor's (the "DOL") proposed "final rule" on independent contractor classification under the

Fair Labor Standards Act (the "FLSA"). The final rule will codify the DOL's "general interpretations for determining whether workers are employees or independent contractors under the FLSA" and endorse a multi-factor "economic realities" test determining classification similar to the one used by many federal courts (and by the DOL prior to the Trump administration). The DOL's final rule emphasizes that an analysis of independent contractor classification must consider the "totality of the circumstances" and evaluate the following six factors, with none necessarily considered dispositive:

- **1. Opportunity for profit or loss depending on managerial skill:** This factor considers whether the worker exercises managerial skill that affects the worker's economic success or failure in performing the work. Relevant considerations include whether the worker determines or can meaningfully negotiate the charge or pay for the services provided; whether the worker accepts or declines jobs or chooses the order and/or time in which the jobs are performed; whether the worker engages in marketing, advertising, or other efforts to expand their business or secure more work; and whether the worker makes decisions to hire others, purchase materials and equipment, and/or rent space. If a worker has no opportunity for profit or loss, the factor suggests that the worker is an employee.
- **2. Investments by the worker and the potential employer:** This factor considers whether any investments by a worker are "capital or entrepreneurial" in nature and would "generally support an independent business and serve a business-like function, such as increasing the worker's ability to do different types of or more work, reducing costs, or extending market reach."
- **3. Degree of permanence of the work relationship:** This factor supports a determination of employment "when the work relationship is indefinite in duration or continuous, which is often the case in exclusive working relationships." Conversely, the factor supports a finding of independent contractor status "when the work relationship is definite in duration, non-exclusive, project-based, or sporadic based on the worker being in business for themself and marketing their services or labor to multiple entities."
- **4. Nature and degree of control:** This factor considers both active and reserved control (e.g., the right to control) by the entity receiving the services over "the performance of the work and the economic aspects of the working relationship," including whether the engaging entity sets the worker's schedule, has the ability to discipline the worker, limits the worker's ability to work for others, etc.
- **5. Extent to which the work performed is an integral part of the employer's business:** This factor does not depend on whether any individual worker in particular is an integral part of the business, but rather whether the function the worker performs is an integral part—e.g., whether it is "critical, necessary, or central to the [engaging entity's] principal business."
- **6. Skill and initiative:** This factor considers "whether the worker uses specialized skills to perform the work and whether those skills contribute to business-like initiative." It supports employee status where the worker does not use specialized skills in performing the work or "where the worker is dependent on training from the employer to perform the work."

Absent a legal challenge, we expect that the DOL's final rule on these factors will be codified in early March 2024. These factors align with the approach already utilized by many federal courts and should not require any major adjustments from most employers. However, employers should remain vigilant about their compliance with more stringent independent contractor laws already in effect in many states.

For a more detailed discussion of this topic, please see our blog posts here and here.

New Jersey

New Jersey's Temporary Workers Bill of Rights went into effect on August 5, 2023, with the hire notice requirement and non-retaliation provisions effective as of May 7, 2023. The law covers temporary workers who are assigned to work by a temporary help service firm in a "designated classification placement," including certain workers in food preparation and service, building and grounds cleaning/maintenance,

personal care and service, construction, and transportations occupations, among others. Covered temporary workers must be paid no less than the average rate of pay and cost of benefits provided to direct employees in similar positions with similar skills.

The new law prohibits these service firms from restricting the rights of temporary workers to accept permanent employment and limits the amount these service firms can charge in placement fees. These service firms must also apply for and receive certification from the New Jersey Division of Consumer Affairs. Under the new law, employers contracting with temporary service firms will be jointly and severally liable for any violations of both the wages and placement fee notice provisions.

Following passage, the New Jersey Department of Labor & Workforce Development proposed new rules to implement the law, including clarifications on scope of the law, benefits provided, placement fee calculation, pay rates, and detailed itemized statements, among others. The comment period for the proposed regulations expired on September 21, 2023, and no further action has been taken.

Read our blog posts on the new law and proposed regulations.

Illinois

As of August 4, 2023, Illinois temporary workers assigned to work at a third-party employer for more than 90 calendar days must be paid at a rate equal to the lowest-paid comparable employee of the third-party employer. Comparable employees are those with "the same level of seniority at the company and performing the same or substantially similar work on jobs the performance of which requires substantially similar skill, effort, and responsibility, and that are performed under similar working conditions." A temporary worker must also receive the same benefits, or equivalent benefits, as comparable employees.

The new law does not apply to temporary workers in positions of a "professional or clerical nature." Also, if requested, third-party employers will be required to provide temporary staffing agencies with any relevant information related to employee job duties, pay, and benefits, with a fine of $500 for failure to timely provide.

Learn more here.

New York

New York State's "Freelance Isn't Free Act" will go into effect on May 20, 2024. The law will only apply to contracts entered into on or after that date. The new law provides certain protections for freelance workers, mirroring protections in the New York City law, which took effect in May 2017.

The law provides the definition for a "freelance worker," which includes any natural person or organization composed of no more than one natural person, whether or not incorporated or employing a trade name, that is hired or retained as an independent contractor by a hiring party to provide services in exchange for an amount equal to or greater than $800, either by itself or when aggregated with all contracts for services between the same hiring party and freelance worker during the immediately preceding 120 days.

When a hiring party retains a freelance worker's services, the terms must be listed in a written contract between the parties and provided to the freelancer as either a physical or electronic copy. The law details information that must be included in the contract, such as (i) the names and address of the parties, (ii) an itemization of services, (ii) a date and mechanism for payment of contracted compensation, and (iv) a date to submit the list of services rendered. The hiring party must retain a copy of the contract for at least six years. The Commissioner of Labor is empowered to enforce the law through the issuance of rules, to investigate workers' complaints, and to award remedies, including civil and criminal penalties.

Find out more information about this law, see our blog post here.

Harassment and Discrimination

New York City

Effective November 26, 2023, anti-discrimination protections under the New York City Human Rights Law have been expanded to protect individuals from discrimination in employment, housing, and access on the basis of height and weight.

Employers are now prohibited, among other things, from refusing to hire or employ an individual or discriminating against them as to compensation or other terms, conditions, or privileges of employment on the basis of height and weight. The law also restricts the ability of any employer, labor organization or employment agency to publish "any statement, advertisement or publication, or to use any form of application for employment or to make any inquiry in connection with prospective employment, which expresses, directly or indirectly, any limitation, specification or discrimination" as to height or weight.

An affirmative defense is, however, available to employers if they are able to demonstrate that (i) a person's height or weight prevents the person from performing the essential requisites of the job, and there is no alternative action the covered entity could reasonably take that would allow the person to perform the essential requisites of the job; or (ii) the decision based on height or weight criteria is reasonably necessary for the execution of the employer's normal operations.

For more information, please see our blog post.

Paid Leave Laws

Illinois

Effective January 1, 2024, the "Paid Leave for All Workers Act" requires Illinois employers to provide at least 40 hours of paid leave per year to be used for any reason. The new law will provide most Illinois employees with paid leave to be used at their discretion.

The act applies to all private sector employers, of any size, state, and local governments. Most Illinois employees are covered except: (i) those covered by the federal Railroad Unemployment Insurance Act or Railway Labor Act; (ii) certain student employees; and (iii) short-term higher education employees. Employees will have access to leave at the later of 90 days after the beginning of their employment or 90 days after the effective date of the law.

Paid leave may be taken for any reason, and employees are not required to provide a reason to their employer and cannot be asked for documentation or certification of the reason for the leave. Employees may file a complaint with the Illinois Department of Labor within three years of an employer's alleged violation of the Act. Employers found to have violated the Act are subject to actual damages, compensatory damages, attorneys' fees/costs, and equitable relief. Additionally, an employer that violates the Act also will be subject to a civil penalty of $2,500 for each separate offense.

For more details on the Illinois Paid Leave for All Workers Act, see our blog post.

Maine

Maine has enacted the Maine Paid Family Leave Insurance Program (the "PFML"). The PFML will require employers and employees to begin contributing to a paid Family and Medical Leave Insurance fund on January 1, 2025, with the processing of claims beginning May 1, 2026.

The program provides wage-replacement benefits to eligible persons who are on family medical leave from employment. The law will cover nearly all employees in Maine, including private and public sector workers. It will cover employees regardless of employer size and include full time, part-time, temporary, and

seasonable workers.

Leave provided includes medical, caregiving, parental, safe, and deployment related leave. To be eligible for the benefits, a worker will need to have earned at least six times the state average weekly wage in total over the base period. Workers can receive up to 12 weeks of leave per benefit year and will receive 90 percent of the portion of their weekly wages that is less than or equal to 50 percent of the state average weekly wage plus 66 percent of the portion of their weekly wages that is more than 50 percent of the state average weekly wage.

For more information on Maine Paid Family Leave Insurance Program, see our blog post.

California

Effective January 1, 2024, an amendment to California's statewide paid sick leave law will increase the minimum amount of sick leave time eligible employees must accrue each year from three days to five days. While many California cities already mandate 48-72 hours of paid sick leave per year, workers outside of these areas will now have their sick leave significantly expanded.

The new law also raises the total amount of paid sick leave that employers must allow employees to accrue over time and carry over from one year to the next from six days to 10 days.

For a detailed look at the new law see our blog post.

New York City

Effective October 15, 2023, New York City employers must ensure that their safe and sick leave policies comply with amendments to the city's Earned Safe and Sick Time Act (the "ESSTA"). The ESSTA requires that New York City employers provide employees with time off each year to address illness, injuries, or health conditions that affect them or their family members. Additionally, the leave can be used to seek services for legal or mental health counseling for family members who have been victims of domestic violence, sexual offenses, stalking, or human trafficking.

The amount of leave provided depends upon the size of the employer:

- Employers with 4 or fewer employes with a net income of less than $1 million in the prior tax year are required to provide 40 hours of unpaid sick and safe leave.
- Employers with between 5 and 99 employees and employers with 4 or fewer employees and a net income of greater than $1 million in the prior tax year are required to provide each employee with up to 40 hours of paid sick and safe leave per year,
- Employers with 100 or more employees are required to provide up to 56 hours of paid sick and safe leave per year.

Notably, the employer's size for purpose of the ESSTA is calculated based on the number of employees nationwide, and the calculation will include employees under a joint-employment agreement and those on paid or unpaid leaves of absence so long as the employer reasonably expects the employee to return.

Virtual workers, however, will only be entitled to the ESSTA leave if they: (i) perform work, including virtual work, while physically located in New York City, regardless of the employer's location; or (ii) have a primary work location outside of New York City, but regularly perform, or are expected to regularly perform, work within New York City during a calendar year.

For more information on the amendments to the ESSTA see our blog post.

Artificial Intelligence

New York City

Effective July 5, 2023, the New York City Automated Employment Decisions Tools Law ("AEDT") requires that any employer using an AEDT to hire or make a promotion decision must have an independent auditor conduct an annual "bias audit" on the AEDT.

An AEDT is defined as any computational process, derived from machine learning, statistical modeling, data analytics, or artificial intelligence, that issues simplified output, including a score, classification, or recommendation, that is used to substantially assist or replace discretionary employment decisions that impact natural persons. Under this definition, an AEDT is likely only covered by the new law if its output is the most significant or only driving factor in a hiring decision or promotion.

The law will also require employers or employment agencies to provide notice to candidates and employees who reside in New York City that an AEDT will be used. Employees and candidates are entitled to notice of the qualifications and characteristics that the AEDT will consider and to request the use of an alternative selection process.

Employers or employment agencies using an AEDT must disclose on their website the date that they began using the program and the date of the most recent bias audit with a summary of the results. This information must remain posted online for at least six months after the latest use of the AEDT for an employment decision.

For more information on New York City's new law on AEDTs see our blog post.

Executive Compensation

The Mobile Workforce and Related Complexities

COVID-19 work-from-home policies helped to usher in a host of changes to the work environment. Although companies have generally been encouraging or requiring employees to return to the office on a more regular basis, some version of "working from home" or "remotely" appears to be here to stay. As a result, employees have more opportunities than before; they do not need to move to take a new job and they can move without having to change jobs. A positive for employers is greater access to talent — the talent pool is no longer limited to just those individuals who are located near a specific office of the company. But, how do you retain employees when opportunities abound? Employers have both "carrots" and "sticks" in their toolbox to overcome this challenge.

Recently, we have seen an uptick in employers offering retention bonuses. These bonuses can be designed to pay out solely based on continued employment or they could include performance conditions (or both). Similarly, existing compensation programs can be designed to reward both specific company goals as well as "soft" goals that seek to develop a strong company culture. For example, there has been increased prevalence of performance metrics tied to environmental, social and governance issues affecting a company's business. On the flip side, employers could potentially use restrictive covenant agreements (i.e., noncompetition and non-solicitation of customer and employee clauses) to limit employee movement and reduce turnover. These are not perfect solutions. For example, many states already restrict the use of restrictive covenant agreements and other states are seeking to pass laws to restrict their use, and the federal government is looking to restrict their usage as well.

In addition to retention issues that are raised as a result of a more mobile workforce, "remote" work raises other complexities, including:

> **Employer withholding may be impacted**. Each state has its own laws that should be consulted. Many states assert the right to tax an employee's income if the employee works (or

is deemed to be working) within the state. These states typically also require the employer to withhold state (and local) income taxes from the employee's wages, and the penalty for failure to withhold is requiring the employer to pay the tax (and interest and possibly penalties) that it failed to withhold. To comply with these requirements, employers might have to register and withhold taxes in states where they did not previously do business.

- **Employees are exposed to potential double tax**. If an employee works remotely from a state other than the state where the employer has previously done business, the employer may be required to withhold income taxes in both states with respect to wages paid for work done (or deemed to be done) within each state, and the employee might not receive a tax credit in either state for the withholding tax paid to the other.[50] In some cases, this may result in double taxation on an employee's wages. For example, New York State has a rule that generally treats an employee who is principally assigned to an employer location in New York but works remotely out of state as if he or she were physically working in New York on those remote working days, so as to subject the employee's income to New York taxation.[51] New York does not provide a credit for taxes paid to the state where the employee actually works. This means the employee can end up having to pay taxes in both New York and the state where they actually work.
- **Employers could have to pay additional taxes**. In many states, the mere presence of employees in the state can create "nexus" for the employer in that state, which could (i) subject the employer itself to state (and local) income taxes and tax filing obligations; (ii) obligate the employer to collect and pay over state sales taxes; and/or (iii) require the employer to register to do business in that state.
- **For non-exempt employees, it may be more difficult to track hours worked and meal breaks.**
- **Employers need to manage providing tools for remote work**. For example, being required to provide laptop computers and phones to employees are obvious, but things like ergonomic support, paper, and ink can be more complicated. Some state laws impose minimum requirements on employers.

Profits Interests vs. Phantom Carry

Compensation packages for private fund advisers typically include performance incentives that align their compensation with the private fund's performance and the timing of distributions made by the private fund. Traditional profits interests (carry) are often attractive, because they provide a way for compensation to be taxed at the lower capital gains rate rather than ordinary income rates. Also, profits interests can often be subject to forfeiture (or buy-back for an amount below fair market value) upon breach of a restrictive covenant, so profits interests can be used as a carrot to incentivize compliance with any such covenants. An important drawback, however, is that holders of profits interests generally have to be treated as partners for tax purposes (and cannot be treated as employees of the issuer), which means the sponsor is required to provide annual K-1s (even before they are vested) to the recipient.

"Phantom" carry arrangements are a way to mirror the economics of a profits interest, but without treating employees as partners. There are two key drawbacks to a phantom carry arrangement. First, payments under the arrangement are treated as ordinary income that is subject to withholding for income and employment taxes (at rates that are generally higher than capital gains rates). Second, phantom carry arrangements are subject to Section 409A of the Internal Revenue Code (and, for some advisers and private funds, Section 457A).[52] This means that phantom carry arrangements typically must specify a

[50] Currently 16 states and the District of Columbia have reciprocal agreements that permit residents to only pay income tax in their state of residence.

[51] A petition has been filed with the New York Division of Tax Appeals challenging this rule, which is still in the appeals process and awaiting a decision. See *In the Matter of the Petitions of Edward A. and Doris Zelinsky*, New York Division of Tax Appeals, Determination Nos. 830517 and 830681 (Hearing April 24, 2023).

[52] In general, Section 457A applies to (1) foreign corporations with respect to which significant income is not subject to tax in the

payment schedule that is not aligned with the timing of distributions made by the private fund pursuant to the LLC or partnership agreement. Failure to have a compliant payment schedule would result in accelerated income tax on the full value of the award (before the recipient is paid and before there is an underlying distribution by the fund to generate cash) plus an additional 20% tax and potentially other penalties. The taxes fall on the employee, but the employer also 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:

- **Condition payment on the employee remaining employed until shortly before the payment is made.** This approach is useful for retention, but can cause problems if the private fund has a long investment horizon, because recipients would not have any "vested" interest if they resign or terminate employment involuntarily.
- > **Specify a payment schedule that complies with the requirements of Section 409A.** (This approach is not available if the private fund is subject to Section 457A.) To comply with Section 409A, the arrangement must specify in advance that payment will be made upon a specified 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.

Defensive Compensation Elements: Employment-Related Clawbacks

While we generally view performance compensation as a "carrot" to align the financial interests of service providers with those of private fund entities and their investors, it is important to not overlook the other side of the coin – disincentives.

Compensation clawbacks have long been a focus in the financial industry and public company spaces. Private funds can also consider adopting clawbacks with respect to certain compensation arrangements. Compensation clawbacks can serve a number of purposes. First, clawbacks can be structured to recoup payments that were made improperly (whether because of flawed accounting or otherwise), and in this case would typically track closely to public company-style clawbacks contemplated by the Dodd-Frank Act. The SEC adopted the long awaited final regulations to implement the Dodd-Frank clawback provisions (the "Final Rules") on October 26, 2022, which were codified in the formal listing standards adopted by the national securities exchanges to implement the Final Rules that became effective on October 2, 2023. Accordingly, listed companies had until December 1, 2023 to adopt a compliant written clawback policy and must also meet any additional compliance requirements issued by the national securities exchanges,[53] or be subject to delisting for noncompliance. The written clawback policy under the exchanges' formal listing standards must meet certain minimum requirements requiring the recovery of "erroneously awarded" incentive-based compensation received by an executive officer (*regardless of whether the officer was at fault*). Additionally, the U.S. Department of Justice (the "DOJ") has (i) released revised clawback guidance, and (ii) launched a three-year clawback pilot program (the "Program") effective March 15, 2023.[54]

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 sponsored by U.S. managers are subject to Section 457A.

[53] Issuers listed on the NYSE must confirm through the Listing Manager no later than December 31, 2023 that they have either timely adopted a compliant compensation clawback policy or that they are relying on an applicable exemption under the NYSE listing standards. We note that Nasdaq has not announced any similar requirement(s) at this time, and we are monitoring for any further updates.

[54] The Program (a) provides that when entering into criminal resolutions, companies will be required to implement compliance-related criteria in their compensation and bonus structures and to report annually to the DOJ about such implementation during the term of such resolutions, and (b) directs DOJ prosecutors to consider possible fine reductions where companies seek to recoup compensation from culpable employees and others who both (1) had supervisory authority over the employee(s) or business area engaged in the misconduct and (2) knew of, or were willfully blind to, the misconduct.

Therefore, public companies now must navigate two different regimes when implementing a clawback policy (i.e., the SEC's civil no-fault approach and the DOJ's focus on criminal culpability), which is further discussed along with the interaction of the Final Rules and the DOJ's clawback guidance in our blog post and this Law360 article. Moreover, these are not the only clawback regimes that companies must be attentive to – for example, Section 304 of the Sarbanes-Oxley Act imposes, by statute, severe financial penalties on CEOs and CFOs if the financial statements issued by their company are determined to have been materially inaccurate and proxy advisors (such as ISS and Glass Lewis) have also pressured public companies to have clawback policies that are broader than those required by the Final Rules to pick up more people and cover a broader array of circumstances triggering clawback. In light of the various clawback regimes in effect, from the Sarbanes-Oxley Act, to the Final Rules, and the proxy advisors' and the DOJ's focus on executive compensation, a multidisciplinary approach should be considered when reviewing, implementing and enforcing any clawback policies, particularly with respect to public companies. Second, clawbacks can be structured with an eye toward retention – for example, a clawback of a significant signing bonus or relocation fringe benefit if a service provider resigns prior to a stated date (typically 12- 24 months following commencement of service). Third, clawbacks can be structured to dis-incentivize certain types of behavior, for example misconduct or breach of restrictive covenants. This type of clawback functions like liquidated damages; it tends to be the most controversial with service providers and most complicated to enforce.

Compensation clawbacks can apply to a range of compensatory elements, including in the context of cash compensation and cash fringe benefits (for example, bonuses – including signing bonuses, and relocation reimbursements), as well as carried interest and/or portfolio company equity or equity-linked incentive gains. In structuring a clawback provision and/or policy, consider the behavior that the clawback is intended to incentivize/dis-incentivize, the desired length of the clawback, and whether the clawback should be based on pre-tax or after-tax amounts. This final consideration is often negotiated, as clawbacks that occur in a tax year that follows the tax year of payment can lead to a service provider not being able to recover the full tax benefit of the repayment.

Compensation clawbacks may be further complicated by state laws concerning earned wages. To give a clawback provision and/or policy a better chance of success, clawbacks should be in writing and agreed to by the fund entity and service provider at the outset of service, and employment/labor counsel should be involved to address state-specific considerations. Enforcing a clawback may result in litigation and attendant negative publicity, so fund entities might wish to consider including arbitration clauses and otherwise relying on the clawback more for its chilling effect than for purposes of recovery of the underlying funds.

Notably, the clawbacks discussed above are separate and apart from clawbacks in fund documents that tie to fund performance (i.e., clawbacks that permit recovery of carry that is distributed before limited partners receive their full return, particularly prevalent in American waterfall structures). Interestingly, the issue of pre-versus post-tax recovery has come up in the context of these clawbacks in connection with the SEC's proposed and adopted rules under the Advisers Act. On August 23, 2023, the SEC adopted the "Private Funds Rules", which include the "Restricted Activities Rule", that reform the regulation of private fund advisers under the Advisors Act and became effective on November 13, 2023. These adopted rules are described in greater detail under the heading "SEC Policy and Rulemaking Updates".

Debt-to-Equity Transitions and Out-of-Court Restructurings

After years of strong growth, and ready availability of both public and private credit, we have entered into an era of greater volatility and a more uncertain market. This has resulted in some companies having a harder time repaying their debt and some others defaulting on their debt covenants entirely. In some cases, this has resulted in private credit parties restructuring their positions in the company and taking some form of equity position.

While the structuring aspects of these arrangements is beyond the scope of this short article, we would like to focus on the opportunities that these restructured arrangements create for incentivizing employees even in out-of-court restructuring scenarios. Equity-based incentive structures in these scenarios are often

similar to equity-based incentive structures in general, non-distressed situations. Existing equity incentives may need to be modified or adjusted to align with the company's post-restructuring organization and goals. In addition, creditors and lenders may address how to incentivize "pre-equity" performance, that is performance that must occur in order for the equity to come into the money at all.

In these circumstances, the flexibility of private credit arrangements is a significant asset to incentivize and align performance. "Pre-equity" incentive plans all share one fundamental feature – they provide for executives and other members of management to share in value that would have otherwise only been available for distribution or payment to regular or convertible debt-holders. Beyond this common denominator, there are a number of levers that can be adjusted to drive the specific behavior that the debt- and equity-holders would like to incentivize. For example, payment can be made as debt is paid down, upon an "exit" or other significant capital transaction, or upon some combination of these triggers. The amount payable can be calculated as a simple percentage of the payment on some or all of the debt or payment can be determined through a more nuanced formula that takes into account other factors such as the types of debt being repaid and other financial, strategic, and/or operational metrics. Unlike equity arrangements, "pre-equity" arrangements will generally be taxed as compensation to the individuals, without the potential tax advantages of equity incentives such as profits interests which in some cases can benefit from capital gains tax rates.

As with other forms of compensation, care should be taken in structuring these types of arrangements in a manner that does not result in additional tax (including Section 409A or Section 457A if the private fund is subject to Section 457A) and companies should work closely with their tax preparers and accountants in order to fully understand the tax reporting and accounting consequences of these awards.

Estate Planning

Inflation Indexing – Federal Estate and Gift Tax Exemptions Continue to Increase, but Decrease in 2026 is Looming

On January 1 of each year, the federal lifetime estate, gift and generation-skipping transfer ("GST") tax exemption amount (also known as the "Basic Exclusion Amount") is adjusted for inflation. The Basic Exclusion Amount increased to $12,920,000 per individual (or $25,840,000 for a married couple) in 2023. Similarly, the annual gift tax exclusion amount also increased to $17,000 per individual (or $34,000 per married couple) in 2023.

On November 9, 2023, the IRS published Rev. Proc. 2023-34, which provides the tax inflation adjustments for tax year 2024. On January 1, 2024, the Basic Exclusion Amount will increase to $13,610,000 per person (or $27,220,000 per married couple), which is an increase of $690,000 per individual from the prior year. Also on January 1, 2024, the annual gift tax exclusion amount will increase to $18,000 per person ($36,000 for a married couple). By January 1, 2025, the exemption amount is projected to be in the neighborhood of $14,000,000 per person ($28,000,000 for a married couple). However, under current law, the lifetime estate and gift tax exemption is scheduled to be cut in half on January 1, 2026. Therefore, it is important for clients to consider taking advantage of these record high exemption amounts now, before they are reduced in 2026.

The historically high exemption amounts, coupled with the economic downturn in the market, have created an optimal time to transfer wealth. Using tax-efficient wealth transfer strategies, donors can leverage their exemptions and take advantage of market volatility by transferring currently-undervalued property.

Increasing Interest Rates, Increasing Exemption Amounts and Estate Planning Opportunities

Interest rates have drastically increased from their historic lows. At the same time, the federal estate, gift and GST tax exemption amounts have also substantially increased. This combination makes it an optimal time for individuals to leverage their increased exclusion and exemption amounts by passing assets to the next generation and reducing their estate, gift and income tax exposure. Just as increasing rates make

certain investment strategies more attractive, a higher interest rate environment and increased exemption and exclusion amounts bring certain estate planning techniques into focus.

Clients who have not yet used their full Basic Exclusion Amount should consider creating long-term trusts (sometimes referred to as "dynasty trusts") for the benefit of their descendants and other family members (which can include spouses). Certain jurisdictions allow such trusts to last in perpetuity. Therefore, under current Federal law, as of January 1, 2024, it will be possible to transfer up to $13,610,000 per grantor into such a trust, and avoid the imposition of Federal and state estate tax on the assets in the trust on the death of the grantor and on the deaths of future generations.

For clients who already have used most of their Basic Exclusion Amount but want to make additional wealth transfers, one effective technique in this environment is the qualified personal residence trust ("QPRT"). A QPRT is created by transferring title to a personal residence, which could be either a principal home or a vacation home, to a trust that contains certain provisions required by the Internal Revenue Code. Generally, an individual is permitted to transfer no more than two residences to a QPRT. The trust provides that the trust creator (the "Grantor") retains the exclusive right to live in the personal residence for a specified number of years (the "Trust Term"). During the Trust Term, the Grantor continues to be responsible for paying property taxes and other expenses related to the maintenance of the personal residence. At the end of the Trust Term, title to the personal residence is distributed in accordance with the provisions of the QPRT (*i.e.*, to children or a continuing trust for their benefit). During the Trust Term, the trustees are permitted to sell the residence and purchase a new one for the Grantor. If the cost of the new residence is more than the proceeds from the sale of the old one, the Grantor can pay the difference and co-purchase a new home with the trust. If the new residence costs less, the excess proceeds from the sale of the old residence can be returned to the Grantor or remain in the trust with the Grantor receiving an annuity from the cash (in an amount determined by certain tables published by the IRS) and with the remainder beneficiaries receiving any cash remaining at the termination of the QPRT.

Upon creating the QPRT, the Grantor has made a gift. The value of the gift is determined by subtracting the value of the Grantor's retained right to live in the personal residence from the fair market value of the personal residence at the time it is transferred to the QPRT. The value of the Grantor's retained right to live in the personal residence is determined actuarially, using statistical tables and interest rates published each month by the Internal Revenue Service. The value of the retained interest and the gift depends on prevailing interest rates, the length of the Trust Term and the Grantor's age. As interest rates increase, the value of the Grantor's retained interest also increases, resulting in a decrease in the amount of the gift. Therefore, a QPRT can be a very effective strategy when interest rates are relatively high. Upon expiration of the Trust Term, the personal residence, including any appreciation in its value, passes pursuant to the terms of the QPRT without any further exposure to gift tax.

Corporate Transparency Act – Impact on Trusts and Private Investment Funds

Effective January 1, 2024, the Corporate Transparency Act ("CTA") will require certain domestic and foreign entities ("Reporting Companies") to disclose their Beneficial Owners to the Treasury Department's Financial Crimes Enforcement Network ("FinCEN"). Pursuant to the Act, a domestic Reporting Company is defined as a corporation, limited liability company, or "other similar entity" created by the filing of a document with the secretary of state or similar authority within the United States. A foreign Reporting Company includes any foreign entity that is registered to do business in the United States.

Unless a Reporting Company falls within one of the twenty-three types of entities that are exempt, Reporting Companies formed on or after January 1, 2024, must file their initial report within 90 days of receiving their notice of formation or registration. Reporting Companies that were formed or registered prior to January 1, 2024, have until January 1, 2025, to submit their initial report. According to the CTA, a Beneficial Owner is any individual who, directly or indirectly, either (1) exercises substantial control over the Reporting Company, or (2) owns or controls at least 25% of the ownership interests of a Reporting Company.

The CTA represents a significant step forward in enhancing transparency to combat illicit financial activities within the corporate landscape by establishing new reporting and compliance obligations for foreign and

domestic Reporting Companies. Enacted to address concerns related to money laundering, tax evasion, and other financial crimes, the CTA's broad language has implications that extend far beyond traditional corporate entities, encompassing a variety of legal structures including private investment funds, trusts, and other entities structured to facilitate investment by a group.

While the CTA aims to enhance transparency, it raises concerns about the privacy of individuals involved in trust structures. Trusts do not meet the definition of a Reporting Company. However, a trust can be a Beneficial Owner of a Reporting Company. For trusts, the reporting requirement also captures individuals with significant control over the trust, such as the trustee, grantor and each beneficiary or class of beneficiaries. Furthermore, reporting may also be required with respect to limited liability companies, partnerships, and other entities commonly used for business and estate planning purposes.

The implications of the CTA are still evolving. However, the CTA undeniably represents a major shift in reporting enforcement for companies and Beneficial Owners. As regulations and guidance continue to be refined, fiduciaries will need to carefully adapt trust planning strategies to balance transparency compliance, administrative feasibility, and flexibility for grantors and beneficiaries.

The Impact of Revenue Ruling 2023-2 on Estate Planning

On March 29, 2023, the IRS issued Revenue Ruling 2023-2, which clarifies the IRS' long-time unsettled position regarding the basis adjustment for assets owned by an irrevocable grantor trust on the death of the grantor. The IRS determined that the assets held in an irrevocable grantor trust do not receive a "step-up" in income tax basis to fair market value under section 1014(a) of the Internal Revenue Code if the trust assets are not includible in the deceased grantor's estate gross for federal estate tax purposes. Even though the grantor trust's owner is liable for federal income tax on the trust's income, the assets of the grantor trust are not considered as acquired or passed from a decedent by "bequest, devise, inheritance," or otherwise within the meaning of section 1014(b), and therefore section 1014(a) does not apply on the death of the grantor.

As noted above, section 1014(a) of the Code is extremely desirable for heirs, as it provides that upon a decedent's death, property inherited from the decedent generally receives a "step-up" in income-tax basis. This may allow the heirs to sell the inherited assets shortly after the decedent's death without generating much, if any, capital gain tax liability. Therefore, Revenue Ruling 2023-2 is a reminder that the income tax implications of lifetime gifts must always be weighed carefully before a transfer is made.

Generally, it is recommended that clients transfer high-basis assets, rather than low-basis assets, to an irrevocable trust to mitigate the cost of any foregone basis step-up. Individuals who have settled irrevocable trusts that now hold highly appreciated assets (with low basis) should consider substituting higher-basis assets in their place (if the trust contains a substitution power) so that the low-basis assets are owned by the individual personally, rather than the trust, on his or her death and therefore receive a step-up in basis under Code section 1014(a) on the death of the decedent.

Shareholder Activism

Effect of Mandatory Use of Universal Proxy Cards in Contested Elections

As discussed in last year's report, on August 31, 2022, the SEC's newly adopted amendments to the proxy rules requiring the use of a "universal proxy card" in all non-exempt director election contests became effective, making the 2023 proxy season the first in which the use of universal proxy cards was mandated. Despite predictions that the new rules would result in an increased level of shareholder activism, activism activity in the United States remained largely flat in the first half of 2023. According to Insightia, there were 403 targets subject to activism in the first half of 2023, as compared to 406 during the prior year period. The number of new campaigns initiated in the United States in the first half of 2023 decreased by approximately 23% as compared to the prior year, while new activist activity in Europe and Canada increased by 41% and 333%, respectively, according to Barclays H1 2023 Review of Shareholder Activism.

Of the campaigns seeking board seats in the first half of 2023, Insightia reports that there was an approximately 40% decrease in the number of campaigns that were ultimately submitted to a shareholder vote in the U.S. as compared to the prior year period. There was also a greater percentage of board campaigns resolved by settlement – a trend to monitor going forward. Of the campaigns that were submitted to a shareholder vote, dissident nominees recommended by ISS enjoyed an approximately 75% winning percentage, as compared to 54% in the prior year period, indicating that the required use of universal proxy cards in contested elections may enhance the power of proxy advisory firms in effecting the outcome of such elections. On the other hand, predictions that the universal proxy rules would result in activists nominating larger slates relative to past years and initiating more single-issue campaigns due to decreased barriers to entry proved unfounded during the 2023 proxy season.

Advance Notice Bylaws

Since adoption of the new universal proxy rules, many public companies have undertaken to amend their bylaws in order to address these new rules. A large subset of these companies have also used these amendments as an opportunity to enhance the advanced notice requirements in their bylaws, which generally set forth the process and procedures upon which an activist may nominate candidates to serve on the board of directors of a target company.

Delaware courts have historically upheld extensive advance notice requirements as promoting orderly election contests by prescribing a timeline upon which nominations may be made and providing disclosure to the target's board regarding the nominating shareholder and its proposed candidates. However, since the adoption of the universal proxy rules, a number of activists challenged the adoption and/or application of advance notice requirements as preclusive of their fundamental right to participate in the voting process and nominate directors, with mixed results.

During the 2023 proxy season, courts have continued to uphold extensive advance notice requirements, which have resulted in the disqualification of nominations at companies such as AIM Immunotech and Paragon Technologies.

On the other hand, companies in some situations have backed down in the face of shareholder opposition to advance bylaw requirements. In one high profile situation, Politan Capital challenged as preclusive of its ability to nominate directors, an amendment to the bylaws of Masimo Corporation that required a nominating shareholder to disclose, among other things, the names of all passive limited partners and its plans for nominations at other companies. Masimo ultimately removed these requirements from its bylaws in the face of broad public sentiment against them and impending litigation in which many believed Masimo would not prevail. A number of other situations arose during the 2023 proxy season in which challenges to advance notice requirements were resolved through settlements, allowing the activist's nominees to stand for election.

A recent decision in *Kellner v. Aim Immunotech Inc.* offers valuable insight into how the Delaware Chancery Court will scrutinize advance notice bylaws in the face of challenge and predicts that the spotlight on advance notice requirements is likely to remain bright. In this case, the Court upheld the target company's rejection of a nomination notice on the basis that it did not comply with certain valid advance notice requirements, but also invalidated some of the company's advance notice bylaws on the basis that they are "disproportionate responses to any threatened corporate objectives." In doing so, the Court noted the following:

> *"Since the universal proxy rules took effect in August 2022, this court has only begun to hear disputes involving the wave of new and amended advance notice bylaws. Even with this limited set, it is apparent that the court must—more than ever—carefully balance the competing interests at play. On one hand, it is legitimate for companies to refresh their bylaws to comport with SEC rules and further the twin goals of order and disclosure. On the other hand, onerous bylaws that stray far afield from these purposes risk frustrating any nomination of alternative director candidates."*

Amendments to Section 13(d) and Section 13(g) of the Securities Exchange Act

On October 10, 2023, the SEC adopted amendments to the rules governing beneficial ownership reporting under Sections 13(d) and 13(g) of the Securities Exchange Act of 1934. The amendments have wide-ranging effects on how activists will accumulate and report their beneficial ownership positions. Specifically, the SEC's rule changes:

- shorten the deadline for initial Schedule 13D filings from 10 calendar days to five business days, although they now can be filed until 10:00 pm Eastern Time rather than 5:30 p.m.;
- require that Schedule 13D amendments be filed within two business days of a material change rather than the former facts and circumstances approach;
- accelerate the filing deadlines for Schedule 13G beneficial ownership reports and amendments; and
- expressly require the disclosure of certain derivative securities.

Importantly, the SEC did not adopt proposed changes to its rules regarding when a "group" acquires beneficial ownership. The SEC also did not adopt a proposed rule that would have included certain cash-settled derivative securities within the definition of what securities are beneficially owned for purposes of Regulation 13D-G. Instead, the SEC's adopting release provides additional guidance and commentary on the parameters around what activities do and do not result in the formation of a "group," as well as when cash-settled derivatives may result in beneficial ownership of the associated reference securities. See our October 19, 2023 alert for more a detailed overview of the new rules and guidance and practice points with respect to their application: SEC Strengthens Regulation 13D-G Rules for Beneficial Ownership Reporting - Insights - Proskauer Rose LLP.

Insurance

During 2023, Proskauer continued to work with a wide variety of private funds of all types and sizes on insurance matters, including reviewing and negotiating their insurance programs; assisting in recovering on their insurance claims through mediations, arbitrations, and litigations; and advising on insurance in connection with various types of transactions. Below are a few of the key developments and trends we saw in 2023, along with our thoughts on where we see things headed in 2024.

The SEC's Increased Focus on Enforcement Activity Heightens the Need for Holistic Analysis of Insurance Coverage

In its report on its 2023 fiscal year, the SEC noted that it had brought the highest amount of enforcement actions since 2019. Its press release stated that the SEC "prioritizes identifying misconduct by investment professionals" and touted several high-profile actions it brought against advisers during the past year. The SEC's increased focus on enforcement activity has made it critical to ensure that advisers' insurance policies are reviewed and negotiated with this important risk in mind.

Many insurers' standard forms provide only limited coverage for investigations, as coverage is not triggered until late in the investigation (after significant costs have already been incurred) or limited to individuals only rather than advisers or private funds. If the policies are negotiated, however, advisers are commonly able to obtain coverage for the costs of defending government investigations from the very earliest stages. Given the wide availability and critical importance of this broad coverage, it would be a significant missed opportunity to not seek and obtain such enhanced coverage.

There are also a number of other provisions in policies – such as exceptions to the definition of covered "Loss" and various exclusions – that can limit coverage for government investigations if not properly addressed. The increased risk of enforcement actions also often raises questions about whether additional coverage limits should be purchased and whether stand-alone "Side A" coverage should be purchased to protect individuals. A holistic analysis of coverage can help protect the adviser, funds and individuals from

the increased risks presented by the SEC's enforcement activities in the fund space.

Continuing Contentious Coverage Environment

During 2023, insurers in the private fund space have continued to take aggressive positions in seeking to deny coverage, and we have represented a number of adviser clients in resulting coverage disputes, including matters that have required litigation and arbitration. Insurers have attempted to deny coverage on numerous grounds in the past year, including based on policy exclusions, policy definitions and public policy arguments. We have also witnessed insurers making the claim process difficult for their insureds, including refusing to provide consent to settlements, refusing to allow the insured to use its counsel of choice, and denying coverage based on alleged breaches of policy consent and cooperation provisions. This continued contentious claims environment reinforces the importance of carefully reviewing and negotiating coverage at the outset, as well as ensuring that the claim process (including any notice and consent requirements) is carefully managed from the outset to avoid falling into any coverage traps.

Increased Attention on Insurance in Distress Scenarios

Due to economic challenges faced in many sectors during the past year, we saw an increase in change of control transactions at operating companies through debt for equity transactions, Article 9 foreclosures, and chapter 11 credit bid sales or debt-for-equity conversion plans. These transactions commonly cause the company's D&O insurance to go into "run-off" and no longer cover claims for wrongful acts occurring after the change of control transaction. This creates important insurance implications for any existing private equity sponsor of the company and any asset managers that are acquiring the equity in the company and/or appointing board representatives. First, these transactions typically lead to the purchase of tail coverage to protect the company's prior board (including board members appointed by the sponsor) against future claims. Second, the acquiring company (often an acquisition vehicle formed by the lenders, "NewCo") must also buy new D&O coverage to protect NewCo and its new board (including board members appointed by the new equity-holder) on a go-forward basis.

There also are a number of restructuring scenarios that involve asset manager lenders appointing directors to a borrower's board. This often occurs consensually in connection with a forbearance agreement or amendment. Other times it occurs non-consensually in connection with the exercise of remedies. In either scenario, D&O insurance is critically important, including assessing whether a change of control transaction has taken place such that new insurance is required, carefully reviewing the coverage being purchased to ensure it provides adequate protection for the appointed directors, and coordinating the relevant company's coverage with the asset manager's own coverage.

Increased Attention to Protecting against Risks Arising from Portfolio Companies

Private equity firms and activist hedge fund advisers continue to face risks from lawsuits against their individuals who serve as directors of portfolio companies and against the firm itself. During 2023, we represented several clients in seeking insurance coverage for such lawsuits under both the private funds' insurance policies and portfolio companies' policies.

Coverage disputes in this scenario are more likely when strong coverage under both sets of policies has not been negotiated and attention has not previously been given to ensuring that the two sets of policies work together. Attention to capacity exclusions, allocation provisions, other insurance clauses, and outside capacity coverage agreements is critical. Additionally, particularly careful attention needs to be given to the renewal of insurance policies for portfolio companies experiencing financial distress, as insurers often use those circumstances as a basis for adding exclusions and provisions that can significantly limit coverage, such as insolvency exclusions, creditor exclusions. and other problematic provisions. Careful review, negotiation, and coordination of portfolio company policies and private fund-level policies can help mitigate the risks arising from portfolio companies to funds and individuals.

One promising development we have seen in the last year is that some asset managers have begun to

negotiate strong, manuscript policies for their portfolio companies. Historically, the quality of coverage provided under D&O policies issued to portfolio companies has been poor – and that continues to be true of the majority of portfolio company policies – but as more advisers begin focusing on the quality of their portfolio companies' policies, we hope to see that change. We are focusing, and expect to do so more in 2024, on drafting strong manuscript portfolio company policies.

Relatedly, we have also seen an increased focus on protecting individuals against the legal and regulatory risks they face for serving in outside capacities, such as serving as directors of portfolio companies. This increased focus on individual protection has included: review and negotiation of adviser and private fund policies for protection of individuals in their various respective capacities; review and negotiation of portfolio company policies when individuals are serving on portfolio company boards; and an increased emphasis on obtaining dedicated insurance limits for individuals (called "Side A" policies") at the private fund-level and/or portfolio company-level and to negotiate enhancements to such policies. It is critically important to ensure that sponsor policies and portfolio company policies respond seamlessly and in a prearranged coordinated fashion in these claims.

Continued Focus on Transactional Risk Insurance Products

Although M&A activity was down in 2023, we saw a continued focus on transactional risk insurance products. Representation and Warranties Insurance ("RWI") policies are now purchased in connection with most transactions, and sophisticated buyers of such insurance continue to negotiate for stronger manuscript policies. We also saw a significant amount of RWI policies for secondaries transactions during 2023.

An important area to watch in 2024 with respect to RWI is whether insurers attempt to restrict the damages that can be recovered under their policies. In a recent M&A case in New York federal court, the court ruled that a buyer was entitled to recover damages based on the implied earnings before interest, taxes, depreciation, and amortization ("EBIDTA") multiple used in calculating the relevant purchase price. Traditionally, RWI policies have been silent on whether recoverable damages include damages based on diminution in the value of the purchased company. This should enable buyers to recover damages based on investment multiples in claims where the breach of representations caused a reduction in the value of the acquired business. It is possible that some insurers may respond to the recent decision awarding damages based on EBIDTA multiples by trying to add exclusions or other limiting language to their policies. Buyers of RWI policies will need to be vigilant in negotiating to avoid such policy language.

We also expect more rigorous underwriting by RWI insurers of pre-closing tax indemnities and representations involving financial statements in secondaries transactions. Some RWI insurers have begun to offer more extensive coverage for these types of losses in secondaries transactions without knowledge qualifiers with enhanced diligence.

Although RWI policies continue to be by far the most prevalent policy in connection with M&A transactions, we also saw tax indemnity policies and contingent liability policies purchased in connection with transactions that presented specific, serious risks. If M&A activity rebounds in 2024, we would expect to see transactional risk insurance policies become an even more significant focus for private equity firms as they buy and sell companies.

Increased Focus on Cyber Insurance, But Challenging Cyber Market

Cyber risks continued to be a significant focus for advisers during 2023, particularly due to the SEC implementing new rules with respect to advisers' cyber policies, procedures and disclosure obligations. The combination of the SEC's increased focus on cyber risks as well as increased focus from investors has caused many advisers to obtain cyber insurance. The market for cyber insurance has hardened in the past two years, however – with increased premium costs and additional limitations on coverage – due to cyber insurers having paid out more and larger claims than they had anticipated for cyber events. The more challenging market has made it even more important for careful analysis and review of potential insurance coverage, particularly because it is rare for all cyber risks of concern to fund clients to be covered under the same policy. Instead, it is common for cyber "crime" risks (for example, social engineering and

fraudulent transfers) to be covered under a crime policy or endorsement to a fidelity bond, with other cyber risks (for example, data breaches and business interruption from cyber events) to be covered under a separate cyber policy. Coordinating these separate coverages is important to ensure that as broad a spectrum of cyber risks as possible are covered.

Looking Ahead to 2024

As the SEC continues to prioritize enforcement actions against advisers, and advisers and their individuals continue to face risks with respect to portfolio companies, it will remain critical for advisers and private funds to negotiate as strong coverage as reasonably possible when purchasing or renewing coverage in order to minimize the chance of claims disputes and put themselves in a position of strength if a dispute does arise.

Reorganization and Chapter 11

Nonconsensual Third-Party Releases in Chapter 11 Plans of Reorganization

Nonconsensual third-party releases have been increasingly utilized by debtors in chapter 11 restructurings to preclude creditors of the debtor from pursuing claims against *non-debtor* third parties. Such nonconsensual third-party releases have been subject to a longstanding, widespread debate, as a circuit spilt exists as to whether nonconsensual third-party releases are permissible in a chapter 11 plan of reorganization. Most recently, in *In re Purdue Pharma L.P.*, the United States Court of Appeals for the Second Circuit (the "Second Circuit") reversed the U.S. District Court for the Southern District of New York's decision and affirmed the permissibility of nonconsensual third-party releases.

The Purdue *Second Circuit Decision*

On September 15, 2019, Purdue Pharma L.P. ("Purdue Pharma") commenced its chapter 11 case in the U.S. Bankruptcy Court for the Southern District of New York ("District Court") to resolve the flood of opioid litigation against the company and other non-debtor affiliates, and to halt and resolve any further litigation and uncertainty surrounding Purdue Pharma's total opioid liability.

On September 17, 2021, the Bankruptcy Court confirmed Purdue Pharma's chapter 11 plan, which contained provisions releasing direct claims against members of the Sackler family (the private owners of Purdue Pharma) as well as other non-debtor entities. As consideration for the third-party releases, the Sacklers agreed to contribute approximately $4.5 billion to fund charities and various recoveries under Purdue Pharma's chapter 11 plan.

The District Court later vacated the Bankruptcy Court's confirmation order, holding that the nonconsensual third-party releases in the plan were unauthorized by the clear and express text of the Bankruptcy Code. The District Court noted that, "the sections of the Code on which the learned Bankruptcy Judge explicitly relied, whether read separately or together, do not confer on any court the power to approve the release of non-derivative third-party claims against non-debtors . . . ."

Purdue Pharma, certain Sackler family members, as well as many other interested creditors appealed the District Court's decision to the Second Circuit.

On May 30, 2023, the Second Circuit reversed the District Court's decision and affirmed the permissibility of nonconsensual third-party releases. In doing so, the Second Circuit explained that Bankruptcy Code sections 105(a) and 1123(b)(6) jointly provide the Bankruptcy Court the requisite statutory authority to approve a chapter 11 plan's nonconsensual third-party releases against non-debtors and the inclusion of such releases is both equitable and appropriate when considering the specific factual circumstances of Purdue Pharma's case. Section 105(a) of the Bankruptcy Code generally provides a bankruptcy court the power to issue any order necessary or appropriate to carry out the provisions of the Bankruptcy Code, while section 1123(b)(6) provides that a chapter 11 plan may include any other appropriate provision not inconsistent with the Bankruptcy Code.

The Second Circuit noted that, while Bankruptcy Code section 105(a) alone does not permit a bankruptcy court to approve nonconsensual third-party releases, when acting in tandem with section 1123(b)(6), the statutory provisions jointly provide bankruptcy courts with a "'*residual authority*' consistent with 'the traditional understanding that bankruptcy courts, as courts of equity, have broad authority to modify creditor-debtor relationship.'" *In re Purdue Pharma, L.P.*, 635 B.R. 26, 78 (S.D.N.Y. 2021), *rev'd and remanded*, 69 F.4th 45 (2d Cir. 2023) (quoting *United States v. Energy Resources Co. Inc.*, 495 U.S. 545. 549 (1990) (emphasis in original). Indeed, the Second Circuit explicitly rejected the view that section 524(e) of the Bankruptcy Code, which provides that a discharge of a debtor does not affect the liability of any other entity for such debt, bars nonconsensual third-party releases because "no reason grounded in the text of the Bankruptcy Code … bar[s] the inclusion of third-party releases in plans of reorganization."

In upholding the Bankruptcy Court's statutory authority to grant nonconsensual third-party releases against a non-debtor, the Second Circuit developed a seven-factor test for bankruptcy courts to consider when determining whether to approve such releases:

- (1) "whether there is an identity of interests between the debtors and released third parties, including indemnification relationships, 'such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete the assets of the estate.'"
- (2) "whether claims against the debtor and nondebtor are factually and legally intertwined, including whether the debtors and the released parties share common defenses, insurance coverage, or levels of culpability."
- (3) "whether the scope of the releases is appropriate."
- (4) "whether the releases are essential to the reorganization, in that the debtor needs the claims to be settled in order for the *res* to be allocated, rather than because the released party is somehow manipulating the process to its own advantage."
- (5) "whether the non-debtor contributed substantial assets to the reorganization."
- (6) "whether the impacted class of creditors "overwhelmingly" voted in support of the plan with the releases."
- (7) "whether the plan provides for the fair payment of enjoined claims."

The Second Circuit further noted that even though the bankruptcy court is required to consider each factor in the seven-factor test, the satisfaction of all seven factors does not automatically lead to the conclusion that the third-party releases should be approved. The bankruptcy court is required to "support each of these factors with specific and detailed findings," and "as with any term in a bankruptcy plan, a provision imposing releases of claims…. must be imposed against a backdrop of equity."

Implications of the* Purdue *Second Circuit Decision

Whether nonconsensual third-party releases remain a viable tool in bankruptcy may soon be decided. Given the significant legal issues nonconsensual third-party releases present, the Supreme Court has decided to weigh in on the viability of such releases. On August 10, 2023, the Supreme Court halted the implementation of the Purdue Pharma chapter 11 plan to determine the legality of nonconsensual third-party releases and whether such releases are authorized by the Bankruptcy Code. The Supreme Court heard oral argument on December 4, 2023, and will render an opinion by June 2024.

Eighth Circuit Provides Flexibility for Determining Cramdown Interest Rates

The Bankruptcy Code provides two ways to obtain court approval of a chapter 11 plan—consensual or nonconsensual. The proposed plan can be approved if the debtor obtains acceptance of every class of creditors. A debtor may nonetheless obtain approval of its proposed plan over the objection of a class of creditors through what is colloquially referred to as "cramdown."

To obtain approval of a proposed plan through cramdown, the plan must not "discriminate unfairly" and

must be "fair and equitable" with respect to the objecting class. With respect to a class of secured creditors, a plan is "fair and equitable" to the secured class if, among other things, secured creditors in the class receive deferred cash payments whose total present value is at least equal to the allowed claim.

In determining the present value of the deferred cash payments, the bankruptcy court must determine the appropriate discount rate to account for risk of nonpayment and the time value of money, among other things. However, the Bankruptcy Code is silent on how to determine the discount rate. Since the U.S. Supreme Court's decision in *Till v. SCS Credit Corp.* provided guidance for determining cramdown interest rates, albeit in context of a chapter 13 case, a body of caselaw has developed providing greater flexibility to the Supreme Court's methodology in *Till*. Most recently, an Eighth Circuit decision shows that courts are may be willing to provide more flexibility to determine the appropriate cramdown interest rate.

The* Till *Decision

In 2004, the U.S. Supreme Court endorsed in *Till v. SCS Credit Corp.* the "formula approach" to determine the discount rate to be imposed on secured creditors in cramdown chapter 13 plans. The Court held the approach consists in using a base risk-free rate, such as the national prime rate, and then adjusting it upward to account for the risk of default of a debtor (*i.e.* adding a risk premium). The Court presumed the prime rate as the starting point, but recognized that it was note entirely risk-free.

The Court explicitly left the door open for a different approach in chapter 11, explaining that efficient markets for debtor-in-possession financing may exist in the chapter 11 context, in which case the rate offered in those markets could be appropriate.

However, the formula approach articulated in *Till* has sometimes been extended to chapter 11 cases, especially when courts find that no such efficient markets exist. In these circumstances, a key question is whether the prime rate should always operate as the base rate in the formula.

The Eighth Circuit's* Topp *Decision

This year, the U.S. Court of Appeals for the Eighth Circuit answered this question in the negative and found that the U.S. Treasury rate could also be used as the base rate. In *Farm Credit Services of America v. Topp (In re Topp)*, the Eighth Circuit addressed the issue in the context of Chapter 12, which applies to family farms and fisheries. In *Topp*, the farmer debtor proposed a cramdown plan that would pay a secured lender its $595,000 mortgage over 20 years. The parties agreed on the payment term and the use of the formula approach but disagreed on the appropriate base rate.[55] The creditor advocated for the prime rate, relying on *Till*, while the debtor advocated for the (lower) Treasury rate, which is considered risk-free.

Affirming the bankruptcy court, the Eighth Circuit sided with the debtor. The Eighth Circuit held that a proper application of the formula approach should focus on whether the ultimate discount rate is appropriate given case-specific risk factors, irrespective of the chosen base rate. The circuit court therefore approved the bankruptcy court's determination that a 4% discount rate, comprised of the 20-year Treasury rate at the relevant time plus a 2% risk premium, was appropriate considering the circumstances of the debtor. In particular, the bankruptcy court had considered the proposed maturity period, the fact that the claim was substantially over-secured, and the overall risk of non-payment.

The Eighth Circuit explained that courts may properly begin their analysis with *either* a risk-free rate (*e.g.* the Treasury rate) *or* a low-risk rate (*e.g.* the prime rate), provided that they adjust the total discount rate accordingly in each case. A Treasury base rate requires adjusting for risk solely through the risk premium, whereas a prime base rate already accounts for certain risk before the risk premium is added.

The Eighth Circuit further held that the lender's reliance on *Till* was misplaced, as the Supreme Court "did not explicitly analyze the merits of starting with the prime rate versus the treasury rate." While recognizing

[55] The parties further agreed to add a 2% risk premium to the base rate.

that many courts have followed *Till* in starting with the prime rate, the Eighth Circuit did not construe the case as establishing a mandatory rule of law. Instead, the circuit court read the Supreme Court's opinion as approving the prime rate as part of an overall adequate discount rate given the circumstances before it.

Implications of the* Topp *Decision

Topp only directly addressed chapter 12 and chapter 13 cases, but courts asked to confirm cramdown chapter 11 plans could nonetheless find the Eighth Circuit's reasoning persuasive. The opinion provides a legal basis for courts considering an alternative to the prime rate base.

More generally, *Topp* shows that courts are still interpreting the Supreme Court's *Till* opinion in different ways, and present value issues in bankruptcy are not entirely settled. The Eighth Circuit's decision underscores the fact-intensive nature of risk and discount rate considerations, which parties should anticipate when proposing or contesting a plan of reorganization.

Marketing Rule Compliance – A Year of Living with the Marketing Rule

When compliance with amended Rule 206(4)-1 (the "Marketing Rule") became mandatory for all RIAs on November 4, 2022, investment advisers faced several challenges in applying the Marketing Rule to their practices: negotiating with uncooperative placement agents, overhauling their marketing materials and changing their policies and procedures.

Now more than a year later, investment advisers continue to find challenges in applying the Marketing Rule to their practices. However, as they have adapted, one lesson has emerged: it could have been worse. At the same time, the Marketing Rule has changed existing investment adviser marketing practices. Investment advisers have found that that the Marketing Rule is not exactly a minefield of technical foot faults, but instead has equipped the SEC staff with new tools that they can bring to bear when examining advisers.

Below are some of the more notable changed investment adviser marketing-related practices stemming from the rule:

- *Requirement to include net returns on individual investments and subsets of investments within a portfolio.* In January 2023, the SEC issued guidance through an FAQ clarifying that the requirement to show net performance if showing gross performance applies when showing the net performance of a single investment (e.g., a case study) or a group of investments.
- *Specific Required Disclosures.* Investment advisers must now include disclosures in their marketing materials on the following topics: (1) third-party ratings, (2) endorsements and testimonials, and (3) hypothetical performance.

Third-Party Ratings: In terms of third-party ratings (including rankings, such as HFR for hedge funds and Preqin for closed-end strategies), the disclosures must include the date on which the rating was given and the period of time upon which the rating was based, the identify of the third-party that created the rating and, if applicable, the compensation provided in connection with obtaining or using the rating.

Endorsements and Testimonials: The disclosure must prominently disclose that it was given by a current client or investor (testimonial) or by someone other than a current client or investor (endorsement) and a brief statement of any material conflicts of interest on the part of the person giving the testimonial or endorsement resulting from the investment adviser's relationship with such person. The adviser must also, *either* in the advertisement or separately, disclose a more detailed description of any material conflicts of interest resulting from the investment adviser's relationship with the person giving the testimonial or endorsement.

Hypothetical Performance: There are several types of hypothetical performance including: target or projected returns, model performance, backtested performance and extracted performance. The hypothetical disclosures should identify: (1) that returns are not guaranteed and actual results may vary

materially, (2) the assumptions or other relevant methodology used to determine the target return, (3) the factors believed necessary to achieve the hypothetical return, (4) the factors that may affect the hypothetical return but are outside of control of the adviser (e.g., market conditions) *and* (5) the potential for both profit and loss. Advisers using hypothetical performance must also adopt and maintain written policies and procedures designed to ensure that the hypothetical performance is "relevant to the likely financial situation and investment objectives of the intended audience".[56]

Division of Examinations: Marketing Rule Risk Alert

- On June 8, 2023, the SEC Division of Examinations issued a risk alert regarding the staff's areas of focus during its Marketing Rule-related examinations. The risk alert announced that staff will continue to conduct target exams to test for compliance with the Marketing Rule, and continue to focus on:

Marketing Rule policies and procedures;

backup support for factual statements;

compliance with the rule's requirements for performance advertisements (i.e., net returns, related performance, extracted performance, predecessor performance, and hypothetical performance); and

books and records, as required by the corresponding amendments to Rule 204-2 under the Advisers Act.

- The Risk Alert also announced that staff will focus on the additional areas:

Use of testimonials and endorsements, including whether: (i) disclosures are provided, (ii) oversight conditions are met, (iii) written agreements have been entered into and (iv) ineligible persons (e.g., "bad actors" prohibited from acting as promoters unless meeting the conditions for an exception) have been compensated for testimonials or endorsements.

Use of third-party ratings, including whether: (i) the adviser provides or reasonably believes that the third-party rating provides the required clear and prominent disclosures and (ii) questionnaires or surveys used in preparation of a third-party rating meet certain conditions (e.g., that the survey is not designed to produce a predetermined result).

Targeted Marketing Rule Examinations

- The Exams Division's 2023 Examination Priorities announced the Exams Division's continued intent to conduct targeted reviews of RIAs regarding compliance with the Marketing Rule. Our February 2023 Alert provides additional background on this annual announcement.
- As discussed in our 2022 Annual Review, the effect of highlighting compliance with the Marketing Rule as a "Notable New and Significant Focus Area" signals a continued deep and prolonged focus by the staff of the Exams Division on RIA marketing practices.

Recent SEC Marketing Rule Enforcement Actions

- In September 2023, The SEC also brought its first enforcement actions for violations of the Marketing Rule, citing ten separate investment advisers for use of hypothetical investment performance without maintaining policies and procedures reasonably designed to ensure that the performance was relevant to the likely financial situation and investment objectives of the intended audience.
- In each case, the hypothetical performance included model and/or backtested performance, and in one case the SEC also found that the adviser had not fully or clearly disclosed the limitations and risks relating to an annualized return calculation (in addition to citing the adviser for other unrelated violations). All cases involved advisers that marketed through advertisements appearing on the advisers' public websites, and none involved the marketing of interests in a private fund.

[56] Rule 206(4)-1(d)(6)(i).

- Nine firms settled and each paid civil penalties ranging from $50,000 to $175,000. The tenth firm, a FinTech investment adviser, agreed to settle and paid more than $1 million combined in civil penalty, disgorgement and prejudgment interest.

Takeaways

- The Marketing Rule prohibits RIAs from including any hypothetical performance in their advertisements unless they have adopted and implemented policies and procedures reasonably designed to ensure that the performance is relevant to the likely financial situations and investment objections of the intended audience.
- Nevertheless, the Marketing Rule applies in the private fund context as well as in the retail context. Therefore, even for private fund advisers, these enforcement actions can serve as an illustration of the ease with which the SEC can now pursue what it finds to be misleading advertising practices by invoking the new specific requirements.
- Given the SEC's focus on the use of hypothetical performance, all RIAs should be careful when using hypothetical performance in their marketing materials. All RIAs should also review their marketing materials and practices, and their policies and procedures, to determine whether their use of hypothetical performance complies with the Marketing Rule requirements above.

European Union and United Kingdom

ESG Disclosure Requirements and Taxonomy Regulation for Asset Managers – What Comes Next?

Background to SFDR

On 10 March 2021, the new European regime on sustainability-related disclosures in the financial sector ((EU) 2019/2088) (the "Disclosure Regulation", or the "SFDR") came into force, with detailed requirements for compliance on content, methodologies and presentation set out in regulatory technical standards ("SFDR Level 2") which came into force on 1 January 2023.

The SFDR is part of the wider European sustainable finance package that requires firms in scope to integrate ESG considerations into their investment decisions and advisory processes in a consistent manner across financial sectors to support the EU's Green Deal and goal of net zero carbon emissions by 2050. It introduced new transparency and disclosure requirements for "financial market participants", which includes investment firms and asset managers and their "financial products", including funds.

At product level, firms need to provide pre-investment disclosures to European Economic Area (the "EEA") investors before investing in the product, alongside website disclosures. As a result, firms have to classify each financial product that they make available in the EEA and categorize it in three different ESG fund-types:

- Art. 6 fund for products that do not promote ESG factors;
- Art. 8 fund for products that promote environmental and/or social characteristics, with some flexibility for non-ESG focused assets to be included; or
- Art. 9 fund for products that have a sustainable investment objective and only invest in sustainable investments.

There is a prescribed template for Art. 8 and Art. 9 funds that must be completed for pre-contractual disclosures and also on an ongoing basis in periodic reporting, with no such templates for Art. 6 funds that require only disclosures on the integration and likely impact of sustainability risks. The relevant disclosures should be included in the offering documentation such as the private placement memorandum or the AIFMD disclosure addendum. The prescribed templates and website disclosures should also be complied with for

non-EU fund managers, such as U.S. fund managers, which market funds in the EEA under AIFMD's National Private Placement Regimes, as part of the Article 23 AIFMD disclosures. "AIFMD" means the Directive 2011/61/EU of the European Parliament and the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and regulations (EC) No 1060/2009 and (EU) No 1095/2010.

Entity-level disclosures need to be made on a financial market participant's website and include information on their policies on the integration of sustainability risks in their investment decision-making processes and that remuneration policies are consistent with the integration of sustainability risks. For financial market participants with over 500 employees, there is a requirement to publish a statement covering all investments (whether ESG-focused or not) on the principal adverse impacts of investment ("PAI") on the sustainability factors. For all other financial market participants, the entity-level PAI statement is to be made on a "comply or explain" basis. Where they do not make such a PAI statement, there is a required website disclosure on the clear reasons for why they do not do so, including, where relevant, information as to whether and when they intend to consider such adverse impacts.

Updates to SFDR Level 2

The European Supervisory Authorities ("ESAs") published their final report on proposed updates to SFDR Level 2 on 4 December 2023, including:

- new templates, including a "dashboard";
- new disclosures on greenhouse gas reduction targets;
- new social principal adverse impact indicators (PAIs);
- changes to the "do no significant harm" disclosures; and
- further technical adjustments including on calculation of sustainable investments.

The European Commission has three months from 4 December 2023 to decide whether to endorse the changes.

European Commission consultation papers

Whilst the market has generally become accustomed to the disclosure requirements, there have been challenges with the interpretation of various concepts under SFDR, including the definition of "sustainable investment". This has mostly arisen because of it being a disclosure and transparency regime, rather than with express labels for sustainable finance products and there often being a lack of clarity in SFDR concepts.

As a result, the European Commission published two consultation papers on 14 September 2023 that seek views on the fundamental features and effectiveness of SFDR. The purpose of both the targeted and the public consultation is to gather information on stakeholders' experiences with the implementation of the SFDR. In particular, the Commission is interested in understanding how the SFDR has been implemented, how it interacts in practice with the other parts of the European framework for sustainable finance, and in exploring possible options for improving the framework. These options include removing Articles 6, 8 and 9 altogether and introducing a new labelling regime, which would be a significant departure from the current regime. Responses for both consultations need to be submitted via an online questionnaire by 15 December 2023 and next steps on the development of SFDR are expected in 2024 and beyond.

It is likely that the update to SFDR Level 2 will be implemented and then there will be further, more fundamental, changes for SFDR as a result of these consultation papers.

Taxonomy Regulation

The EU's regulation on the establishment of a framework to facilitate sustainable investment (EU/2020/852)

("Taxonomy Regulation") introduced an EU-wide classification system (or taxonomy) of environmentally sustainable activities. It seeks to establish a common language and classification tool to help a variety of stakeholders understand what can be considered environmentally sustainable economic activities and disclosures on Taxonomy Regulation alignment are required under SFDR. To be considered an "environmentally sustainable economic activity" the activity needs to contribute substantially to one of six defined environmental objectives, not significantly harm any of the environmental objectives, comply with a series of minimum social safeguards and comply with very detailed criteria known as "technical screening criteria". Whilst introduced on 1 January 2022 with a significant number of sustainable economic activities the taxonomy will be gradually expanded to cover more activities over time.

Most recently the Taxonomy Regulation has been expanded (with effect from 1 January 2024) to include technical screening criteria for four of the environmental objectives: 1. sustainable use and protection of water and marine resources; 2. transition to a circular economy; 3. pollution prevention; and 4. control and protection and restoration of biodiversity and ecosystems. There are also amended / new sectors and activities for the existing "climate change mitigation" and "climate change adaptation" objectives covering, for example, aviation, construction and manufacturing.

Non-financial corporate reporting – EU Corporate Sustainability Reporting Directive

The Corporate Sustainability Reporting Directive ("CSRD") is also part of the EU's Green Deal, alongside SFDR and the Taxonomy Regulation.

The breadth and depth of the CSRD reporting requirements vastly expand the existing EU non-financial reporting requirements, with requirements phased in from financial year 2024 onwards. For U.S. companies, there is extra-territorial reach of the CSRD which could either directly bring a U.S. company in scope to meet the reporting obligations, or alternatively, U.S. companies may be brought within scope as a result of certain requirements to report on a consolidated group basis. Some market estimates are that at least 10,000 companies outside the EU will need to comply with CSRD and a third of those will be in the U.S.[57] Establishing whether an entity or group is in scope may be a complex exercise as there are a variety of triggers for reporting, including: any listing of transferable securities on an EU regulated market, turnover size, balance sheet size and/or number of employees.

The reporting requirements for CSRD are set out in the European Sustainability Reporting Standards (ESRS). These consist of:

- Cross-cutting standards – general principles, setting out the mandatory concepts and principles for reporting under CSRD (ESRS1) and general disclosures, setting out disclosures applicable to all in-scope entities regardless of their sector/activity (ESRS2).
- Ten topical standards – the disclosure under these standards is dependent on whether they are material, following a materiality assessment carried out by the in-scope entity – climate change (ESRS E1), pollution (ESRS E2), water and marine resources (ESRS E3), biodiversity and ecosystems (ESRS E4) and resources use and circular economy (ESRS E5), own workforce (ESRS S1), workforce in value chain (ESRS S2), affected communities (ESRS S3) and consumers and end-users (ESRS S4) and disclosure of corporate strategy, approach and governance processes in respect of business conduct that give rise to material impacts, risks and opportunities (ESRS G1).
- Sector-specific standards – these are yet to be published but will set out specific disclosures required of companies operating in particular sectors.

The structure of the disclosures for the general disclosures and topical disclosures broadly follows this structure: a) governance; b) strategy; c) impact, risk and opportunity management and d) metrics and targets. This structure will be familiar to those who currently report under TCFD Recommendations.

[57] At Least 10,000 Foreign Companies to Be Hit by EU Sustainability Rules - WSJ

Reporting will be subject to assurance requirements.

There are two particularly challenging areas of CSRD with the first being that some CSRD requirements set out above need to be reported on a mandatory basis with the remainder subject to a "double materiality" test. This test, covering both financial and impact materiality on over 1,000 data points is very broad, in particular in relation to "impact materiality" which covers the material impacts of operations and value chains on the environment and people, reaching significantly beyond a company's own finances and operations.

A further area that requires careful analysis is that the value chain must be reported on under CSRD, which is defined as "the full range of activities, resources and relationships related to the companies' business model and the external environment in which it operates. A value chain encompasses the activities, resources and relationships the entity uses and relies on to create its products or services from conception to delivery, consumption and end-of-life". This is extremely broad in coverage, and the information on material impacts, risks and opportunities need to be reported on with regards to both direct and indirect business relationships in an upstream and/or downstream value chain. Identifying and engaging with the relevant stakeholders will be critical to meet this requirement. There is some transitional relief for the first three years of reporting on value chain. If a company is unable to meet these requirements, they can instead explain their efforts and challenges in trying to do so and what their plans are for obtaining the information moving forward.

CSRD is an EU "directive", which in practice means that EU Member States will have to determine how to implement it. It could be that national legislation implementing the directive in an EU Member State adds to or clarifies requirements. However, given the complexity of CSRD, our expectation is that typically the EU Member States will implement CSRD "as is".

In-scope U.S. parent companies could be exempt from reporting if there is consolidated sustainability reporting in a manner deemed to be equivalent to CSRD. However, the requirement to report on a double materiality basis is likely a significant hurdle for U.S. entities to rely on the CSRD equivalency exemption, which sets out that there is no requirement to report under CSRD if there is already sustainability reporting on an equivalent basis, as other proposed regimes (including the draft SEC Rules and California climate reporting State Bills) apply a financial materiality test alone, instead of the double materiality test. More information on the interoperability of CSRD with other international non-financial reporting regimes will be clearer following the publication of guidance that is expected to be published in 2024.

Further specific guidance and standards will be published over the coming years, including on how to apply the standards for non-EU companies and for sectors in (1) Oil and Gas, (2) Coal, Quarries and Mining, (3) Road Transport, (4) Agriculture Farming and Fisheries, (5) Motor Vehicles, (6) Energy Production and Utilities, (7) Good and Beverages and (8) Textiles, Accessories, Footwear and Jewellery. Guidance will also be published in relation to the application of CSRD to the financial services industry and on the interoperability of CSRD with other non-financial reporting regimes. Despite such a significant amount of guidance yet to be published, the expectation is that in-scope entities and groups will move forwards with complying with CSRD.

Even if it can be determined that an entity or group is out of scope of CSRD, there may be CSRD-related reporting obligations requested of that out-of-scope entity or group where it is part of another in-scope entity's "value chain", as this is another key area that needs to be reported on. There would be no direct regulatory obligation to provide this information, but the entity requesting the information to meet their own CSRD reporting on their value chain may apply commercial pressure to obtain the information, so there could be indirect impact.

UK FCA Sustainability Disclosure Rules

On 28 November 2023, the long-awaited UK regime for the labelling, marketing and disclosure of sustainable funds (Sustainability Disclosure Requirements or "SDR") was published in the Financial Conduct Authority's ("FCA") Policy Statement PS23/16.

SDR also introduces a new anti-greenwashing rule that will apply to all communications about financial products or services which refer to the environment and/or social characteristics of those products or services from 31 May 2024. Such references could be in statements, assertions, strategies, targets, policies, information and images, as examples. This new rule to ensure sustainability claims align with the sustainability profile of products and services and are clear, fair and not misleading will apply to all UK-regulated firms (not just UK AIFMs), regardless of any use of labels. The FCA has published, alongside SDR, a consultation paper guidance on the anti-greenwashing rule, requesting feedback by 26 January 2024.

Whilst the scope of the anti-greenwashing rule is for all UK-regulated firms, there is more limited scope for the labelling, marketing and disclosure rules under SDR with them applicable to asset managers in the UK only from 31 July 2024. The FCA has signposted that it will consider extending the scope of SDR to overseas managers and funds in conjunction with HM Treasury but this does not seem to be as imminent. Therefore, for non-UK managers/non-UK funds there is no direct capture under the regulatory regime, however, it may be that the market is influenced by SDR's labelling and disclosure standards and there is indirect impact through investor expectation of sustainability funds more broadly.

The FCA has also not included within the scope of SDR portfolio managers or advisers noting that it plans to consult on an expansion to portfolio managers in early 2024 and set up an independent working group to consider the role of advisers too. The exception to this is in relation to entity-level TCFD and on-demand product-level TCFD reporting which are already implemented by the FCA but will now be considered as part of SDR. These reporting requirements remain applicable to portfolio managers who have the UK regulatory permission of managing investments or alternatively are entities that carry out private equity or other private market activities consisting of either advising on investments or managing investments on a recurring or ongoing basis in connection with an arrangement the predominant purpose of which is investment in unlisted securities (as well as AIFMs).

The three labels for funds are Sustainability Focus; Sustainability Improvers; and Sustainability Mixed Goals. They are not designed to be in a hierarchy and it is a choice for UK asset managers to use a label. In contrast to draft rules, "sustainability" is in their title rather than "sustainable" to reflect that some assets may be transitioning or improving in terms of sustainability. If an asset manager does decide to use a label there are general criteria which must be met to support its use, which in summary covers:

- Need for a sustainable investment objective;
- At least 70% of the assets to be invested in accordance with the sustainability objective (with the remainder used only for liquidity, risk or diversification purposes);
- A "robust-evidence based" standard must be used to select the assets and this must be independently assessed (although this can be carried out in-house provided the assessors are separate from the investment process);
- KPIs must be set to demonstrate progress towards the sustainability objective and can measure either the performance of the fund or individual assets;
- An escalation plan must be devised for assets that do not demonstrate sufficient performance.

Each label then has its own specific criteria attached to reflect the differences between 'Impact', 'Improvers', 'Focus' and 'Mixed Goals'.

Further requirements for all labelled funds include a version of the SFDR's "do no significant harm" regime which requires asset managers to determine and disclose whether any material negative environmental and/or social outcomes may arise in pursuing the sustainable investment objective in a labelled fund. Where stewardship is part of the sustainability strategy this must also be disclosed.

Beyond the product labelling and disclosure requirements there are also requirements on firms to have in place appropriate resources, governance and organizational arrangements commensurate with the delivery of the sustainability objective, and for this to be maintained on an ongoing basis. There are also

requirements to ensure that the sustainable investment policy (including but not limited to the robust, evidence-based standard), escalation plan and independent assessment remain valid and that the review of negative outcomes (the SDR version of "do no significant harm") is monitored on an ongoing basis. Any use of labels must be reviewed every 12 months.

In terms of SDR's interaction with SFDR, the FCA has set out a summary of the SDR criteria and which requirements under EU SFDR can be used to leverage to meet SDR. However, there is no direct synergy between the four labels proposed and Article 8 or Article 9 of EU SFDR and the FCA notes that all "Article 8 funds would need to level up to qualify for the SDR labels".

EU Rules on Marketing and Pre-marketing of Funds

In August 2021, rules concerning the marketing and pre-marketing of funds were introduced (being made up of Directive ((EU) 2019/1160) and Regulation ((EU) 2019/1156) aimed at reducing the regulatory barriers for the cross-border distribution of funds in the EU (the "CBDF Package"). Previously, the interlinked concepts of "pre-marketing" and "marketing" were interpreted differently between EU Member States and the CBDF Package introduced a new harmonized definition of "pre-marketing" of funds. The new "pre-marketing" definition allows for fund-specific information, including draft private placement memoranda or offering documents, to be provided to potential investors and for this to still fall within the scope of pre-marketing, provided certain disclaimers are included in the documentation and as long as it does not amount to "an offer or placement" to an investor, which would trigger a formal marketing notification requirement.

EU fund managers are now required to notify their local home state regulator within two weeks of beginning their pre-marketing. Non-EU Managers intending to pre-market in EU Member States are required to submit a pre-marketing notification in Member States who have implemented the CBDF package (including, for example, Germany and Luxembourg) or will need to wait for registration approval under the National Private Placement Regime of the relevant Member State, before it commences any pre-marketing or marketing activity. Any third party carrying out pre-marketing or marketing activities on behalf of a fund manager must be authorized as an investment firm under the Markets in Financial Instruments Directive (2014/65/EU) ("MiFID"), a credit institution under the Capital Requirements Directive (2013/36/EU) ("CRD IV"), a Undertakings for the Collective Investment in Transferable Securities ("UCITS") management company or an alternative investment fund manager ("AIFM") under AIFMD, or act as a tied agent in accordance with MiFID. In addition, the agent is directly subject to the pre-marketing rules in the CBDF Package. Fund managers should ensure that any potential placement agents and fund distributors have the appropriate authorizations.

The CBDF Package also introduces restrictions on the use of "reverse solicitation" in jurisdictions where there has been any prior marketing or pre-marketing activity. Where there is a subscription by professional investor(s) in the relevant EU Member State within 18 months of the EU AIFM having begun pre-marketing, it is deemed to have taken place as a result of active "marketing" (triggering the requirement to make a formal marketing notification).

The CBDF Package included new de-notification requirements, which include that EU AIFMs must notify their home Member State regulator when intending to cease marketing of an alternative investment fund ("AIF"). This would mean that the EU AIFM will not be able to carry out pre-marketing in relation to the AIF and a "similar investment strategy" or "investment ideas" for 36 months after the de-notification.

The AIFMD marketing rules under the CBDF Package do not apply to marketing activities in the UK because the UK has not on-shored the relevant European legislation.

Prudential Rules for UK Investment Firms

The UK Investment Firms Prudential Regime ("IFPR") came into force on 1 January 2022 and applies to UK investment firms authorized under MiFID as it is applied in the UK post-Brexit, which includes previous

"BIPRU" firms and "Exempt CAD" firms, as well as AIFMs that have MiFID top-up permissions (known as collective portfolio management investment firms ("CPMI")). The IFPR is based on the European Investment Firms Regulation ((EU) 2019/2033) ("IFR") and the Investment Firms Directive ((EU) 2019/2034) ("IFD") which came into force in June 2021 and the UK has adopted it for the prudential regulation of FCA investment firms.

The IFPR introduced new regulatory capital requirements for firms within its scope and, among other things, new remuneration, reporting and disclosure requirements.

The IFPR regime distinguishes between "small and non-interconnected investment firms" ("SNI" firms) and non-SNI firms. The level of compliance with certain rules that apply to a firm within the scope of the IFPR is determined by whether or not the firm is an SNI or a non-SNI firm.

SNI firms are defined in the prudential sourcebook for MiFID firms ("MIFIDPRU 1"), prescribing a series of permission-based and quantitative thresholds for firms to determine whether they are an SNI. The FCA expects approximately 70% of firms to be SNI and firms that exceed the relevant thresholds are known as "non-SNI".

The regulatory capital requirements require all firms subject to the IFPR to hold an "initial capital" requirement as well as an additional capital amount by reference to their "annual fixed overheads." A number of firms have been particularly impacted by the regulatory capital requirements, such as Exempt CAD firms, which have seen their capital requirements significantly increase. Certain firms are able to benefit from temporary transitional provisions enabling them to gradually adjust to the additional requirements under the IFPR. For example, Exempt CAD firms are able to gradually increase their capital over the course of five years from 1 January 2022.

All firms within scope of the IFPR need to comply with the new MIFIDPRU Remuneration Code requirements, which vary depending on the type of firm. The MIFIDPRU Remuneration Code applies to remuneration, including carried interest, paid to a firm's staff (which has a wide meaning under the FCA rules). In particular, SNI firms have to comply with basic remuneration requirements, requiring them to establish and implement remuneration policies, while applying proportionality. Larger SNI firms are subject to enhanced remuneration rules, which amongst other things, also have to establish risk and remuneration committees, comply with pay-out process rules and provide certain additional remuneration disclosure.

Amendments to the EU Alternative Investment Fund Managers Directive (AIFMD II)

The AIFMD has applied since July 2013 and contains the key regulatory framework for AIFMs in the EEA and has also been implemented and on-shored in the UK. Following a review of the AIFMD by the European Commission, the final text of the amending Directive to the AIFMD ("AIFMD II") was published on 10 November 2023.

AIFMD II will impact EU AIFMs and some funds which are marketed in EEA Member States under the National Private Placement Regimes. It will not be directly applicable to UK AIFMs (unless they market their funds into the EEA), as the UK is no longer part of the EEA. The finalised AIFMD II text does not overhaul the AIFMD, but does address a few key areas of change including:

- a new regime for "loan originating AIFs", including certain risk retention requirements, leverage limits and diversification requirements;
- additional disclosure, substance and reporting requirements in respect of delegation arrangements;
- additional investor disclosure requirements around fees and expenses; and
- liquidity management requirements in respect of open ended-funds.

The next step is for European Parliament to consider the final text at its plenary session commencing in

February 2024. If the text is approved and published in the EU's Official Journal without delay, we would expect AIFMD II to likely come into force in 2026, as Member States of the EEA would then have 24 months to implement the new rules.

Amendments to the European Long-term Investment Fund Regulation (ELTIF II)

Regulation (EU) 2023/606 ("ELTIF II"), which will amend Regulation (EU) 2015/760 ("ELTIF Regulation"), will come into force on 10 January 2024 across EEA Member States.

The original ELTIF Regulation was aimed at boosting European long-term investments in the real economy, but did not gain a lot of traction, with very few ELTIFs having been authorised. The purpose of ELTIF II is to enhance and reshape the ELTIF Regulation so that it can remain attractive to professional investors and also align private market strategies to a wider, retail investor base.

ELTIF II has amended the ELTIF Regulation and addresses a number of issues, including (amongst other things) the provision of greater flexibility for fund managers to design appropriate investment strategies and portfolio compositions for ELTIFs, a removal of the minimum investment requirement, as well as a greater facilitation of fund-of-fund and master-feeder structures.

These changes are aimed at increasing the popularity and use of ELTIFs and it is yet to be seen what the impact of this will be.

UK Tax

United Kingdom's Implementation of OECD's Pillar Two

In October 2021, over 130 countries in the OECD Inclusive Framework reached an agreement to implement a two-pillar solution to reform the international tax framework. Pillar Two of this framework aimed to implement a global minimum effective tax rate and to ensure tax is collected in countries where large multi-national enterprises have their operations as well as countries where these groups have holding structures and ultimate parent entities. Pillar Two will capture low-taxed profits from low tax rate jurisdictions and will ensure that a 15% minimum tax in each jurisdiction applies where a multi-national enterprise's global revenue exceeds €750 million.

Pillar Two is due to come into force from 31 December 2023 in the UK for those captured groups with accounting periods in line with this. The UK has already introduced legislation implementing two elements of Pillar Two: the Income Inclusion Rule ("IIR") and the Qualifying Domestic Minimum Top-up Tax ("QDMTT"). The IIR will require qualifying UK headquartered multi-national groups to pay top-up tax where the group's foreign operations have an effective tax rate of less than 15% and the QDMTT will require large groups, including those that operate exclusively from the UK, to pay a top-up tax where UK operations have an effective tax rate of less than 15%. The UK has confirmed that draft legislation has been prepared for the Under Taxed Profits Rule ("UTPR"), which will come into effect for accounting periods beginning on or after 31 December 2024. The UTPR is intended as a backstop to collect top-up taxes from in-scope entities resident within the jurisdiction where tax is not collected from other jurisdictions via an IIR or QDMTT. The OECD has recommended that all countries have the IIR and QDMTT in force by the end of 2024, and the UTPR by 2025. More movement has been seen both in the EU and outside the EU on implementation: EU Member States are required to transpose the EU Directive setting out Pillar Two into their domestic law by 31 December 2023, and outside the EU, Canada and South Korea have made implementation progress.

The OECD also published further Administrative Guidance in February and July 2023, relating to the stand alone Subject to Tax Rule ("STTR"), which takes priority over the IIR, QDMTT, and UTPR to allow developing countries to amend treaties to impose additional taxation on cross-border payments (including interest, royalties and intragroup services) where the recipient is subject to a corporate tax rate lower than 9% on those payments, and safe harbours to be introduced to minimise the compliance burden of Pillar Two.

The following is a high-level explanation of the safe harbours and their application under the UK legislation to date. The Transitional Country-by-Country Reporting safe harbour will be a short-term measure to exclude the compliance obligation of preparing full calculations under Pillar Two for group operations in low-risk countries with information taken from Country-by Country reporting and financial statements instead. This will apply for three years and where it applies, the top-up tax for the jurisdiction the entity is in will be zero. The Permanent QDMTT safe harbour will allow a business to elect to complete a single QDMTT computation for a country so no additional top-up tax will arise under the IIR and UPTR. This simplifies compliance, but only applies in a jurisdiction where there is a QDMTT adopted and domestic legislation meets additional safe harbour standards. A final safe harbour will be introduced later in the form of the UTPR Transitional safe harbour; no top-up tax will be payable under UTPR in the ultimate parent entity country if the jurisdiction has a statutory corporate tax rate of at least 20%, and this will apply to all profits until the fiscal year beginning in 2026. This safe harbour is being introduced to accommodate countries while legislation is implemented and will be important for groups with US ultimate parent companies.

Fund managers will need to be aware of the potential impacts of these rules, though these will largely only apply to fund structures with revenues over €750 million. However, there will be increased complexity relating to compliance and the increased burden for portfolio investment tax teams in assessing investments and ensuring that consolidated portfolios will not reach the threshold to bring the fund into scope of Pillar Two. We have already seen an increase in GPs concerned about the potential issues that consolidation of portfolios could have on returns to investors and potential tax leakage from investment structures, particularly where large corporate groups may invest into partnership fund structures as limited partners and may have to consolidate with fund portfolio companies for Pillar Two purposes. Funds will also need to consider whether there are entities within their structure that could benefit from one of the three safe harbours to be introduced under Pillar Two. Staggered implementation in different jurisdictions will also cause increased complexity; fund managers will have to monitor the jurisdictions of potential in-scope entities for their implementation of Pillar Two.

ATAD 3/Unshell

The European Parliament has proposed legislation to extend the original Anti-Tax Avoidance Directive introduced in 2016 (further amended in 2017) with the aim to prevent the misuse of shell entities in the EU to evade or avoid tax ("ATAD 3"). The European Commission originally proposed the directive in 2021, and draft legislation was provided by the European Parliament in January 2023. The legislation is now being negotiated by the EU Council. The legislation provides that entities resident in the EU with little or no commercial or economic activity that do not satisfy the "gateways" and minimum substance requirements, will be required to comply with additional reporting and tax information exchanges, and may also be subject to further consequences. Please see our submission to the 2022 PIF Annual Review for a detailed breakdown of the substance of ATAD 3. Fund managers may be concerned about the extent to which the proposal will impact any EU holding structures set up by investment funds.

The draft legislation includes an exemption for "regulated financial undertakings", which covers vehicles established as alternative investment funds ("AIFs") under the EU Council Directive 2011/16/EU and vehicles managed by AIF managers ("AIFMs"). Fund managers with EU holding structures will be comforted by the inclusion of the exemption. However, the draft legislation currently requires the Commission to submit a report five years after the implementation in which it must assess whether the requirement for entities to report on minimum substance indicators should be extended to include regulated financial undertakings. This obligation further provides for the Commission to review the AIF and AIFM exemption if necessary, which could lead to the revocation of the exemption after five years and bringing regulated financial undertakings in-scope of ATAD 3, reviving the current concerns of fund managers.

ATAD 3 would also require the exchange of information, including tax audits, between EU Member States and compliance with minimum substance requirements to be recorded on tax returns for entities, with penalties including: the refusal of tax benefits based on treaties or EU directives, and the denial of a tax residency certificate. The directive would have a 'look back' period of two years before the implementation date, meaning that circumstances and structures may be caught despite being implemented prior to the effective date of implementation.

ATAD 3 had been intended to take effect from 1 January 2024. However, the draft legislation requires unanimous voting in from all members states and there is no guaranteed consensus, with certain EU Member States reluctant to implement the directive as currently drafted, as highlighted by the EU Council in February 2023. There are several reservations over the current drafting of the directive including: (i) the appropriate indicators of substance, (ii) the tax consequences that should follow an entity being designated a shell entity, (iii) the information that must be reported by taxpayers and exchanged, and (iv) the exclusion for regulated financial undertakings. The main concern of EU Member States has been on the tax consequences, with some countries suggesting the limitation of consequences to the denial of benefits under EU directives only or removing all consequences and merely subjecting shell entities to reporting requirements and exchange of information. It would not be surprising, given the political background, if implementation is ultimately deferred to 2025.

ATAD 3 is not intended to replace any existing national or international rules concerning shell entities and tax abuse in the EU. Many EU Member States already have domestic legislation in place relating to this issue with substance requirements already present that could conflict with the substance requirements under ATAD 3. EU Member States such as France, Germany and the Netherlands, for example, already have substance requirements and anti-abuse laws that are arguably more restrictive than the current drafting of ATAD 3. There is no guidance as to whether these countries will repeal their own domestic legislation, or merely use the implementation of ATAD 3 as a first stage test before applying more rigid domestic laws. In comparison, other EU Member States do not currently have domestic legislation in place, for example Belgium and Luxembourg, and ATAD 3 will have a much wider impact in these states. This lack of cohesion could lead to further difficulties for fund managers trying to manage tax risks efficiently and structure instruments efficiently.

HMRC v Bluecrest Capital Management (UK) LLP: Greater Clarity on the Salaried Members Rules

The Upper Tribunal (UT) has upheld the decision of the First-tier Tribunal (FTT) regarding the application of the UK's salaried member rules (the Rules) to certain members of BlueCrest Capital Management (UK) LLP (BlueCrest), an asset manager engaged in the provision of hedge fund management services. A high-level summary of the relevant aspects of the Rules, which can treat certain limited liability partnership (LLP) members as employees, and the FTT's decision is set out below.

The case heard by the UT had two strands: an appeal by HMRC that the FTT was wrong to determine that certain of the members in question were not salaried members because they had significant influence over the affairs of BlueCrest; and an appeal by BlueCrest that none of the members in question were salaried members because they all received sufficient "variable remuneration." The discussion and decision on the significant influence point is of the most interest. The decision on variable remuneration is not surprising given the very limited circumstances in which BlueCrest's overall profits might affect the bonuses awarded to the members.

Overview of the Rules and FTT decision

For UK tax purposes, the general position is that UK LLPs are treated as partnerships and their members as self-employed partners, each carrying on the business of the LLP. The Rules were introduced to treat UK LLP members as employees for UK tax purposes unless one or more of three conditions are satisfied by the member. The conditions are, in a very broad sense, intended to be proxies for characteristics of partners in traditional partnerships. The most notable consequence of the Rules applying to a member (so that the member is categorised as a "salaried member" and an employee) is that the UK LLP is then required to operate PAYE (including accounting for employee and employer national insurance contributions and, if relevant, apprenticeship levy) on the member's remuneration. The Rules are actually drafted in the negative, so that a member is a salaried member unless they "fail" one of the three conditions. We discuss the Rules below as if the member had to "satisfy" one of the conditions to avoid being a salaried member for ease of reading.

In the BlueCrest case, HMRC claimed that the members of the LLP were all salaried members because

they did not satisfy any of the conditions, only two of which were in dispute. BlueCrest claimed that all of the members in question satisfied at least one of the conditions so that they were not salaried members. The two conditions that were in dispute were:

Condition A: It must be reasonable to expect at the beginning of the tax year that at least 20% of the member's pay will vary by reference to the overall profitability of the LLP; and

Condition B: The LLP member must have "significant influence" over the affairs of the LLP.

The case involved three classes of members. The first were senior investment managers who had control of significant amount of BlueCrest's funds (which generally had $100 million of commitments or more) and/or who supervised members with control over significant amounts of BlueCrest's funds but who were not, in either case, necessarily involved with the overall strategy or management of BlueCrest's business (senior investment managers). The second were members providing investment management services with no overall control over funds (investment managers). The third were members with responsibility for BlueCrest's back office activities (back office managers). In summary, the FTT found that the senior investment managers had "significant influence" over the affairs of the LLP based on their financial influence over a material part of BlueCrest's overall business, notwithstanding not having managerial influence over the whole of the LLP's affairs. This was in disagreement with HMRC's published view that significant influence requires influence over the affairs of the LLP as a whole and not just over part of its business. The FTT also found that the investment managers and the back office managers did not, on the facts, have significant influence. Those members indirectly contributed and assisted with portfolio management, but this was not sufficient to amount to significant influence.

On Condition A, regarding variable remuneration, the FTT found that all of the remuneration of all of the members in question was disguised salary as their bonuses were calculated by reference to their personal performance rather than by reference to the performance of the LLP as a whole and the mechanism that had been introduced into the LLP's remuneration process, which would reduce members' allocated bonuses/profit shares to the extent that the overall profits of the LLP were insufficient to pay them all (and which had never been used), was not sufficient to meet the test that the members' remuneration was, in practice, variable by reference to the overall profitability of the LLP.

HMRC's Grounds of Appeal and UT findings – Significant influence

HMRC put forward nine grounds of appeal to the UT. As noted by the UT, in essence, they all went to the same points that the FTT had incorrectly addressed what was meant by significant influence and the affairs of the LLP and had incorrectly applied the facts to the Rules as a result. HMRC's grounds of appeal and the UT's findings are summarised below.

Ground 1 - The FTT failed to adequately consider the legal distinction between traditional partners and employees in a partnership and failed to apply this test in the assessment of whether members had significant influence. The UT rejected this contention noting that the FTT was required to apply the words of Condition B to the facts of this case rather than apply any strict or rigid test seeking to distinguish traditional partners from employees.

Ground 2 - The FTT erred in its construction of "affairs of the partnership." HMRC argued that the business as a whole needed to be examined rather than just particular aspects of it. The UT rejected this, stating that to do so would be to write additional words into Condition B and that this approach is unrealistic for larger, more sophisticated partnerships as very few would satisfy HMRC's interpretation of Condition B.

Ground 3 - The FTT was wrong to approach the test of "influence" as being what an individual might do or the impact that an individual might have. Rather, the requirement was to focus on influence over the management of the LLP's business and not, for instance, financial influence or impact. Otherwise, the distinction between partner and employee would be difficult to discern. The UT rejected this submission stating that the effect would be to add extra words to the statute. Responsibility and/or activities in respect

of operations, financial performance or management could all give rise to significant influence, but this would depend on the facts of each case.

Ground 4 - The word “significant” should have been a qualifier to the word “influence” and, as such, appreciably add to the concept of having “influence.” Again, the UT rejected this noting that there is no one size fits all approach to Condition B. While noting that the word “significant” is important and the requirement is for more than simple influence, whether there is significant influence in any case of an individual member will depend on the specific facts and circumstances.

Ground 5 - Any significant influence must ultimately derive from the LLP agreement as the document governing the LLP and the FTT failed to properly take into the account the terms of the BlueCrest LLP agreement, noting that the senior investment managers’ influence did not stem from that agreement. This ground was also dismissed, the UT noting that the FTT had undertaken a thorough analysis of the constitutional documents of the LLP as well as the practical realities of the business and that significant influence could derive from the way that the business actually operated outside the terms of the governing documents.

Ground 6 - The FTT was wrong to apply the analogy with a traditional professional services firm in the way that it did, in particular referring to the role of a partner as being to “find, mind and grind.” Even if this approach was right, the senior investment managers were limited to doing work, not seeking it out (the only client being the fund in question), nor in most cases did they supervise others. However, the UT held that the FTT’s analysis did not actually turn on the senior investment managers having such a role. Rather, the analogy had been applied in discussion about HMRC’s assertion that significant influence required managerial influence. The UT stated that the FTT had then considered all of the evidence and had not decided that the senior investment managers had significant influence applying a simple “find, mind and grind” or any similar test.

Ground 7 - The FTT was wrong to conclude that the relevant portfolio managers had “managerial clout,” that it conflated managerial and operational issues and that its conclusions were inconsistent with the evidence of the witnesses. For similar reasons to those for Ground 3, the UT rejected this submission. Nothing in the wording of Condition B restricts the types of activity or sources of influence within an LLP which can be considered for the purposes of deciding whether an individual has the required significant influence. In addition, the UT emphasised that the FTT had the benefit of two-and-a-half days of evidence, that it had reached its conclusions based on the entirety of that evidence, and that the UT did not have to accept that the extracts from the FTT’s judgement presented by HMRC were definitive of the basis on which the FTT had reached its conclusions.

Ground 8 - The FTT’s findings in relation to “involvement” in operational decisions (recruitment, development of juniors, identifying new business opportunities and managing counterparty relationships) were not sufficient to demonstrate significant influence of the type required by Condition B. The UT held that this assertion was nothing more than an attempt to reargue the evidential case that was before the FTT and did not consider that there was a basis for interfering with the FTT’s conclusions on these matters.

Ground 9 - The FTT was wrong to conclude that a capital allocation of $100 million was sufficient evidence to demonstrate significant financial influence. The UT observed that the FTT did not rely on financial impact alone and that the senior investment managers exercised influence for a number of different reasons and that the FTT had not relied on $100 million as providing a clear line between members with and without significant influence. Equally, the FTT found, in the case of senior investment managers with supervisory roles over other senior investment managers, that they exercised significant influence without making express reference to a specific level of capital allocation.

Accordingly, the UT held that the FTT had not misapplied itself on the meaning of Condition B and had been perfectly entitled to reach the conclusion that the senior investment managers did have the required significant influence over the affairs of the LLP based on the copious evidence heard by it. While not providing any bright line test as to what does qualify as significant influence, the decision will provide some

level of comfort to taxpayers that it is not limited to top-level managerial involvement as asserted by HMRC.

Cross Appeal by BlueCrest – Variable remuneration

In general terms, BlueCrest's remuneration committee set the members' individual bonuses principally by reference to their individual performance or the performance of their particular portfolio. They had added a term in response to the introduction of the Rules that provided for those bonuses to be scaled back if the LLP did not generate enough profit to pay all of the allocated bonuses, but did not otherwise vary pay based on overall performance of the LLP. BlueCrest argued that the FTT was wrong in its construction and approach to whether all members received "disguised salary" or variable remuneration for the purposes of Condition A, given the possible scaling back of bonuses and that the FTT had set the bar too high in terms of the link required between the bonus paid to each member and the profits and losses of the LLP.

The UT noted that the variable remuneration question is concerned with what it is reasonable to expect at the relevant time (that is, at the beginning of each tax year) each member will receive. Applying that approach, the UT agreed with the FTT that, because bonuses were set initially without reference to the overall profits of the LLP and the question of whether there would be sufficient funds to pay such amounts come the end of the year was a separate question, all of the bonus payments were "disguised salary," none were variable by reference to the overall profits of the LLP and the members all failed Condition A.

Accordingly, those members who failed the significant influence test were salaried members.

The UT's decision on the significant influence question will be welcomed by LLPs which have members in senior positions who are important to the business but not necessarily involved directly in top-level managerial decisions. Given the rejection of HMRC's published position on the requirement for significant influence.

We understand that HMRC are in the process of appealing to the Court of Appeal and a decision will be made as to whether the appeal will be allowed by the end of December 2023.

DEBRA: Postponed Negotiations on Debt/Equity Balance

On 11 May 2022, The Debit Equity Bias Reduction Allowance ("DEBRA") was proposed by the European Commission due to the perceived bias in the market for debt versus equity finance. The European Commission identified that debt is generally treated more favourably from a tax perspective, with greater deductions and treaty benefits available for interest payments on loans in comparison to equity, with dividends often non-deductible for tax. This unbalanced tax treatment between debt and equity leads to an increase in business investments being structured for debt, leading to higher levels of indebtedness within the EU.

There are two elements to the directive:

1) An allowance to be introduced on increases in net company equity in the tax year, pegged to 10-year risk-free interest rates and a risk premium, that would be deductible from the entity's tax base for ten years; and

2) Placing a cap on deductions at 85% of net borrowing costs.

The interest limitation rule would apply in parallel with the existing earnings stripping rules in ATAD 1 (these rules limit the deductibility of excess net interest expenses to thirty percent (30%) of tax EBITDA or a de minimis threshold of EUR €3,000,000, whichever is higher). Certain entities would have to calculate the deduction under both DEBRA and ATAD 1 and would only be entitled to deduct the lowest amount, but would be entitled to carry forward or back the difference between the two amounts to reduce a tax liability. However, certain entities which would not be caught by ATAD 1 due to the de minimis element, would be caught by DEBRA which has no such threshold.

The directive was originally due to commence on 1 January 2024, but negotiations were suspended in December 2022 due to the impact of other changes to the corporate tax regimes in the EU. Certain EU Member States, including the Swedish parliament, have also questioned the proposal and the limit it would place on jurisdiction's corporate tax sovereignty with more restrictions in relation to setting domestic corporate tax rules. It appears that the proposal may have lost some political impetus over the last year.

The implementation of this proposal would have consequences for fund managers relating to the use of debt financing and would potentially push fund managers towards considering more equity financing to take advantage of the increased tax benefits for structures resident in the EU.

Latin America

Overview

The Latin American funds market has been in constant expansion. In Brazil alone, it is an eight trillion reais (approximately 1.6 trillion dollars) industry, having grown about half a trillion reais during 2023. Acknowledging this trend, regulators have been endeavoring to create an investor-friendly framework that further fosters the investment environment in Latin American countries, having efficiency, competitivity and systematization as main pillars.

In Brazil, for instance, work groups created within the Ministry of Finance for the improvement of economic regulation during the prior administration have been kept in place under the recently inducted government, and many of the initiatives proposed by such groups has come to reality.

From a business perspective, Brazil and Latin America in general are still fertile ground for infrastructure investments. For instance, as further detailed below, the Brazilian government has recently created certain tax exemptions for foreign investments in infrastructure, in an attempt to attract foreign capital to Brazilian infrastructure initiatives.

Funds focused on high-yield fixed-income assets, such as private credit, securitization of receivables and mortgage-backed securities can also take advantage of opportunities resulting from the high interest rates currently observed in Latin American economies.

New Regulatory Framework for Investment Funds

The Brazilian Securities Exchange Commission (*Comissão de Valores Mobiliários* - CVM) enacted in April 2023 a new regulatory framework that aims at modernizing the rules for investment funds. The creation of such new framework was preceded by intense discussions with authorities and industry players, which enabled the CVM to specifically seek to address some of the shortcomings identified in the previous regulatory regime. The main concepts introduced by the new framework are described below:

- *Limited liability*. The new rules allow for the limitation of the liability of investors to the amount of their investment, similar to the treatment in a limited liability partnership. While veilpiercing is still possible when the factual requirements are met, in general this rule provides a safer setting to investors of Brazilian funds, as investors will not run the risk of being held liable in excess of their committed capital.
- *Classes of quotas*. The regulations now contemplate the creation of different classes of quotas within a single fund, with the possibility of assignment of specific assets and related liabilities to each of such classes (similar to a segregated portfolio company). This concept will likely make fundraising more efficient, as it will enable investors to deploy capital on a specific asset – or group of assets – without the need for the incorporation of separate entities.
- *Insolvency regime*. The CVM implemented a specific insolvency regime for investment funds, aligned with the Brazilian insolvency law – including judicial recovery proceedings similar to Chapter 11 in the U.S. It also contemplates the possibility of the insolvency affecting a fund as

a whole or just a class of quotas. This can be seen as a tool of additional safety to investors and creditors of Brazilian funds, in that it enables for better foreseeability of the outcomes of an eventual insolvency process, thus fostering the access to resources by funds incorporated in Brazil.

- *Clearer governance rules*. More modern and objective governance rules for investment funds were also adopted. These rules include clear delimitation of the duties and liabilities of managers, administrators and other services providers and players in the context of managing investment funds. Such new rules are expected to reduce the costs of incorporating and administering funds in Brazil, for they reduce the exposure of such players to unforeseen risks associated with them taking part on a fund structure.
- *Specific rules*. The new ruling contains tailormade subsidiary rules for specific classes of funds, such as private equity funds, real estate investment trusts, ETF, among others. These rules, aimed at addressing specific concerns raised by players of each industry in public hearings held by the CVM before the new regulation was officially published, seek to allow managers to manage funds more efficiently, on one hand, and investors to have additional layers of protection, on the other hand.

The new CVM ruling has come into effect on April 3, 2023, however funds existing on the date of enactment of the new rules must adapt to comply with them by December 31, 2024, – except for credit rights investment funds (the so-called FIDCs), which must comply by April 1, 2024.

Taxation of Investments in Private Equity Funds

The taxation of foreign investments in Brazilian private equity funds (the so-called FIPs) has been modified towards a friendlier framework.

The main change was the suppression of the maximum stake and portfolio requirements for foreign investors to benefit from an exemption from income tax over distributions. Previously, in order to enjoy the exemption, foreigners could only hold up to 40% of the total outstanding equity of the fund. Also, certain portfolio limitations should be observed.

Under the new rules, foreign investors are exempted from income tax regardless of their stake in a given fund, provided that such investors qualify as “investment entities” – which term is still subject to further definition by Brazilian authorities.

In practical terms, this change will allow for more straightforward and cost-efficient structures for investments in Brazilian private equity.

The tax exemption is also no longer affected or modified by the fund’s portfolio, which now must only comply with the regulatory requirements imposed by the CVM for any equivalent fund. The reach of the tax exemption has also been expanded, now applying to foreign investment in infrastructure funds, research and development funds, as well as the investment made by non-Brazilian sovereign funds, regardless of those being located in a tax haven.

It is also worth mentioning that an attempt to exclude investors located in “jurisdictions with privileged tax regime” – which would encompass Delaware, for instance – was barred by the Brazilian government. Thus, from a Brazilian perspective, structures using pass-through Delaware entities should continue to be a valid option for Brazilian sponsored funds.

New Regulatory Framework for Public Offerings of Securities

In our 2022 report, we announced the enactment of a new framework for public offerings of securities in Brazil. Such new framework became effective on January 1, 2023, and currently all public offerings of securities in Brazil – which include quotas of investment funds – must comply with the provisions thereof.

Potential Taxation of Closed Funds

The Brazilian Congress is discussing a bill of law that intends to eliminate tax exemptions and advantages applicable to closed funds – that is, funds held by a single investor. The current wording only affects Brazilian investors but, as the discussions are still ongoing, further amendments to the text may also affect the taxation applicable to foreign investors.

New Legal Framework for Creation and Enforcement of Collateral

The Brazilian Government recently reformed the legal framework for the creation and foreclosure of collateral over real estate, movable assets, credits and securities. The changes include (i) regularization of the collateral agent figure, (ii) electronic registration of securities, in line with the U.S. UCC and international best practices, (iii) creation of a unified lien search for movable assets and securities, and (iv) extrajudicial enforcement of mortgages.

While these changes do not directly impact the funds industry, they are expected to foster the credit industry in Brazil, thus likely benefiting investment funds focused on credit and credit-like assets.

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 other actions will be required pursuant to applicable federal, state, and/or non-U.S. laws and/or regulations.

We further note that the SEC has made a number of rule proposals that, if enacted, will result in material changes to certain forms, including Form ADV, Form PF and Schedules 13D and 13G. Please see "SEC Policy and Rulemaking Updates" for a discussion on the rule proposals.

Form ADV

RIAs 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 (e.g., by March 30, 2024 for advisers with a December 31 fiscal year-end). RIAs must deliver the updated Form ADV Part 2A, or a summary of the material changes made, to clients within 120 days following the adviser's fiscal year-end (e.g., by April 29, 2024 for advisers with a December 31 fiscal year-end). Although underlying investors of private funds managed by an adviser are not "clients" of the adviser under the Advisers Act, it is generally considered best practice to deliver the updated Form ADV Part 2A to these investors on an annual basis. Part 2B of Form ADV is called the "brochure supplement." RIAs must give a client a brochure supplement for each individual that it supervises who: (1) formulates investment advice for that client and has direct client contact; or (2) makes discretionary investment decisions for that client's assets, even if the supervised individual has no direct client contact.

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 adviser and/or its personnel, becomes inaccurate or, in certain cases, materially inaccurate. Form ADV Part 2A 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, must also 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, and the Exams Division does ask for Part 2B when they undertake exams.

ERAs are subject to similar reporting requirements with respect to sections in Form ADV Part 1 that apply to them. If the ERA is exempt from SEC registration under the "private fund adviser" exemption, the ERA must register with the SEC once it reports in its annual amendment to Form ADV that its 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 from a place of business in the U.S. have reached $150 million). The ERA must apply for registration within 90 days of filing the amendment. If the ERA is exempt from SEC registration under the "venture capital fund adviser" exemption, the ERA 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 RIA 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 (e.g., by April 29, 2024 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, a 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, 2024 for the quarter ending December 31, 2023).
- *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, 2024 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 and registered money market funds under its management. Large Liquidity Fund Advisers must file Form PF within 15 days of each quarter-end (by January 15, 2024 for the quarter ending December 31, 2023).

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

ERAs 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 virtual filing be made on their central electronic filing system in connection with the Form D 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.

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 2023, the first Form 13F filing deadline in 2024 will be February 14, 2024 (for the quarter ending December 31, 2023).

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/or certain controlling persons and/or parent companies of the adviser. If the due date of a Schedule 13D or 13G falls on a weekend or federal holiday, the due date is the following business day.

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%.

Effective February 5, 2024 and required beginning on September 30, 2024, Schedule 13D must be filed within 5 days after crossing the 5% threshold. An amendment to Schedule 13D must be filed within 2 business days of the triggering event.

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, 2024 for 2023). 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.

Effective February 5, 2024 and required beginning on September 30, 2024, Schedule 13G must be filed within 45 days after the calendar quarter-end if its holding crossed the 5% threshold. Schedule 13G must be amended within 5 days (rather than the current deadline of 10 days) of a month-end when required as detailed above.

- 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 holdings exceed 10% of the class of equity securities and if it thereafter increases or decreases by more than 5% of the class of equity securities.

Effective February 5, 2024 and required beginning on September 30, 2024, Schedule 13G must be filed within 5 business days after crossing the 5% threshold. Schedule 13G must be amended within 2 days (rather than the current "promptly" deadline) when required as detailed above.

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, if other conditions are met. Each such exempt filer is required to file a Schedule 13G within 45 days after the end of a calendar year (by February 14, 2024 for 2023).

Effective February 5, 2024 and required beginning on September 30, 2024, a beneficial owner that crossed the 5% threshold as of calendar-year end but is exempt from filing a Schedule 13D is required to file a Schedule 13G within 45 days after calendar quarter-end.

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 2023 amendments

will be February 14, 2024.

Effective February 5, 2024 and required beginning on September 30, 2024, QII, passive investor and exempt investor filers must amend Schedule 13G within 45 days of each calendar quarter-end in which a material change occurred.

Forms 3, 4 and 5

Form 3. A person, including an adviser or other affiliate, depending on various factors, 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 of the securities under the Exchange Act.

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 end to report any exempt or other insider transactions not previously reported on Form 4 (by February 14, 2024 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, 2024 for 2023). 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 Commodity Pool Operator ("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 Commodity Trading Advisor ("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, 2024 for 2023).

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, 2024, 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. 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.

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

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

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

The upcoming filing deadlines for the period ending on December 31, 2023 will be February 29, 2024 for Large CPOs and March 30, 2024 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, 2023 will be February 14, 2024.

The CFTC has published a series of FAQs on CFTC Forms 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. If the due date of a report falls on a weekend or federal holiday, the due date is the following business day. 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 advisers or funds, or be used to calculate whether the threshold limits have been exceeded.

A U.S. resident investment adviser 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 adviser 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 advisers 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

The TIC Form S was discontinued in 2023. Institutions that previously filed the TIC S form will still be able to revise data from past submissions and are required to keep records for 3 years.

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).

The U.S. Department of Treasury has recently adopted an amendment to Form SLT to elicit more detailed data from reporting parties. Effective for all Form SLT reports as of December 2022, each reporting party should expect to be required to disclose the above in more detail than they were required to previously.

Form SLT must be filed monthly by the 23rd day following the end of each month (e.g., by January 23, 2024 for December 2023). If the due date of the report falls on a weekend or federal holiday, the TIC Form SLT report should be submitted the following business day. 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.

The discussion above focuses on the regulatory obligations applicable to investment advisers to private funds. The filing obligations applicable to other types of investment advisers (particularly investment advisers to separately management accounts or retail investors, banks, bank holding companies and non-financial entities) may be different.

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 2023, 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 2023 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 2023 will be the due date (including any applicable extensions) of that U.S. person's 2023 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 2023 (and subsequent years), the deadline will be the due date (including any applicable extensions) of the private fund's 2023 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 2023 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);
- IRS Form 8938 (with respect to certain non-U.S. financial assets); and
- IRS Form 8992 (with respect to certain U.S. shareholders of controlled foreign corporations to calculate their share of "global intangible low-taxed income" (GILTI)).

Generally, the deadline will be the due date (including any applicable extensions) of the U.S. person's 2023 U.S. federal income tax return.

Other Annual Requirements and Considerations

Audited Financial Statements Delivery

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 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, 2024, 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 28, 2024, if the fiscal year ends on December 31).

Currently, only auditors to public companies are subject to regular inspection by the PCAOB. However, on December 11, 2019, the staff of the SEC's Investment Adviser Regulation Office in the Division of Investment Management issued a no-action letter that 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 permitted by the SEC through the date the SEC would approve a PCAOB-adopted permanent program for the inspection of broker and dealer auditors.

Privacy Policy Delivery

Following changes to the Gramm-Leach-Bliley Act contained in Section 75001 of the Fixing America's Surface Transportation Act of 2015 (the FAST Act), and subsequent 2019 conforming rulemaking from the CFTC, 2018 rule amendments from the U.S. Bureau of Consumer Financial Protection and 2019 staff guidance from the Division of Examinations, 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 non-public client information to be disclosed to non-affiliated third parties, and the new disclosure is not covered in the existing notice, the financial institution must deliver an updated notice to clients and provide them a reasonable opportunity to opt out of the new disclosure.

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 each investor relating to its 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"), a "real estate operating company" ("REOC") 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/REOC requirements and/or the 25% benefit plan investor limit. Private funds that accept investments from ERISA investors should conduct the VCOC/REOC 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 prior to their admission to the private fund with certain information (sometimes referred to as "408(b)(2) disclosures," by reference to the relevant section of ERISA) relating to any changes to the fees or expenses paid by the fund and/or certain other information relating to the private fund adviser's compensation that is requested by any ERISA investor and required for any ERISA investor's compliance with its reporting and disclosure obligations under 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 recordkeeping 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 their Proskauer team for more information.

In addition, under New York City's Lobbying Law and based on regulatory guidance issued in 2010-2012, placement agents and/or employees of investment advisers 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 requirements 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.

2023 - 2024 Federal Filings and Other Document Delivery Calendar[58]

Filing / Delivery	Who Must File	Deadline
December 2023		
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country)	December 15 (for November 2023)
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 26 (for November 2023) Note: Usually filed on the 23rd calendar day of the following month, but if the 23rd day is a federal holiday, Saturday or Sunday, the filing deadline is extended until the next business day.
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below $500,000)	December 30 (for November 2023)
January 2024		
Form PF	Large Liquidity Fund Advisers	January 15 (for the quarter ending December 31, 2023)
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 16 (for December 2023) Note: Usually filed on the 15th calendar day of the following month, but if the 15th day is a federal holiday, Saturday or Sunday, the filing deadline is extended until the next business day.

[58] Any deadlines for filings to be made with the SEC that fall on a federal holiday, Saturday or Sunday may be filed on the first business day following such date.

Filing / Delivery	Who Must File	Deadline
TIC Form BQ-1, BQ-2 and BQ-3	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country) (Form BQ-1 and BQ-2 Part 1), in excess of $50 million (no country limit) (Form BQ-2 Part 2) or in excess of $4 billion (no country limit) (Form BQ-3)	January 22 (for the quarter ending December 31, 2023) Note: Usually filed on the 20th calendar day of the following quarter, but if the 20th day is a federal 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	January 23 (for December 2023)
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, 2023)
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 2023)
February 2024		
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 (e.g., Qualified Institutional Investors and/or passive investors)	February 14 (for 2023)
Form 13H Annual Update	Large traders of Regulation NMS securities	February 14 (for 2023)
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, 2023)

Filing / Delivery	**Who Must File**	**Deadline**
Form 13F	Investment managers that exercise investment discretion over $100 million or more in Section 13(f) securities	February 14 (for the quarter ending December 31, 2023)
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country)	February 15 (for January 2024)
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding $1 billion as of the last day of any calendar month	February 23 (for January 2024)
Form PF	Large Hedge Fund Advisers	February 29 (for the quarter ending December 31, 2023)
CFTC Form CPO-PQR	Large CPOs	February 29 (for the quarter ending December 31, 2023)
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 2023)
March 2024		
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 2024)
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country)	March 15 (for February 2024)

Filing / Delivery	Who Must File	Deadline
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding $1 billion as of the last day of any calendar month	March 25 (for February 2024) Note: Usually filed on the 23rd calendar day of the following month, but if the 23rd day is a federal holiday, Saturday or Sunday, the filing deadline is extended until the next business day.
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below $500,000)	March 30 (for February 2024)
Form ADV Annual Update	Registered investment advisers and ERAs	March 30 (for an investment adviser with a December 31 fiscal year-end)
NFA Commodity Pool Annual Financial Statements Filing	Registered CPOs	March 31 (for a pool with a December 31 fiscal year-end)
CRS Information Reports	Financial institutions in "Participating Jurisdictions" (which currently do not include the US)	Consult local advisers for timing
FATCA Information Report	Participating FFIs (except for FFIs in Model 1 IGA jurisdictions) FFIs in Model 1 IGA jurisdictions	Consult local advisers for timing
April 2024		
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)
Form PF	Large Liquidity Fund Advisers	April 15 (for the quarter ending March 31, 2024)
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 2024)

Filing / Delivery	Who Must File	Deadline
TIC Form BQ-1, BQ-2 and BQ-3	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country) (Form BQ-1 and BQ-2 Part 1), in excess of $50 million (no country limit) (Form BQ-2 Part 2), or in excess of $4 billion (no country-limit) (Form BQ-3)	April 22 (for the quarter ending March 31, 2024) Note: Usually filed on the 20th calendar day of the following quarter, but if the 20th day is a federal 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	April 23 (for March 2024)
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)
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)
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 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 2024)
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 March 2024)
May 2024		
NFA Form PR	All registered CTAs	May 15 (for the quarter ending March 31, 2024)
Form 13F	Investment managers that exercise investment discretion over $100 million or more in Section 13(f) securities	May 15 (for the quarter ending March 31, 2024)

Filing / Delivery	**Who Must File**	**Deadline**
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 2024)
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding $1 billion as of the last day of any calendar month	May 23 (for April 2024)
Form PF	Large Hedge Fund Advisers	May 30 (for the quarter ending March 31, 2024)
CFTC Form CPO-PQR	Large CPOs	May 30 (for the quarter ending March 31, 2024)
NFA Form CPO-PQR	All registered CPOs, except Large CPOs	May 30 (for the quarter ending March 31, 2024)
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 2024)
June 2024		
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country)	June 17 (for May 2024) Note: Usually filed on the 15th calendar day of the following month, but if the 15th day is a federal 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	June 24 (for May 2024) Note: Usually filed on the 23rd calendar day of the following month, but if the 23rd day is a federal holiday, Saturday or Sunday, the filing deadline is extended until the next business day.
Delivery of Annual Audited Financial Statements to Private Fund Investors	Registered investment advisers (with respect to fund-of-funds)	June 29 (for a fund-of-funds with a December 31 fiscal year-end)

Filing / Delivery	**Who Must File**	**Deadline**
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 2024)
July 2024		
Form PF	Large Liquidity Fund Advisers	July 15 (for the quarter ending June 30, 2024)
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 2024)
TIC Form BQ-1, BQ-2 and BQ-3	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country) (Form BQ-1 and BQ-2 Part 1), in excess of $50 million (no country-limit) (Form BQ-2 Part 2), or in excess of $4 billion (no country-limit) (Form BQ-3)	July 22 (for the quarter ending June 30, 2024) Note: Usually filed on the 20th calendar day of the following quarter, but if the 20th day is a federal holiday, Saturday or Sunday, the filing deadline is extended until the next business day.
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding $1 billion as of the last day of any calendar month	July 23 (for June 2024)
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, 2024)
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 2024)
August 2024		
NFA Form PR	All registered CTAs	August 14 (for the quarter ending June 30, 2024)

Filing / Delivery	**Who Must File**	**Deadline**
Form 13F	Investment managers that exercise investment discretion over $100 million or more in Section 13(f) securities	August 14 (for the quarter ending June 30, 2024)
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country)	August 15 (for July 2024)
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding $1 billion as of the last day of any calendar month	August 23 (for July 2024)
Form PF	Large Hedge Fund Advisers	August 29 (for the quarter ending June 30, 2024)
CFTC Form CPO-PQR	Large CPOs	August 29 (for the quarter ending June 30, 2024)
NFA Form CPO-PQR	All registered CPOs, except Large CPOs	August 29 (for the quarter ending June 30, 2024)
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 2024)
September 2024		
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country)	September 16 (for August 2024). Note: Usually filed on the 15th calendar day of the following month, but if the 15th day is a federal 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	September 23 (for August 2024)

Filing / Delivery	**Who Must File**	**Deadline**
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 2024)
October 2024		
Form PF	Large Liquidity Fund Advisers	October 15 (for the quarter ending September 30, 2024)
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 2024)
TIC Form BQ-1, BQ-2 and BQ-3	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country) (Form BQ-1 and BQ-2 Part 1), in excess of $50 million (no country limit) (Form BQ-2 Part 2), or in excess of $4 billion (no country limit) (Form BQ-3)	October 21 (for the quarter ending September 30, 2024) Note: Usually filed on the 20th calendar day of the following quarter, but if the 20th day is a federal holiday, Saturday or Sunday, the filing deadline is extended until the next business day.
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding $1 billion as of the last day of any calendar month	October 23 (for September 2024)
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, 2024)
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 2024)
November 2024		
NFA Form PR	All registered CTAs	November 14 (for the quarter ending September 30, 2024)

Filing / Delivery	Who Must File	Deadline
Form 13F	Investment managers that exercise investment discretion over $100 million or more in Section 13(f) securities	November 14 (for the quarter ending September 30, 2024)
Schedule 13G Quarterly 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 (e.g., Qualified Institutional Investors and/or passive investors)	November 14 (for the quarter ending September 30, 2024)
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 2024)
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 2024) Note: Usually filed on the 23rd calendar day of the following month, but if the 23rd day is a federal 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, 2024)
CFTC Form CPO-PQR	Large CPOs	November 29 (for the quarter ending September 30, 2024)
NFA Form CPO-PQR	All registered CPOs, except Large CPOs	November 30 (for the quarter ending September 30, 2024)
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 2024)

Filing / Delivery	Who Must File	Deadline
Other Floating Deadlines		
Form D	Private funds conducting an offering under Regulation D	Initial Filing: Within 15 days of the initial sale of securities Annual Amendment: Anniversary date of the previous Form D filing, if the offering is still ongoing Interim Amendment: As soon as practicable to correct material mistakes or errors after certain changes in information Note: Additional state blue sky filing requirements may apply
Schedule 13D	Beneficial owners of at least 5% of a class of outstanding equity securities of a U.S. public company	Initial Filing: Within 10 days (5 days as of September 2024) of crossing the 5% threshold Amendment: Promptly (2 days as of September 2024) after any material change in beneficial ownership percentage

Filing / Delivery	Who Must File	Deadline
Schedule 13G	Beneficial owners of at least 5% of a class of outstanding equity securities of a U.S. public company eligible to file Schedule 13G (*i.e.*, Qualified Institutional Investors and/or passive investors)	Initial Filing: Generally, within 45 days of year-end (if a QII or passive investor) or within 10 days of crossing the 5% threshold (if a passive investor) Annual Amendment: Within 45 days of year-end (see above) Interim Amendment: Within 10 days (5 days as of September 2024) of month-end (if a QII) or promptly (2 days as of September 2024) (if a passive investor) if holding exceeds 10% or if it thereafter increases or decreases by over 5%
Form 13H	Large traders of Regulation NMS securities	Initial Filing: Promptly (usually 10 days) after reaching reporting threshold Annual Amendment: Within 45 days of year-end (see above) Interim Amendment: Promptly after quarter-end if there is any change in information
Form 3	Beneficial owners of more than 10% of a class of equity securities of a U.S. public company, or officers or directors of a U.S. public company	Within 10 days of becoming a 10% beneficial owner, officer or director For an IPO, on the effective date of registration of the securities under the Exchange Act

Filing / Delivery	**Who Must File**	**Deadline**
Form 4	Beneficial owners of more than 10% of a class of equity securities of a U.S. public company or officers or directors of a U.S. public company that effect a transaction changing the beneficial ownership of securities previously reported on Form 3	Within 2 business days of the transaction
Hart-Scott-Rodino Filings	Persons contemplating a business transaction which is not "solely for the purpose of investment" and relates to either: (i) the acquisition of voting securities valued in excess of $84.4 million (adjusted annually); or (ii) the acquisition of a majority of interests in certain unincorporated entities (such as certain partnerships or LLCs). The passive investor exemption is available only for holdings not exceeding 10% of an issuer's voting stock	Prior to completion of the proposed business transaction Note: Filers are generally subject to a 30-day waiting period after submitting their HSR notice filing
Form BE-13A or BE-13 Claim for Exemption	U.S. advisers to private funds in which a non-U.S. person acquires direct or indirect ownership or control of 10% or more of the voting securities If the cost of the transaction exceeds $3 million, then the U.S. entity should file Form BE-13A If the cost of the transaction does not exceed $3 million, then the U.S. entity should file a BE-13 Claim for Exemption	Within 45 days after a reportable transaction
New Issues Affirmations	Private funds that invest in new issues	Annually
Delivery of Privacy Policy Notice to Clients	Financial institutions who have changed their privacy policies and practices since the last distribution of a privacy notice (see above)	Annually

Filing / Delivery	**Who Must File**	**Deadline**
Delivery of ERISA/VCOC/REOC Annual Certification to ERISA Investors	Private funds operating as a VCOC/REOC 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 2023	Due date (including any applicable extension) of that entity's 2023 U.S. federal income tax return
QEF Election	In the case of a private fund that has invested in a non-U.S. portfolio company that is (or may be) a PFIC, the first U.S. person in the PFIC's ownership chain (e.g., the fund itself if a U.S. fund, or each U.S. investor if a non-U.S. fund)	Due date (including any applicable extensions) of that U.S. person's 2023 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 2023 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 2023 U.S. federal income tax return

Filing / Delivery	**Who Must File**	**Deadline**
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 IRS Form 8992	Generally, due date (including any applicable extensions) of the U.S. person's 2023 U.S. federal income tax return

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