# 2013 RECOMMENDED ANNUAL REVIEW FOR HEDGE FUND AND OTHER PRIVATE FUND ADVISERS

In 2013, we continued to see significant regulatory activity targeted at investment advisers to hedge funds and other private funds. The following (this **"Annual Review"**) is a summary of some of the noteworthy regulatory changes affecting investment advisers that occurred in 2013, as well as certain "best practices" that investment advisers should consider in preparing for 2014. This Annual Review is general in nature and does not constitute legal advice for any specific situation.

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## RULE 506 AMENDMENTS

On July 10, 2013, as a result of the Jumpstart Our Business Startups Act (the **"JOBS Act"**)[1], the Securities and Exchange Commission (the **"SEC"**) amended Rule 506 of Regulation D under the Securities Act of 1933 (the **"1933 Act"**). Rule 506 is one of the most commonly relied upon safe harbors for the private offering exemption of Section 4(a)(2) of the 1933 Act. The Rule 506 amendments included new Rules 506(d) and (e), which, among other things, may disqualify a private fund from conducting a Rule 506 offering as a result of certain "bad acts" by the private fund or certain other "Covered Persons" (as defined below).[2] The amendments also included new Rule 506(c), which eliminated the prohibition on general solicitation and general advertising (together, **"general solicitation"**) for certain private offerings under Rule 506, subject to conditions.[3] We note that the Rule 506 amendments did not repeal Rule 506(b), the existing private offering exemption "safe harbor" under Rule 506 that hedge funds and other private funds have historically relied upon. The Rule 506 amendments became effective on September 23, 2013.

Concurrently with the adoption of the Rule 506 amendments, the SEC also made corresponding amendments to Form D and proposed an additional package of amendments to Regulation D, Form D and Rule 156 under the 1933 Act.

A more detailed description of the Rule 506 amendments, the Form D amendments and the proposed amendments appears below. In addition, for more information on the Rule 506 amendments, the Form D amendments and the proposed amendments, please see our July 2013 alerts on the bad actor rule and Rule 506(c), and our September 2013 FAQ on new Rule 506 (which will be provided upon request).

### "Bad Actor" Rules

New Rule 506(d) prohibits a private fund from relying on Rule 506 (including both Rule 506(b) and Rule 506(c)) if the private fund or certain other "Covered Persons" have a "Disqualifying Event" (as defined below) that occurs on or after September 23, 2013. If any Covered Person has such a Disqualifying Event, the private fund will for a period of time be prohibited from relying on Rule 506, absent a waiver from the SEC or in some cases another authority. The length of the disqualification will vary depending upon the nature of the Disqualifying Event.

In addition, new Rule 506(e) provides that if any Covered Person has a Disqualifying Event that occurred prior to September 23, 2013, the Disqualifying Event will not disqualify the private fund from relying on Rule 506, but must be disclosed to prospective investors a reasonable time before they invest. We note that while this disclosure must be reasonably prominent, the SEC has not provided definitive guidance as to location, form and/or content of this disclosure that it would consider sufficient for these purposes.

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[1] The text of the JOBS Act is available here. Our client alert regarding the JOBS Act can be found here.

[2] Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, SEC Release No. 33-9414, available here.

[3] Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, SEC Rel. No. 33-9415, available here.

We note that the triggering event that would result in “bad act” disqualification or disclosure is not the conduct itself, but rather an order or conviction as a result of that conduct. Accordingly, there may be a significant time period between the conduct itself and the Disqualifying Event.

*Covered Persons.* For purposes of the bad actor rules, **“Covered Persons”** include:

- The private fund and any predecessor of the private fund or any affiliated issuer;
- A general partner or managing member of the private fund;
- A director or executive officer of the private fund, or other non-executive officers of the private fund participating in the offering;
- A holder of at least 20% of the private fund’s voting securities;
- An investment adviser of the private fund, as well as: (i) directors, executive officers or other officers of the investment adviser participating in the offering; (ii) general partners or managing members of the investment adviser; (iii) directors, executive officers of the general partners or managing members, or other officers participating in the offering;
- A promoter connected with the private fund in any capacity at the time of the sale (e.g., possibly a seed investor); and
- Any compensated solicitor (i.e., a person that has been or will be paid, directly or indirectly, compensation for soliciting purchasers), as well as any director, executive officer, or other officer of such compensated solicitor participating in the offering, or a general partner or managing member of any such compensated solicitor.

*Disqualifying Events.* For purposes of the bad actor rules, **“Disqualifying Events”** include:

- Criminal convictions within ten years before the sale of securities (or five years, in the case of the private fund and its predecessors and affiliated issuers) of any felony or misdemeanor: (i) in connection with the purchase or sale of any security; (ii) involving the making of any false filing with the SEC; or (iii) arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;
- Court orders, judgments or decrees entered within five years before the sale of securities in the offering, that, at the time of the sale, restrain or enjoin a Covered Person from engaging or continuing to engage in any conduct or practice: (i) in connection with the purchase or sale of any security; (ii) involving the making of a false filing with the SEC; or (iii) arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;
- Final orders from specified state or federal regulators, such as a state securities, banking, savings association, credit union, and insurance regulators; federal banking agencies; the Commodity Futures Trading Commission (the **“CFTC”**); or the National Credit Union Administration that either: (i) bar the Covered Person at the time of the sale from: (a) associating with an entity regulated by these federal or state authorities; (b) engaging in the business of securities, insurance or banking; or (c) engaging in savings association or credit union activities; or (ii) are based on a violation of any law or regulation that prohibits fraudulent, manipulative or deceptive conduct entered within ten years prior to the sale of securities;

- SEC disciplinary orders that, at the time of the sale of securities: (i) suspend or revoke a Covered Person's registration as a broker, dealer, municipal securities dealer, or investment adviser; (ii) place limits on the activities, functions, or operations of the Covered Person; or (iii) bar the Covered Person from being associated with any entity or from participating in the offering of any penny stock;
- SEC cease and desist orders entered within five years before the sale of securities that, at the time of the sale, order a Covered Person to cease and desist from committing or causing a violation or future violation of (i) any anti-fraud provision of the federal securities laws, such as Rule 10b-5 under the Securities Exchange Act of 1934 (the "**Exchange Act**"), that requires a particular intention, state of mind, or scienter, or (ii) the requirement to register offerings of securities with the SEC under Section 5 of the 1933 Act;
- Suspension or expulsion of a Covered Person from membership in a securities "self-regulatory organization" or from association with a member of a securities self-regulatory organization, such as a U.S. registered national securities exchange or national securities association, for any act or omission constituting conduct inconsistent with just and equitable principles of trade;
- Either (i) SEC refusal or stop orders issued within five years before the sale of securities applicable to a registration statement under the 1933 Act (and orders suspending a Regulation A exemption for an offering statement) that either a Covered Person filed (as a registrant or issuer) or in which a Covered Person was or was named as an underwriter, or (ii) investigations or proceedings to determine whether any such order should be issued to which a Covered Person is subject that are pending at the time of the proposed sale of securities; and
- Either (i) U.S. Postal Service false representation orders to which a Covered Person is subject entered within five years before the sale of securities, or (ii) temporary restraining orders or preliminary injunctions pending at the time of the sale of securities concerning conduct alleged by the U.S. Postal Service to constitute a scheme for obtaining money or property through the mail by false representations.

***Reasonable Care Exception.*** The "bad actor" rules contain an exception from the disqualification from relying on Rule 506 if the private fund establishes that it did not know and, in the exercise of reasonable care, could not have known that a Disqualifying Event existed because of the presence or participation of another Covered Person. The SEC declined to provide guidance on the specific steps that should be taken in order to demonstrate reasonable care, noting that these would vary depending upon the facts of each case. Nevertheless, the SEC advised that reasonable care necessarily includes some inquiry into the relevant facts, and that in general, private funds (or their investment advisers) should ask Covered Persons whether they have Disqualifying Events.

In addition, the SEC indicated that when an offering continues indefinitely or for a long period of time, reasonable care includes updating prior factual inquiries. Again, the SEC declined to specify the frequency and extent of the required updates, commenting that these will depend upon the circumstances of the private fund, the offering, and the participants involved in the offering. At the same time, the SEC noted that periodic updates could be sufficient in the absence of circumstances, such as pending judicial or regulatory proceedings or known weaknesses in screening procedures, that suggest closer monitoring is required.

***Waivers.*** The SEC delegated to the Director of its Division of Corporation Finance authority, on behalf of the SEC, to grant waivers of the disqualification from relying upon Rule 506. In addition, disqualification will not apply if, before a sale is made under Rule 506, the court or regulator that issued an order or judgment advises in writing, whether in such order or judgment or in a separate communication to the SEC, that disqualification from relying on Rule 506 should not arise as a consequence of such order or judgment.

*Action Items.* **Hedge funds and other private funds conducting a Rule 506 offering should, if they have not done so already, conduct appropriate due diligence and factual inquiries to determine whether any Covered Person is subject to a Disqualifying Event that occurred before September 23, 2013 and provide any necessary disclosures to prospective investors.** Private funds should also implement a program to determine on an ongoing basis whether any of their Covered Persons is subject to a Disqualifying Event. Such a program could require, for example, that relevant new hires and new large investors certify that they have no Disqualifying Events, that relevant existing personnel and large investors certify annually (or more frequently depending on the facts) that they have no Disqualifying Events, that placement agents certify that they have no Disqualifying Events, that the private fund perform periodic due diligence to identify any unreported Disqualifying Events and that Covered Persons notify the investment adviser promptly of any Disqualifying Events or of any facts and circumstance that could lead to a Disqualifying Event. Registered investment advisers may consider combining some of these factual inquiries with existing processes in place for responding to Form ADV disciplinary history questions.

We note that the SEC is expected to issue further guidance on the applicability of the bad actor rule to private equity funds and their affiliated issuers. We will continue to monitor this issue and will provide updates when appropriate.

## New Rule 506(c)

New Rule 506(c) permits the use of general solicitation in connection with an offering of securities under Rule 506, provided that: (i) all purchasers of securities in the offering are “accredited investors,” as defined in Rule 501(a) of Regulation D; (ii) the private fund takes “reasonable steps to verify” that all purchasers of the securities are accredited investors; and (iii) all terms and conditions of Rule 501 and Rules 502(a) and 502(d) of the 1933 Act are satisfied. Accordingly, a hedge fund or other private fund (or its investment adviser on its behalf) may engage in all forms of general solicitation without violating the Rule 506 safe harbor, so long as it complies with these conditions. A hedge fund or other private fund that is relying on Rule 506(c) will be required to check a box on Form D.

We note that it is currently unclear whether Rule 506(c) will significantly change the environment in which hedge funds and other private funds raise investor capital. **To date, very few hedge fund managers have sought to rely on Rule 506(c).**

***Continued Availability of Rule 506(b).*** The Rule 506 amendments did not repeal Rule 506(b), the existing private offering exemption “safe harbor” under Rule 506 that hedge funds and other private funds have historically relied upon. As a result, private funds may continue to rely upon

Rule 506(b), which prohibits general solicitation, following the effective date of the Rule 506 amendments. If a private fund relies on Rule 506(b), it will not be required to take "reasonable steps to verify" that all of its purchasers are accredited investors (as would be under Rule 506(c)), but will remain subject to the "reasonable belief" standard in the definition of accredited investors. We note that once general solicitation has been made to potential investors in an offering in reliance on Rule 506(c), the private fund is precluded from making a claim of reliance on Rule 506(b) for the same offering.

***"Reasonable Steps to Verify" Accredited Investor Status — Principles-Based Approach.*** Rule 506(c) requires a private fund that engages in general solicitation to take "reasonable steps to verify" that the purchasers of its securities in the offering are accredited investors. The verification condition is an objective determination to be made by the private fund in the context of the particular facts and circumstances of each purchaser and transaction, that the steps taken to verify a purchaser's accredited investor status are reasonable. The SEC noted that issuers should consider a number of factors to determine the reasonableness of the steps to verify that a purchaser is an accredited investor, including: (i) the nature of the purchaser and the type of accredited investor it claims to be; (ii) the amount and type of information that the issuer has about the purchaser; and (iii) the nature of the offering.

We note that self-certification, the current commonly-used practice for Rule 506(b) offerings whereby each prospective investor completes a qualification questionnaire certifying its accredited investor status, generally will not by itself satisfy the "reasonable steps" standard imposed by the SEC for Rule 506(c) offerings.

***"Reasonable Steps to Verify" Accredited Investor Status of Natural Person Investors — Non-Exclusive List of Methods.*** The SEC adopted four non-exclusive verification methods that are deemed to satisfy the required "reasonable steps" standard for *natural persons* (so long as the private fund or the investment adviser does not have knowledge that a potential investor is not an accredited investor). These non-exclusive verification methods include: (i) verification on the basis of net income; (ii) verification based on net worth; (iii) third-party verification; and (iv) self-verification by an existing natural person investor. In the Rule 506(c) adopting release, the SEC included specific examples of the types of documentation that would satisfy each of these non-exclusive verification methods and the parameters applicable to their use.

***3(c)(1) and 3(c)(7) Funds.*** We note that the SEC made it clear in the Rule 506(c) adopting release that hedge funds and other private funds that rely on Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 may engage in general solicitation in a Rule 506(c) offering without losing their ability to continue to rely on Section 3(c)(1) or 3(c)(7). The SEC also reminded investment advisers of the application of the antifraud provisions of Rule 206(4)-8 under the Investment Advisers Act of 1940 (the "**Advisers Act**"). The SEC did not indicate, however, whether the SEC would view an investment adviser to a hedge fund or other private fund that conducts an offering under Rule 506(c) as not holding itself out as an investment adviser, which is an important condition required in order to take advantage of certain limited exemptions from registration with the SEC as an investment adviser, such as the foreign private adviser exemption.

***Commodity Pool Operators.*** We also note that since the relevant provisions of the JOBS Act only apply to federal securities laws, commodities pool operators (**"CPOs"**) who engage in general solicitation are currently not able to claim an exemption from CPO registration under CFTC Rule 4.13(a)(3), which requires that interests in the pool be "offered and sold without marketing to the public in the United States." The CFTC, when it issued final harmonization rules on August 13, 2013 relating to CPOs registered with the CFTC under CFTC Rule 4.5, acknowledged the disparity between the treatment of private funds under the securities laws and the CFTC's regulations, and indicated that it has directed its staff to evaluate the issue and make recommendations to the CFTC for future action.

***Other Private Offerings.*** Rule 506 is a non-exclusive "safe harbor" from the registration requirements of the 1933 Act under the exemption contained in Section 4(a)(2) (formerly Section 4(2)) of the 1933 Act. The elimination of the prohibition on general solicitation applies only to private offerings made in reliance on the Rule 506 safe harbor, not to private offerings made under Section 4(a)(2) (the so-called "private resale exemption") or any other registration exemptions (other than Rule 144A). In addition, concurrent Rule 506 domestic offerings and Regulations S offshore offerings by a private fund will not be integrated.

***Other Important Regulatory Considerations.*** Previously, the prohibition on general solicitation in Rule 506 offerings had restricted, among other things, the use of advertising, newspaper or magazine articles, public Internet websites, social media, media broadcasts, mass email campaigns, and public seminars or meetings to sell a private fund's Rule 506 offering. By eliminating the prohibition on general solicitation in Rule 506, the amendments permit the use of a much broader array of marketing tools by hedge funds and other private funds that rely on Rule 506(c). However, it is important to note that, in analyzing issues under Rule 506(c), private funds and investment advisers should carefully consider other laws, rules, regulations, principles and standards that may apply or otherwise impact the analysis, including, for example, the advertising and other rules under the Advisers Act, the anti-fraud provisions of Rule 206(4)-8 under the Advisers Act and other applicable anti-fraud rules and principles, Global Investment Performance Standards, CFTC rules and regulations (including the CFTC's anti-fraud rules and principles), the European Union Alternative Investment Fund Managers Directive (the **"AIFMD"**) and other applicable foreign laws, rules and regulations (collectively, the **"Other Important Regulatory Considerations"**). In addition, when assessing whether to conduct a Rule 506(c) offering, private funds and investment advisers should bear in mind that the regulatory consequences of doing so remain uncertain, particularly given the SEC's proposed related amendments to Regulation D, Form D and Rule 156 under the 1933 Act.

## Form D Amendments

Concurrently with the adoption of the Rule 506 amendments, the SEC also adopted two amendments to Form D, effective September 23, 2013. Specifically, a hedge fund or other private fund conducting a Rule 506(c) offering will be required to indicate on Form D that it is relying on Rule 506(c). In addition, a private fund conducting a Rule 506 offering, whether pursuant to Rule 506(b) or 506(c), must certify that it is not disqualified from relying on Rule 506 due to Rule 506(d) (the "bad actor" rule).

## Proposed Amendments to Regulation D, Form D and Rule 156

The SEC also proposed a series of related amendments to Regulation D, Form D and Rule 156.[4] If adopted, the proposed amendments would:

- Require private funds relying on Rule 506(c) to file Form D not later than fifteen days prior to engaging in any general solicitation for an offering (which would include a subset of the information generally required on Form D, including identifying information about the private fund issuer and its related persons, information on the type of security to be offered, information about persons receiving sales compensation, and information on the use of proceeds from the offering);
- Require private funds relying on Rule 506(b) or 506(c) to file a final amendment to Form D within thirty days of terminating the offering;
- Expand the information required to be included on Form D, including information relating to the private fund, the securities being offered and the characteristics of the investors participating in the offering;
- Automatically disqualify private funds from relying on Rule 506(b) or 506(c) for one year for any new offering, if they have failed to comply within the last five years with all of the Form D filing requirements in a Rule 506 filing;[5]
- Apply Rule 156 under the 1933 Act, which interprets the antifraud provisions of the securities laws in connection with sales literature used by investment companies, to the general solicitation materials used by private funds in reliance on Rule 506(c);
- Require general solicitation materials to include a legend that would inform potential investors of potential risks associated with the offering, as well as the statutory mandate that sales are limited to accredited investors, and require certain additional legends and disclosures for private fund issuers; and
- Require, on a temporary and nonpublic basis, that private funds submit their written general solicitation materials to the SEC.

For Rule 506(c) offerings, private funds would also be required to file an amendment providing the remaining information required by Form D within fifteen days after the first sale of the securities. For Rule 506(b) offerings, the requirement to file a Form D within fifteen calendar days after the first sale of the securities would remain unchanged.

In contemplating a Rule 506(c) offering, investment advisers should consider that they and the hedge fund and other private funds they advise may become subject to the additional requirements imposed by these proposed amendments (as may be changed as and when adopted) and/or others that may be adopted in the future. We will continue to monitor this issue and will provide updates when appropriate.

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[4] Amendments to Regulation D, Form D and Rule 156, SEC Rel. No. 33-9416, available here.

[5] Disqualification would continue for one year after all required Form D filings have been made or, if the offering has been terminated, after the filing of a closing amendment. Disqualification would not apply to failures that occurred before the effective date of the proposed amendments.

## PRESENCE EXAMS

As a result of the repeal of the "private adviser" exemption from registration under the Advisers Act, many formerly unregistered investment advisers to private funds were required to be registered with the SEC by March 30, 2012. In October 2012, the SEC's Office of Compliance Inspections and Examinations publicly launched an initiative under its National Exam Program to conduct risk-based "presence exams" of newly registered private fund advisers over a two-year period. The initiative consists of three phases: (i) engaging with newly registered investment advisers; (ii) conducting presence examinations of a significant percentage of newly registered investment advisers; and (iii) reporting its observations to the industry. The SEC also highlighted five "higher-risk" areas that may be covered during presence exams, including marketing, portfolio management, conflicts of interest, safety of client assets and valuation. The SEC staff stated that it would contact each investment adviser selected for an examination separately and that examinations would be prioritized where the SEC staff has identified greater risks to investors or indicia of fraud or other serious wrongdoing.

We have seen and continue to see presence exams that last from a few days to a few weeks, as well as follow-up comment letters from the SEC staff regarding the presence exams conducted. Typically, each presence exam and comment letter vary depending on the specific circumstances of the investment adviser and the hedge funds or other private funds managed by the investment adviser. We encourage you to contact your regular Bingham counsel if you have any questions or concerns relating to presence exams.

## 2013 EXAMINATION PRIORITIES

On February 21, 2013, the SEC published its examination priorities for 2013 in a release intended to communicate areas that are perceived by the SEC staff to have heightened risk.[6] The release addressed issues that span the entire market as well as issues that relate specifically to particular business models and organizations, including investment advisers and private funds. The market-wide priorities included fraud detection and prevention, corporate governance and enterprise risk management, conflicts of interest and technology controls. With respect to investment advisers and private funds, ongoing risks that were selected as focus areas included safety of client assets and compliance with custody requirements, conflicts of interest related to compensation arrangements and allocation of investment opportunities, marketing and performance advertising and fund governance. New and emerging risks for 2013 with respect to investment advisers and private funds included newly registered investment advisers (a significant number of whom will be subject to "presence exams"), conflicts of interest for dually-registered investment advisers/broker-dealers, the growing use of alternative and hedge fund investment strategies in open-end funds, exchange-traded funds (**"ETFs"**) and variable annuity structures, and payments for distribution in guise. Policy topics for 2013 with respect to investment advisers and private funds included, among other things, compliance with previously granted exemptive orders and the Pay-To-Play Rule (as defined below). It is important to note that the SEC's list of examination priorities for 2013 is not intended to be exhaustive and that the SEC may examine other areas not mentioned in the report.

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[6] The SEC's examination priorities for 2013 can be found here.

For more information, please see our February 2013 alert on this issue. The SEC has also issued risk alerts on deficiencies found in its examinations of investment advisers and recommended practices, regarding topics such as custody requirements, business continuity plans and Rule 105 of Regulation M (short selling).

## CFTC REGULATORY UPDATES

### Rescission of the CPO Exemption under Rule 4.13(a)(4)

On February 9, 2012, the CFTC rescinded Rule 4.13(a)(4). This rule provided a widely used exemption from registration as a CPO.[7] Absent another available exemption or exclusion from the CPO definition, operators of "commodity pools"[8] were required to register with the CFTC effective December 31, 2012. The rescission of Rule 4.13(a)(4) has also prevented certain investment advisers from relying on a related exemption from registration as a CTA, Rule 4.14(a)(8). Accordingly, certain investment advisers have been required to identify an alternative exemption or otherwise register with the CFTC as a CTA. Newly-registered firms were required to comply with both CFTC and National Futures Association (the "**NFA**") requirements for the first time in 2013.

### De Minimis Trading Exemption under Rule 4.13(a)(3)

In light of the rescission of Rule 4.13(a)(4), certain advisers have been relying instead on the Rule 4.13(a)(3) exemption from CPO registration. Under Rule 4.13(a)(3), an adviser is not required to register with the CFTC as a CPO with respect to a fund if the fund engages in limited trading of commodity interests. Pursuant to this Rule, a fund must satisfy at least one of the following limits:

- *Initial Margin Limit*. The aggregate initial margin, premiums and required minimum security deposit for retail forex transactions required to establish the fund's positions in commodity interests (determined at the time the most recent position was established) must not exceed 5% of the liquidation value of the fund's portfolio, after taking into account unrealized profits and unrealized losses on any such positions into which it has entered.[9]

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[7] The term "commodity pool operator" includes any person engaged in a business that is in the nature of a commodity pool and who, in connection therewith, solicits, accepts or receives from others, funds, securities or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in commodity interests, including any futures, security futures product or swap; authorized commodity option or leverage transaction; or retail forex or commodity transactions as further defined in the Commodity Exchange Act (the "**CEA**"). The definition also includes any entity or person that registers with the CFTC as a CPO for whatever reason.

[8] A "commodity pool" is an enterprise in which funds contributed by a number of persons are combined for the purpose of trading futures or options contracts, including swaps.

[9] In the case of an option that is in-the-money at the time of purchase, the in-the-money amount, as defined in Rule 190.01(x) of the CFTC's regulations, may be excluded in computing this percentage.

- *Aggregate Net Notional Value Limit*. The aggregate net notional value of a fund's positions in commodity interests, determined at the time the most recent position was established, must not exceed 100% of the liquidation value of the fund's portfolio, after taking into account unrealized profits and unrealized losses on any such positions into which it has entered.[10]

To make use of this exemption, each fund investor must meet certain sophistication criteria, and the fund cannot be marketed as a vehicle for trading in commodity interests. The adviser must also file a notice of exemption with the NFA and must affirm at the end of each calendar year that it is conducting its activities in accordance with the terms of the exemption. The de minimis exemption is difficult to apply in the fund of funds context.

## CPO Registration

The CPO registration process is administered by the NFA. An adviser files for registration as a CPO by filing Form 7-R through the NFA Online Registration System. Individuals who are "associated persons" of a registered CPO or CTA must themselves register with the CFTC. This process will generally involve taking and passing the Series 3 exam or obtaining a waiver of the exam requirement from the NFA. For more information, please see our August 2012 alert on this issue. In addition, individuals who are "principals" of an adviser must make certain filings in connection with their adviser's registration, and both "principals" and "associated persons" of an adviser are subject to a fingerprint requirement and background check.

As part of the registration process, CPOs are required to design and implement a program for complying with the rules and regulations of the CFTC and the NFA. Key topics that must be covered by an adviser's compliance program include ethics training for employees, annual compliance reviews, inspections of branch offices, registration of new employees and disaster recovery planning.

In addition, advisers typically include in their compliance manuals procedures for complying with other CFTC/NFA requirements, particularly any applicable disclosure, reporting and recordkeeping requirements relating to commodity pools found in Part 4 of the CFTC's regulations. Advisers that are registered with the SEC as investment advisers may be able to incorporate these separate procedures in their existing manuals.

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[10] Notional value" is calculated for each *futures position* by multiplying the number of contracts by the size of the contract in contract units (taking into account any multiplier specified in the contract), then multiplying that number by the current market price per unit; for each *option position* by multiplying the number of contracts by the size of the contract, adjusted by its delta, in contract units (taking into account any multiplier specified in the contract), and then multiplying that number by the strike price per unit; for each *retail forex transaction*, by calculating the value in U.S. Dollars of such transaction, at the time the transaction was established, excluding for this purpose the value in U.S. Dollars of offsetting long and short transactions, if any; and for any *cleared swap* by the value as determined consistent with the terms of Part 45 of the CFTC Rules. Futures contracts with the same underlying commodity across designated contract markets and foreign boards of trade and swaps cleared on the same designated clearing organization may be netted where appropriate.

## Rule 4.7 – Relief Available under the "CFTC Lite" Regime

A registered CPO may be able to rely on the "CFTC Lite" regime under Rule 4.7, which substantially reduces the disclosure, recordkeeping and reporting requirements discussed above. The CFTC Lite regime is available with respect to a fund in which each investor is a "qualified eligible person" and the offering of interests therein is exempt from registration under the 1933 Act. Note that "qualified purchasers" are automatically qualified eligible persons, so any funds relying on the 3(c)(7) exemption from registration as an investment company under the 1940 Act should be eligible for the CFTC Lite regime. A registered CPO would need to file a separate notice of exemption with the NFA for each fund that relies on the CFTC Lite regime.

## NFA Bylaw 1101

One of the key NFA compliance obligations facing new CFTC registrants and NFA members arises out of NFA Bylaw 1101, which generally prohibits an NFA member, such as a CPO, from conducting business with or on behalf of a non-NFA member that is otherwise required to register with the CFTC. To ensure compliance with this rule, we recommend that investment advisers obtain representations from fund investors, counterparties and others with whom they conduct business to determine such parties' CFTC registration and/or exemption status. For example, an investment adviser should ensure that CPOs of any fund of fund investors are either registered as a CPO and an NFA member or that the operator is exempt from registration.

## Reporting on Form CPO-PQR

Under CFTC Rule 4.27, registered CPOs are required to report information on Form CPO-PQR. This Form mirrors the reporting that SEC-registered investment advisers must make on Form PF. For firms that became registered CPOs earlier in 2013, the first quarterly PQR filing was due on May 30, 2013.

Large CPOs are required to file Form CPO-PQR quarterly, within sixty days of the end of each calendar quarter. Smaller and mid-sized CPOs must file Form CPO-PQR annually, within ninety days of the end of each calendar year. The filing deadlines for Form CPO-PQR and Form PF are not the same.

Form CPO-PQR is divided into: (i) Schedule A, which requests basic identifying and performance information and must be filed by all registered CPOs; (ii) Schedule B, which requests detailed information about commodity pools managed by "midsized CPOs"[11] and "large CPOs";[12] and (iii) Schedule C, which requests additional detailed pool information from large CPOs.

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[11] Form CPO-PQR defines a "mid-sized CPO" as any CPO that had at least $150 million in aggregated pool assets under management as of the close of business on any day during the "reporting period." Note that "assets under management" in this context is net asset value, not the RAUM that the SEC uses for Form ADV and Form PF purposes. For a mid-sized CPO, the "reporting period" is the calendar year-end.

[12] Form CPO-PQR defines a "large CPO" as any CPO that had at least $1.5 billion in aggregated pool assets under management as of the close of business on any day during the reporting period. Note that "assets under management" in this context is net asset value, not the RAUM that the SEC uses for Form ADV and

An adviser that is both an SEC-registered investment adviser and a registered CPO will not need to file Schedules B and C if the adviser includes information on all relevant pools in the Form PF it files with the SEC.

Reporting on Form CTA-PR

CFTC Rule 4.27 requires registered CTAs to file basic identifying and performance information on Form CTA-PR annually, within forty-five days of the end of each calendar year. CTAs are required to submit Form CTA-PR to the NFA, even if the CTA reports on Form PF. In addition, the NFA recently amended Compliance Rule 2-46 to require that CTAs report to the NFA on Form PR on a quarterly basis. The first quarterly filing for registered CTAs was for the quarter ended September 30, 2013 and was due on November 14, 2013. The first annual filing will be due in March 2014.

CPOs and CTAs can access and file these forms via the NFA's online EasyFile System. For more information on these CPO/CTA developments and how they affect investment advisers, please see our earlier alerts from February, March and June 2012 and April 2013 in this area. In addition, you may click here to view our chart regarding filing on CFTC/NFA Forms PQR and PR.

Swaps Regulation under the Dodd-Frank Act

Title VII of the Dodd-Frank Act provides a detailed framework for regulating the swaps market and market participants. On October 12, 2012, the rules defining the term "swap" came into effect. Under these rules, the SEC has regulatory authority over security-based swaps, which generally are swaps based on a narrow-based security index (such as an index with nine or fewer component securities), a single security or certain events relating to a single issuer or narrow group of issuers. The CFTC has regulatory authority over swaps, which is broadly defined to include most swaps, options and similar products, the value of which relates to, among other things, rates, currencies, commodities, indices and other financial or economic interests. The SEC and CFTC will jointly regulate mixed swaps, which is a product that has elements of both a swap and a security-based swap. The SEC will continue to have antifraud authority over certain CFTC-regulated instruments, including security-based swap agreements.

The swap definitions affect certain entity registration requirements (including the Rule 4.13(a)(3) exemption test), as well as clearing, trading, reporting, recordkeeping, margin and business conduct requirements. For example, certain swaps may need to be cleared through derivatives clearing organizations and/or must be executed on a designated contract market or a swap execution facility. These requirements may apply even if a fund sponsor or adviser is not required to register with the CFTC in any capacity. In addition, swap market participants, including funds, will be required to retain and report data relating to swap transactions.

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Form PF purposes. For a large CPO, the "reporting period" is any individual calendar quarter ending March 31, June 30, September 30 or December 31.

## Cross-Border Application of Dodd-Frank Swaps Requirements

On July 12, 2013, the CFTC adopted final guidance concerning the regulation of cross-border swap transactions mandated by the Dodd- Frank Act.[13] Under Section 2(i) of the CEA, as amended by Dodd-Frank, the CFTC may apply the swaps provisions to activities outside the U.S. that have a direct and significant connection with activities in, or effect on, commerce of the U.S., or that contravene CFTC regulations adopted for the purpose of preventing evasion of the swaps provisions. In the Final Guidance, the CFTC adopts a definition of "U.S. person," and then discusses how that definition will bear on determining whether and how the Dodd-Frank swaps provisions will apply to transactions and swap trading relationships.

The final guidance was accompanied by a CFTC exemptive order that provides time-limited relief to non-U.S. swap dealers and foreign branches of U.S. swap dealers from certain Dodd-Frank swaps requirements. The exemptive order is set to terminate no later than December 21, 2013, although certain portions are scheduled to expire earlier in the year. Thus, before the end of the year market participants will be subject to the final guidance in all respects and must consider their cross-border swap activities within the CFTC's rule framework.

For more information on cross-border application of Dodd-Frank swaps requirements, please see our July 15, 2013 and July 27, 2013 alerts.

# CERTAIN TAX CONSIDERATIONS

## FATCA Implementation

***Effective Dates Delayed.*** The Hiring Incentives to Restore Employment Act (the "**HIRE Act**") was signed into law in March 2010. It incorporates the measures of the Foreign Account Tax Compliance Act of 2009 ("**FATCA**") designed to stop tax evasion. For taxable years beginning after December 31, 2012, FATCA imposes new reporting and withholding rules designed to induce a "foreign financial institution" ("**FFI**") and other foreign entities to report information to the Internal Revenue Service (the "**IRS**") regarding their U.S. accountholders and investors. Under these rules, an FFI will have to enter into an agreement (an "**FFI Agreement**") with the IRS agreeing to certain covenants, and provide evidence of such agreement to payors of certain income from U.S. sources, including U.S.-source interest and dividends, as well as the gross proceeds from the sale of instruments that would generate such income. Generally, non-U.S. funds, whether treated as corporations or partnerships for U.S. federal income tax purposes, will be treated as FFIs and subject to these rules unless guidance is issued exempting them.

While the FATCA provisions are effective beginning in 2013 under the HIRE Act, the IRS has since their enactment published guidance delaying or otherwise modifying the effective dates of the provisions. In July 2013, the IRS delayed the date of FATCA withholding with respect to new obligations for 6 months — from January 1, 2014 to July 1, 2014. This delay had a ripple effect in pushing back other elements of FATCA compliance, including:

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[13] A copy of the Final Guidance can be found on the CFTC's website here.

- The definition of a "grandfathered obligation" (as to which no FATCA withholding will be required) was revised to include obligations outstanding on July 1, 2014 (and associated collateral);
- Withholding agents must implement new account opening procedures (pursuant to which the FATCA status of their customers or investors is determined) on July 1, 2014. Customers admitted on or after this date will have to comply with the new procedures;
- The definition of "pre-existing" accounts and obligations will be revised to mean generally such accounts or obligations in existence on June 30, 2014;
- Any FFI Agreement entered into prior to July 1, 2014 will have an effective date of June 30, 2014. Accordingly, the timeliness for performing due diligence on the FATCA status of existing investors generally will all be pushed back by six months. The first round of diligence (on "prima facie" FFIs) will be required to be completed by December 31, 2014; and
- The first reports by participating FFIs on the accounts of their U.S. customers/investors will be due on March 31, 2015 and will relate to the 2014 year.

***Registration Portal Open.*** The IRS online FATCA registration portal opened on August 19, 2013. The IRS has stated that it intends to give taxpayers the remainder of 2013 to submit and amend the information collected during the registration process. Accordingly, subject to the discussion below regarding entities in an "intergovernmental agreement" (an "**IGA**") jurisdiction, registrations will only be "final" once the information is submitted as final after January 1, 2014. Even if information has previously been submitted prior to that date, it must be again submitted in 2014 to be "final" from the IRS' perspective. The IRS will electronically post the first list of registered participating FFIs by June 2, 2014, and will update the list on a monthly basis thereafter. To ensure inclusion in the first list, FFIs must finalize their registration by April 25, 2014. Even FFIs in a jurisdiction covered by an IGA should register with the IRS so as to achieve "registered deemed-compliant" status.

***Cayman Islands Signs Model 1 IGA.*** The Cayman Islands government announced in August 2013 that it had agreed to and initialed a Model 1 IGA and an associated Tax Information Exchange Agreement with the U.S. government. This should simplify FATCA compliance for Cayman Islands financial institutions, including hedge funds and other private funds.

As a result of entering into the IGA:

- The IRS will treat the Cayman Islands as having an IGA in effect. The Cayman Islands will, upon signing, be added to the U.S. Treasury's list of jurisdictions that have signed but have not yet brought into force an IGA, and will accordingly be treated as having an IGA in place for FATCA purposes;
- Compliance with FATCA will be greatly simplified for entities formed in the Cayman Islands. **For example, there will now be no need to enter into an FFI Agreement directly with the IRS**; and
- Cayman Islands institutions will have longer to obtain a global intermediary identification number ("**GIIN**") via the IRS registration portal. Although Cayman Islands financial institutions will be able to complete registration and obtain a GIIN after January 1, 2014, under the IRS rules, a withholding agent need not verify that a reporting financial

institution in a Model 1 IGA jurisdiction has a GIIN prior to January 1, 2015. Accordingly, Cayman Islands funds technically will have additional time beyond July 1, 2014 to register and obtain a GIIN in order to ensure that they are included on the IRS FFI list before January 1, 2015. We would advise, however, that even Cayman Islands funds eligible for later registration take steps to ensure that their registration is final as of June 2, 2014, so as to remain in step with the worldwide financial community.

## Modifications to Individual Tax Items

***American Taxpayer Relief Act.*** The American Taxpayer Relief Act of 2012 (the "**ATRA**") was passed by Congress on January 1, 2013, and was signed into law by President Obama the next day.[14] Pursuant to the ATRA, for tax years beginning after 2012, the 10%, 15%, 25%, 28%, 33% and 35% individual income tax brackets from the Bush tax cuts will remain in place and are made permanent. However, there will be a new 39.6% rate, applicable to individuals with taxable income in excess of $400,000 ($450,000 for married couples filing jointly). These dollar amounts will be inflation-adjusted for tax years after 2013.

The ATRA retains the 0% tax rate on long-term capital gains and qualified dividends, modifies the 15% rate, and establishes a new 20% rate. Beginning in 2013, the rate will be 20% if the taxpayer's taxable income falls in the new 39.6% tax bracket. It should be noted that the 20% top rate does not include the new 3.8% surtax on investment-type income and gains for tax years beginning after 2012, which applies to investment income above $200,000 ($250,000 for joint filers) in adjusted gross income. Thus, the top rate for capital gains and dividends beginning in 2013 may be as high as 23.8% for taxpayers in the 39.6% tax bracket.

Finally, the ATRA reinstates: (i) the phase-out of an individual taxpayer's personal exemption amount ($3,900 per person for the taxpayer, spouse, and any dependents for 2013) by 2% for each $2,500 (or fraction thereof) by which the taxpayer's adjusted gross income ("**AGI**") exceeds a specified threshold; and (ii) the reduction in value of certain itemized deductions (up to 80% of otherwise allowable deductions) by 3% of the amount by which a taxpayer's AGI exceeds a specified threshold. Both phase-outs had previously been reduced, and then eliminated, under prior law. The ATRA reinstates and makes permanent both items, but raises the AGI threshold at which they begin to take effect to $300,000 for married couples filing a joint return ($250,000 for singles and $275,000 for heads of household). The AGI thresholds are indexed for inflation after 2013.

***Additional Medicare Tax.*** Effective for the first time for 2013, the Health Care and Education Reconciliation Act of 2010 subjects some individuals to a 3.8% Medicare contribution tax on their unearned income. This new tax will apply to single taxpayers with a modified adjusted gross income ("**MAGI**") in excess of $200,000 and married taxpayers with a MAGI in excess of $250,000 if filing a joint return (or $125,000 if filing a separate return). For most individuals, their MAGI will be their adjusted gross income, unless they are U.S. citizens or residents living abroad and have foreign earned income. The tax is equal to 3.8% of the lesser of the individual's "net investment

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[14] The full text of the ATRA can be found here.

income" or the amount by which the individual's MAGI exceeds the threshold for application of the tax.

An individual's "net investment income" generally includes interest, dividends, annuities, royalties and rents, other than such income that is derived in the ordinary course of a trade or business, less allocable deductions. It also includes income from a passive activity or a trade or business of trading in financial instruments or commodities, net gain from the disposition of property (other than property held in an active trade or business), gains from trading in financial instruments or commodities, and gain on the sale of a personal residence in excess of the amount permitted to be excluded from income under Section 121 of the Internal Revenue Code of 1986 (the "**IRC**"). It generally does not include distributions from qualified retirement plans or tax-exempt interest.

Although Medicare tax assessed on self-employment income generally is deductible, the Medicare tax on net investment income is not deductible when computing income taxes. The tax is subject to the individual estimated tax provisions.

***Foreign Reporting Requirements.*** Taxpayers with interests in offshore entities, including private funds, should be aware of relatively new reporting requirements in respect of such interests. In particular, an individual who owns an interest in a foreign entity that, when aggregated with the value of certain other foreign assets, is worth more than $50,000 on the last day of a taxable year or more than $75,000 at any time during a taxable year must attach a disclosure statement (IRS Form 8938) to his or her tax return for that taxable year. For married taxpayers filing jointly, the general disclosure statement filing thresholds are $100,000 on the last day of a taxable year or $150,000 at any time during the taxable year. The filing thresholds are higher for U.S. persons whose tax homes are in countries other than the U.S. and who meet one of two "presence abroad" tests. For an individual who meets these requirements, the filing thresholds are $200,000 on the last day of a taxable year or $300,000 at any time during the taxable year. For married taxpayers filing jointly who meet these requirements, the filing thresholds are $400,000 on the last day of a taxable year or $600,000 at any time during the taxable year. The filing of a disclosure statement will not satisfy any filing requirement for purposes of the Report of Foreign Bank and Financial Accounts ("**FBAR**") rules, and the filing of an FBAR form will not eliminate any requirement to file IRS Form 8938.

***Proposed Carried Interest Legislation.*** As another round of appropriations and debt limit negotiations approach at the end of 2013 and early part of 2014, legislators in Congress and the President may again consider proposals to tax the "carried interest" received by investment advisers or their affiliated entities as ordinary income. Such proposals have been discussed since 2007, and versions of the proposal were reintroduced in the American Jobs Act of 2011 (which was not enacted) and in proposed legislation introduced in February 2012 by Representative Sander Levin.

Although the carried interest proposals introduced in Congress since 2007 vary in their drafting and scope, they all share certain key features. In particular, all of the proposals do the following: (i) substantially increase the tax rate paid by investment advisers and other partnership service providers on their carried interest share of a partnership's profits, either during the life of the private fund or on exit, because some percentage, or all, of the profits derived from ownership of a carried interest would be taxed as ordinary income, rather than capital gain; (ii) subject these recharacterized gains to self-employment (Medicare) tax, the rate for which is scheduled under existing law to increase from 2.9% to 3.8% in 2013; (iii) tax gains from a “qualified capital interest,” i.e., that portion of a partnership interest acquired by the service partner in exchange for capital contributions, at capital gain rates, and excluded from self-employment tax, provided that such capital contributions are properly structured; and (iv) exclude interests received in a domestic corporation for services.

## ERISA CONSIDERATIONS

### Avoiding “Plan Asset” Status

Each investment adviser that manages hedge funds and other private funds that accept investments from employee benefit plans, IRAs and other benefit plan investors, but that does not want the funds it manages to become subject to the Employee Retirement Income Security Act (“**ERISA**”), should take the opportunity to confirm that the funds satisfy the requirements of ERISA’s “significant participation” exemption. Under the exemption, a fund is only subject to ERISA and to certain prohibited transaction provisions of the IRC if 25% or more of any class of the fund’s equity interests is held by “benefit plan investors” (“**BPIs**”). Only benefit plans subject to ERISA (primarily private domestic employer and union plans) or to the prohibited transaction provisions of the IRC (such as IRAs and Keogh plans), or entities that themselves are treated as holding the “plan assets” of such plans, will count as BPIs for purposes of the 25% test. Governmental and foreign benefit plans are not BPIs. The 25% test should be conducted each time there is a new investment or any transfer or redemption of interests in the fund. A pro rata rule applies where a fund (such as a fund of hedge funds) that exceeds the 25% test and is therefore a BPI invests in a lower-tier fund. The lower-tier fund in which the fund of funds invests will consider the fund of funds to be a BPI only to the extent that the fund of funds’ equity interests are held by BPIs. However, an investing fund that is a common or collective bank trust or an insurance company separately managed account that has *any* level of BPI investment is generally treated as holding BPI money.

### Becoming a Plan Asset Vehicle

Since many investment advisers are now required to register with the SEC, investment advisers to hedge funds may wish to reconsider their policy of maintaining benefit plan investment below the 25% threshold. Once registered under the Advisers Act, a well-capitalized investment adviser with more than $85 million of assets under management may qualify as a “qualified professional asset manager” (a “**QPAM**”), which will greatly enhance its ability to operate a fund that contains “plan assets” in accordance with the prohibited transaction provisions of ERISA and the IRC. Depending upon the fund’s investor base, trading strategy and geographical area of activity, compliance with these rules may be reasonably practicable. Investment advisers who accept ERISA fiduciary status should establish, as part of their written compliance policies and procedures, clear operational guidelines to ensure compliance with ERISA, including its “prudent expert” standard of care and its bonding, disclosure and indicia of ownership rules, and with the related party and self-dealing prohibited transaction rules of ERISA and the IRC. An investment adviser that invests assets of an employee benefit pension plan covering its own employees or those of an affiliate in its own plan asset hedge fund must remember that it can only act as a QPAM for the fund with respect to the plan if it complies with the additional QPAM conditions for proprietary plans, including maintenance of written policies and an annual independent audit of its QPAM program.

In contrast to hedge funds, private equity and real estate funds, for a number of reasons, will usually not want to operate as plan asset vehicles. These funds will therefore generally seek to remain under the 25% threshold or to qualify under the exemptions for “venture capital operating companies” or “real estate operating companies.”

## Sun Capital Case

In July 2013, the federal Court of Appeals for the First Circuit found that a private equity fund was a “trade or business” and could therefore be liable under ERISA’s “controlled group” rules for the unfunded pension liabilities of the portfolio companies in which it had an 80% or more ownership interest. The court emphasized that a fund’s otherwise passive investment in portfolio companies, when coupled with certain consulting and management activities attributable to the fund, could render the fund a “trade or business.” The court also found in passing that related funds run by the same manager that invested in portfolio companies in parallel – in the same investments in consistent proportions – could be aggregated for purposes of the 80% level of ownership that would trigger liability. While the case is fact specific and is most relevant to private equity funds, particularly venture capital operating companies that *must* take an active management role in their portfolio companies, the decision is also of critical importance for hybrid hedge funds that take larger, longer-term positions in operating companies.

## Advance Disclosures to ERISA Pension Plan Clients Under Section 408(b)(2)

Under the rules of Section 408(b)(2) of ERISA that became effective on July 1, 2012, investment advisers who provide investment management or investment advisory services through separately managed accounts or through “plan asset” funds to ERISA pension plans must disclose to a responsible fiduciary of the plan, a reasonable time before the service arrangement is entered into or the fund investment made, the scope of the services that will be provided and the direct and indirect compensation the investment adviser and its affiliates and subcontractors expect to receive. Investment advisers are typically providing the disclosure in a separate short document; in the hedge fund context, it is provided at the subscription stage along with the fund’s offering memorandum, subscription document and financial statements. It will typically cover management and performance compensation, gifts and entertainment received from brokers and the like, soft dollars, the fund’s expense ratio and some subadvisory arrangements. The plan fiduciary must be notified of changes to the initial disclosure within sixty days of the investment adviser becoming aware of the change. If a covered service provider fails to timely provide the plan with the necessary information, the service arrangement may technically become a “prohibited transaction” under ERISA, with the result that the service provider may have to disgorge some or all of its compensation to the plan and pay excise taxes to the IRS. An ERISA pension plan is also required to *terminate* a covered service provider who does not timely respond to a request for information under Section 408(b)(2).

## Schedule C Reporting

Since 2009, ERISA plans filing an annual Form 5500 report with the Department of Labor (the "**DOL**") must include an expanded Schedule C that identifies certain service providers to the plan who received $5,000 or more in direct and indirect compensation during the year and describes the services for which the compensation was received. Consequently, investment advisers to separately managed ERISA plan accounts, and to private funds with *any* ERISA plan investors (including, significantly, funds, other than venture capital operating companies or real estate operating companies, that do *not* hold plan assets) now receive annual compensation information requests from ERISA clients. For hedge fund and other private fund advisers, the Schedule C disclosure covers very much the same services and compensation as the Section 408(b)(2) disclosure, although the latter provides *prospective* information and Schedule C *looks back* to compensation received and services provided in the prior year. We recommend that a fund complex with a number of ERISA investors prepare a standard Schedule C response each year that can be automatically provided to those investors.

## Expanded Definition of Fiduciary

In 2010, the DOL proposed a significant expansion of its rule that describes when a person provides "investment advice" to an ERISA plan or an IRA and will therefore be treated as a fiduciary of the plan under ERISA and/or the prohibited transaction rules of the IRC. As drafted, the rule would have characterized many consultants, broker-dealers and appraisers as fiduciaries. Many industry participants feared that, under the rule as proposed, broker-dealers might no longer be able to recommend affiliated hedge funds to plans, and advisers of funds (even those that keep under the 25% BPI threshold) might become fiduciaries as a result of providing current net asset valuations to plan investors. The proposed rule met with considerable opposition, was withdrawn in September 2011, but is expected to be reproposed early in 2014.

# DEFERRED FEE AND INCENTIVE COMPENSATION ARRANGEMENTS

## Deferred Fee and Other Arrangements with Offshore Hedge Funds

As a result of IRC Section 457A, adopted in 2008, investment advisers may defer the taxation of fee income earned in 2009 and subsequent years from funds established in tax havens only for up to a year following the end of the year in which the fee is earned. Compensation deferred in 2008 and earlier years may only remain deferred until the end of the 2017 tax year, when it must be "repatriated" and taken into income by the investment adviser. Until then, these surviving pre-2009 deferred fee arrangements must be administered in accordance with IRC Section 409A, the statute that governs the taxation of nonqualified deferred compensation. Under Section 409A, offshore hedge fund deferrals now payable in late 2014 or in 2015 and 2016 may still be redeferred to 2017 with careful tax planning.

Section 457A also adversely impacts incentive fees (but not incentive allocations from partnerships) on side-pocketed investment assets, payment of which is usually postponed until the asset is realized, becomes liquid or acquires a readily available market value. Section 457A also significantly complicates the design of a multiyear fee — whether structured as a fee or a partnership allocation — if the earnings period exceeds two years.

Until further notice, Section 457A will not apply to carried interests in a partnership. Therefore, many investment advisers (particularly those managing funds that generate long-term capital gains) have changed the form of their incentive for services performed from a fee to a partnership allocation.

Section 457A also does not prohibit an offshore hedge fund from issuing options or stock-settled (but not cash-settled) stock appreciation rights to an investment adviser if the exercise price equals or exceeds the fair market value of the hedge fund's shares on the date of grant, nor from entering into split-dollar life insurance arrangements with the investment adviser's principals and employees. However, investment advisers interested in these incentive compensation approaches should consider the various tax issues, including those relating to passive foreign investment companies, carefully with counsel.

### Employee Incentive Compensation Arrangements

The compensatory arrangements of hedge funds and other private investment funds with their investment professionals, whether in the form of equity interests, deferred bonuses, phantom carry or otherwise, must be designed either to avoid or to comply with the requirements of IRC Sections 409A and 457A. End of year planning is important where compensatory arrangements either require or permit the deferral of bonuses or other compensation, when payments subject to IRC Section 409A or 457A are due at year-end, or when an accrual-basis manager wishes to deduct bonuses paid shortly after year-end in the year in which the bonuses are earned.

## PLANS AS "SPECIAL ENTITIES" UNDER THE DODD-FRANK BUSINESS CONDUCT SWAP RULES

Under the CFTC's final business conduct rules for swap dealers and major swap participants, ERISA employee benefit plans (but *not* hedge funds or other collective investment vehicles holding "plan assets"), federal, state or local "governmental" employee benefit plans (such as state teachers' funds), and other employee benefit plans that are not subject to ERISA but that "elect in," qualify as "special entities" to whom special protections are extended. However, swap dealers acting as counterparties to special entities will generally wish to take advantage of certain safe harbors in the CFTC rules which allow them to operate free of these heightened duties to their special entity counterparties. The safe harbors require a swap dealer to have a reasonable basis for believing that its special entity counterparty is represented by a "designated fiduciary" (ERISA plans) or a "qualified independent representative" or "**QIR**" (non-ERISA special entities) that, among other things, is independent of the swap dealer, is sufficiently knowledgeable to assess the transaction and its risks, and has evaluated the fair pricing and appropriateness of the swap. Consequently, an ERISA plan, governmental plan or other special entity wishing to enter into a swap will be asked — together with its advisers — to provide the swap dealer with comprehensive information, representations and covenants attesting to its reliance on a designated fiduciary or QIR and its non-reliance on the swap dealer, usually by adhering to industry-wide standard protocols developed by the International Swaps and Derivatives Association. In turn, investment advisers managing ERISA plan or governmental plan assets through separately managed accounts must not only be prepared to provide swap dealer counterparties with the safe harbor assurances they demand, but must also ensure that they themselves are qualified to make, and in fact perform, the necessary swap evaluations.

## TIC FORM B

Beginning on December 31, 2013, investment advisers may be required to complete TIC Form B,[15] a reporting form that is part of the Treasury International Capital (**"TIC"**) data reporting system, on behalf of the U.S. hedge funds and other private funds they manage.

TIC Form B is designed to gather information on the levels of U.S. international portfolio capital positions. It consists of six separate forms: (i) Form BC (concerning U.S. Dollar claims on foreign residents); (ii) Form BL-1 (concerning U.S. Dollar liabilities to foreign residents); (iii) Form BL-2 (concerning U.S. Dollar liabilities of the reporter's customers to foreign residents); (iv) Form BQ-1 (concerning U.S. Dollar claims of the reporter's customers on foreign residents); (v) Form BQ-2, which is divided into Part 1 (concerning foreign currency liabilities and claims of the reporter and its domestic customers' foreign currency claims with foreign residents) and Part 2 (concerning foreign currency liabilities of the reporter's customers to foreign residents); and (vi) Form BQ-3 (concerning the maturities of certain liabilities and claims of the reporter with foreign residents).

Reportable claims include, among other things, deposit balances due from banks of any maturity (including non-negotiable CDs), negotiable certificates of deposit of any maturity, brokerage balances, customers' overdrawn accounts, loans and loan participations of any maturity, resale agreements and similar financing agreements, short-term negotiable and non-negotiable securities (original maturity of one year or less), money market instruments (e.g., commercial paper, bankers' acceptances) with an original maturity of one year or less, reinsurance recoverables, and accrued interest receivables.

Reportable liabilities include, among other things, non-negotiable deposits of any maturity, including non-negotiable certificates of deposit, brokerage balances, overdrawn deposit accounts, loans of any maturity excluding drawn syndicated loans where there is a U.S. administrative agent, short-term non-negotiable securities (an original maturity of one year or less), repurchase agreements and similar financing agreements, insurance technical reserves, and accrued interest payables.

A reporter will be required to complete Forms BC, BL-1, BL-2, BQ-1 and/or BQ-2, Part 1 if, as of the last business day of the reporting period, (i) the total reportable claims and/or liabilities (as applicable) for all geographic areas to be reported on the form are at least $50 million, or (ii) the total reported claims and/or liabilities (as applicable) for any individual geographic area are at least $25 million. A reporter will be required to submit Form BQ-2, Part 2 if the total reportable liabilities for all geographical areas are at least $50 million. Finally, a reporter will be required to file Form BQ-3 if the total reported data for all geographic areas is at least $4 billion. For an

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[15] Whereas TIC Form B is currently limited to depository institutions, bank holding companies and financial holding companies, and brokers and dealers, the amended TIC Form B will also apply to all other financial institutions, including private funds, as of December 31, 2013. Form C, which also pertains to U.S. international portfolio capital positions and covers certain financial institutions (such as private funds), will be applicable solely to non-financial institutions as of December 31, 2013.

investment adviser to a U.S. private fund, reportable customers' claims and liabilities will include assets under the adviser's management that are not otherwise held by a U.S.-resident custodian.

TIC Form B must be filed as of the last business day of the applicable reporting period in which the applicable threshold is exceeded. Reporters must submit Forms BC, BL-1 and BL-2 no later than fifteen calendar days following the last day of the reporting month and Forms BQ-1, BQ-2 and BQ-3 no later than twenty calendar days following the last day of a calendar quarter (or the next business day, if the filing date in either case falls on a weekend or holiday). Once the exemption level is reached, the reporter will be required to continue to submit the relevant form for the remainder of the calendar year, regardless of subsequent changes in reportable claims and/or liabilities. All reports must be filed with the Federal Reserve Bank of New York.

Investment advisers to hedge funds and other private funds should be aware that it may take substantial work to determine whether an investment adviser is required to file any part of TIC Form B on behalf of entities it manages and subsequently to complete the form. Investment advisers should also be aware that the U.S. Treasury and Commerce Departments (which includes the Bureau of Economic Analysis) may impose additional reporting obligations on investment advisers, including, without limitation, with respect to cross-border transactions involving long-term securities, derivatives, currencies and direct investment.[16] We suggest that you confer with your regular Bingham counsel on any questions relating to TIC Form B or such other reporting obligations.

## REGULATION M, RULE 105 COMPLIANCE

In September 2013, the SEC announced twenty-two settled cases and one litigated case involving violations of Rule 105 of Regulation M under the Exchange Act. In addition, the SEC issued a risk alert regarding Rule 105, in the wake of the announcement of the cases, discussing the basis for the alleged violations and assessed penalties, and suggesting best practices to avoid violations of Rule 105.[17] Rule 105 generally prohibits the purchase of equity securities from an underwriter, broker, or dealer participating in a public offering if the purchaser sold short the security that is the subject of the offering within a specified restricted period prior to the offering's pricing, absent an exception. It can be a violation of Rule 105 even without specific intent to violate the rule.

This latest string of cases brings the total number of Rule 105 actions brought by the SEC in the past four years to over forty. Notably, registered and unregistered (including non-U.S.) investment advisers made up the vast majority of parties charged in the settled and litigated Rule 105 enforcement actions to date. The settled cases generally have required parties to pay disgorgement, prejudgment interest and a civil penalty. For more information, please see our September 2013 alert on this issue, which can be found here. We note that additional SEC Rule 105 actions are expected to be forthcoming.

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[16] Direct investment is the ownership or control, directly or indirectly, by one person of 10% or more of the voting securities of an incorporated or unincorporated business enterprise.

[17] See Securities and Exchange Commission National Exam Program Risk Alert re: Rule 105 of Regulation M: Short Selling in Connection with a Public Offering, Volume III, Issue 4 (Sept. 17, 2013), which can be found here. See also SEC Press Release 2013-182: SEC Charges 23 Firms with Short Selling Violations in Crackdown on Potential Manipulation in Advance of Stock Offerings (Sept. 17, 2013), which can be found here.

Given the heightened regulatory scrutiny on Rule 105 compliance, investment advisers to hedge funds and other private funds should review their Rule 105 policies and procedures to ensure that they are sufficiently robust. Investment advisers should also consider providing periodic training for their employees so that employees have a clear understanding of the rule, its requirements, and possible preventive measures. We encourage you to contact your regular Bingham counsel if you have any questions or concerns regarding Rule 105 or would like assistance with your Rule 105 compliance programs and/or training.

## IDENTITY THEFT RED FLAGS RULES

On April 10, 2013, the SEC and the CFTC jointly issued identity theft red flags rules, which require certain entities that are regulated by the SEC or the CFTC to adopt comprehensive data security programs designed to detect, prevent and mitigate identity theft.[18] The rules became effective on May 20, 2013, and compliance with the rules is required as of November 20, 2013.

Generally, these rules require that a financial institution or creditor that offers or maintains "covered accounts" must, among other things, establish and implement an identity theft program. The program is required to have four elements, including identifying red flags, detecting red flags, responding appropriately to red flags and ensuring that the program is periodically updated. The rules require involvement of the board of directors of the covered firm, or an appropriate committee of the board, in approving the program. In addition, the board, a committee or a designated senior management employee must be involved in the oversight, development, implementation and administration of the program.

The rules list the entities that the SEC and CFTC consider most likely to be deemed financial institutions or creditors, including investment advisers that are registered (or required to be registered) with the SEC. The SEC also indicated that SEC-registered investment advisers would be subject to the rules if they have the ability to direct transfers or payments from accounts belonging to individuals to third parties, or if they act as agents on behalf of individuals.

Under both sets of rules, a "covered account" is an account that is offered or maintained "primarily for personal, family or household purposes, that involves or is designed to permit multiple payments or transactions," as well as any other account "for which there is a reasonably foreseeable risk to customers or to the safety and soundness of the financial institution or creditor from identify theft, including financial, operational, compliance, reputation or litigation risks." The SEC offered, as examples of covered accounts, a brokerage account with a broker-dealer or an account maintained by a mutual fund (or its agent) that permits wire transfers or other payments to third parties. The CFTC offered a margin account as an example of a covered account.

All SEC- and CFTC-registered investment advisers were required to review the rules and the relevant facts and circumstances, and determine whether they are exempt, by November 20, 2013 (and need to do so thereafter to determine whether they remain exempt). Many investment advisers to private funds will not be subject to the rules. Out of an abundance of caution, however, such investment advisers should consider adopting a red flags identity theft policy, and mark their

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[18] Identity Theft Red Flags Rules, SEC Release Nos. 34-69359, IA-3582, IC-30456, which can be found here.

calendars to undertake to determine, annually (perhaps as part of their annual compliance review), whether there has been a change in the risk of identity theft for individual investors in the private fund(s) they advise.

## BROKER-DEALER CONSIDERATIONS FOR PRIVATE FUND EMPLOYEE SALES AND MARKETING ACTIVITIES

On April 5, 2013, David Blass, the Chief Counsel in the Division of Trading and Markets at the SEC, gave a speech to the American Bar Association, Business Law Section, Trading and Markets Subcommittee (the "**Speech**"), in which he addressed the need of private fund advisers to be aware of broker-dealer regulatory requirements in the marketing of private funds by their employees and similar issues arising from transaction-based compensation paid to such employees. In the Speech, Mr. Blass pointed to two types of activities that private funds and their investment advisers should consider in evaluating potential broker-dealer status. The first type of activities that merit consideration occur when a private fund adviser pays its employees transaction-based compensation for selling interests in a private fund, or has employees whose only or primary functions are to sell interests in the private fund. Such an employee could be acting as an unregistered broker-dealer. The second type of activities that merit consideration occur when a private fund adviser, its personnel, or its affiliates receive transaction-based compensation for purported investment banking or other broker activities relating to one or more of the private fund's portfolio companies. Fees for these activities, when linked to effecting the securities transaction, could, at least on their face, cause such an adviser to fall within the meaning of the term "broker." Mr. Blass acknowledged that in some instances, these fees likely are permissible, for example where the fees reduce or offset the advisory fee payable by the private fund. Notwithstanding the cautionary nature of the Speech, Mr. Blass noted that the SEC has been considering taking action to broaden the scope of the "issuer exemption" (the safe harbor for "associated persons" of an issuer under Exchange Act Rule 3a4-1), at least in part to craft an exemption that would cover some fund advisers' conduct in this area beyond that already contemplated by the Rule 3a4-1.

Subsequently, on September 26, 2013, Mr. Blass, together with Bingham partners Amy Kroll and Rich Goldman, participated in a Practicing Law Institute ("**PLI**") webinar entitled "Private Fund Sales and Marketing: A Conversation with Senior Staff from the SEC Division of Trading and Markets." During the PLI webinar, Mr. Blass stated that he had two goals in giving the Speech. First, he had wanted to "get the word out" on broker-dealer status issues arising in the private fund industry, especially since, as a result of the repeal of the "private adviser" exemption from registration, many newly registered private fund advisers are going through initial SEC examinations (and are being questioned about their marketing methods and processes). The second purpose of the Speech was to begin a dialogue with the industry, focusing on the private fund industry, in order to tease out the issues that need to be addressed. Mr. Blass also emphasized that the Speech was not meant to signal that the SEC was targeting private fund advisers.

Similar to his statements during the Speech, Mr. Blass noted at the PLI webinar that the SEC is considering two main questions in connection with private fund marketing: (i) when does private fund marketing and sales activity trip the "broker-dealer status" wire; and (ii) what compensation arrangements would trigger a need to register as a broker-dealer? Mr. Blass emphasized that the SEC is looking to apply a "rule of reason" in considering these questions. In addition, with respect to the application of the "issuer's exemption" under Exchange Act Rule 3a4-1 to fund advisers, Mr. Blass noted that the SEC is focusing on two areas, including: (i) where to draw the line with respect to broker-dealer registration where an employee of a private fund adviser has many functions, including engaging in marketing and sales activities; and (ii) whether a bonus that is related to an employee's overall performance, which includes as one component sales of interests in the issuer, should be distinguished from transaction-based compensation? Mr. Blass also indicated that he would favor a new rule written specifically for private fund advisers that would be similar to Rule 3a4-1, but that such a rule proposal is unlikely in the near term, given other SEC rule-making priorities. Mr. Blass did indicate that he would be open to issuing guidance discussing some of the issues, possibly in the form of FAQs.

Investment advisers may wish to evaluate their sales and marketing activities in light of Mr. Blass's comments. For more information, please see our April 2013 alert on the Speech, which can be found here, and our October 2013 alert on the PLI webinar, which can be found here.

## BUSINESS CONTINUITY PLANS

On August 27, 2013, the SEC issued a risk alert on the business continuity and disaster recovery planning of investment advisers.[19] The risk alert was prompted by the significant market disruptions following Hurricane Sandy and was based on the SEC's review of the business continuity and disaster recovery plans (**"BCPs"**) of approximately forty investment advisers in the impacted regions. The risk alert summarizes the weaknesses and best practices observed by the SEC in seven areas: (i) preparation for widespread disruption, (ii) planning for alternative locations, (iii) preparedness of key vendors, (iv) telecommunications services and technology, (v) communication plans, (vi) regulatory and compliance considerations and (vii) reviewing and testing. Investment advisers to hedge funds and other private funds should review their BCPs for weaknesses identified in the risk alert so as to improve responses to and reduce recovery time after large-scale disruptive events. For more information on the SEC's recommendations, please see our September 2013 alert, which can be found here.

## CUSTODY RULE UPDATE

SEC-registered investment advisers that have custody of client securities or assets are subject to Rule 206(4)-2 under the Advisers Act (the **"Custody Rule"**). The Custody Rule, which is intended to protect client cash and securities held by investment advisers on their behalf, generally requires an investment adviser with custody of a client's assets to maintain such assets with a qualified custodian, subject to certain exceptions. The Custody Rule contains an exception for, among other

[19] The SEC's risk alert can be found here. The risk alert complements a joint advisory issued by the SEC, the CFTC and the FINRA on August 16, 2013, which discusses the responses to Hurricane Sandy by various market participants. The August 2013 joint advisory alert can be found here.

things, certain uncertificated and non-transferable privately offered securities, which are not required to be held with a qualified custodian.[20]

On August 1, 2013, the SEC issued a guidance update that expanded the so-called "privately offered securities" exception to certain certificated, privately offered securities, provided that: (i) the investment adviser's fund client is a pooled investment vehicle that is subject to a financial statement audit in accordance with paragraph (b)(4) of the Custody Rule; (ii) the certificate can be used only to effect a transfer or to otherwise facilitate a change in beneficial ownership of the security with the prior consent of the issuer or holders of the outstanding securities of the issuer; (iii) ownership of the security is recorded on the books of the issuer or its transfer agent in the name of the client; (iv) the certificate contains a legend restricting transfer; and (v) the certificate is appropriately safeguarded by the adviser and can be replaced upon loss or destruction.[21] The guidance update also clarified that partnership agreements, subscription agreements and limited liability company agreements are not "certificates" under the exception and that securities represented by such documents will constitute privately offered securities if they meet the other conditions of the exception.

As noted under "2013 Examination Priorities" above, the SEC also issued a risk alert in March 2013 on custody deficiencies found in its examinations of registered investment advisers.

## MUNICIPAL ADVISOR REGISTRATION

In September 2013, the SEC adopted a set of final rules establishing a permanent registration system for municipal advisors.[22] The permanent registration system will replace the interim registration system that has been in effect since October 2010, which is set to expire on December 31, 2014.

Under the final rules, an investment adviser to a pooled investment vehicle will qualify as a municipal advisor and be required to register with the SEC, if the funds invested in the pooled investment vehicle contain *any* proceeds of an issuance of municipal securities. However, if the investment adviser is registered with the SEC under the Advisers Act, it will be excluded from the definition of "municipal advisor," provided that its investment advice concerns the investment of the proceeds of municipal securities or non-securities, if such advice is offered pursuant to an advisory agreement. The exclusion will not extend to advice regarding whether and how to issue municipal securities, the structure, timing and terms of issuances of municipal securities, or municipal derivatives. It also will not cover solicitation of a municipal entity or obligated person on behalf of an unrelated broker, dealer, investment advisor, municipal securities dealer or municipal advisor/third party, from which the solicitor receives compensation.

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[20] The "privately offered securities" exception applies to securities that are: (i) acquired from the issuer in a transaction or chain of transactions not involving any public offering; (ii) uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client; and (iii) transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.

[21] The August 2013 Custody Rule guidance update can be found here.

[22] Registration of Municipal Advisors, SEC Rel. No. 34-70462, available here.

Municipal advisors will be required to register under the new regime during any of the four successive one-month registration periods, beginning on July 1, August 1, September 1, and October 1, 2014, respectively. The applicable registration period will vary according to a municipal advisor's temporary registration number. A municipal advisor will be required to submit a Form MA for itself and a Form MA-1 for each natural person associated with the adviser and engaged in municipal advisory activities on behalf of the advisor.

## PAY-TO-PLAY RULE UPDATE

In June 2012, the SEC extended the compliance date for Rule 206(4)-5 (the **"Pay-to-Play Rule"**) from June 13, 2012 to nine months after the compliance date of the final rules requiring municipal advisor firms to register under the Exchange Act.[23] The Pay-to-Play Rule generally bans investment advisers from paying third parties to solicit government entities unless the solicitor is a registered investment adviser, broker-dealer or municipal advisor. The SEC has stated that it will issue a notice on the new compliance date in the Federal Register once it has adopted the final rule on registration of municipal advisors, but it has yet to do so as of the date of this Annual Review. We will continue to monitor this issue and will provide an update once the SEC finalizes the new compliance date for the Pay-to-Play Rule's ban on third party solicitation. For an overview of the Pay-to-Play Rule, please see our July 2010 alert on this issue, which can be found here.

In addition, we note that investment advisers may also be subject to pay-to-play or similar restrictions imposed by other federal government authorities, states and municipalities, that in some cases may exceed SEC requirements. Certain states and localities, such as California and New York City, have also imposed lobbyist registration and reporting requirements on certain investment advisers and their placement agents that solicit investment advisory business from the state's or locality's public pension plans. Accordingly, investment advisers should ensure that they have satisfied all applicable state and local requirements prior to engaging in these regulated activities. We suggest that you confer with your regular Bingham counsel with respect to any questions regarding such activities.

## ANTI-SPINNING RULE UPDATE

In August 2013, the Financial Industry Regulatory Authority (**"FINRA"**) filed with the SEC a proposed rule to amend FINRA Rule 5131 to except certain private funds of funds that satisfy a group of proposed preconditions[24] from compliance with Rule 5131's "spinning provision."[25] Rule

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[23] In 2011, the SEC amended the Pay-to-Play Rule by adding "registered municipal advisors" to the categories of regulated entities exempt from the ban on third party solicitation. To qualify for the exemption, the registered municipal advisor is required to register with the SEC pursuant to Section 15B of the Exchange Act and be subject to a Municipal Securities Rulemaking Board's pay-to-play rule. For more information on the amendment to the Pay-to-Play Rule, please see our June 2011 alert on the final rules implementing the Dodd Frank Wall Street Reform and Consumer Protection Act provisions, which may be found here.
[24] The text of the proposed rule change can be found here.
[25] FINRA Rule 5131(b), the spinning provision, prohibits a member or person associated with a member from allocating shares of a new issue to any account in which an executive officer or director of a public company or a covered non-public company, or a person materially supported by such executive officer or director, has a beneficial interest: (i) if the company is currently an investment banking services client of the member or the member has received compensation from the company for investment banking services in the past 12

5131 is intended to curb abuses by FINRA members and their associated persons in the allocation and distribution of "new issues" to accounts in which executive officers and directors of investment banking clients, and persons materially supported by such executive officers and directors, have a beneficial interest in exchange for investment banking business. Currently, the spinning provision excepts allocations of new issues to accounts in which the aggregate beneficial interests of restricted persons do not exceed 25% of such account (i.e., the "de minimis exemption") and certain types of accounts that typically have large and diverse investor bases, such as registered investment companies. Private funds are not currently an excepted account type, and therefore go to great lengths to gather applicable information about their beneficial owners in order to demonstrate that they are eligible to receive new issue allocations under the de minimis exemption. However, gathering that information is particularly difficult, if not impossible, for many funds of funds, which often do not have the ability to gather information about the beneficial owners of the funds in the fund of funds.

To ameliorate this obstacle, FINRA is proposing to expand the account types excepted from the spinning provision to include accounts that do not look through to the indirect beneficial owners of a fund, such as funds of funds, and satisfy certain conditions. Specifically, to rely on the exception, a fund must:

- Be a "private fund" as defined in the Advisers Act;
- Be managed by an investment adviser;
- Have assets greater than $50 million;
- Own less than 25% of the account and not have a single investor with a beneficial interest of 25% or more;
- Not have a beneficial owner that also is a control person of the fund's investment adviser;
- Be "unaffiliated" with the account in that the private fund's investment adviser does not have a control person in common with the account's investment adviser; and
- Not have been formed for the specific purpose of investing in the account.

FINRA members would be permitted to rely on a written representation that an account satisfies the foregoing conditions and could rely on the proposed exception, unless it believes, or has reason to believe, that such representation is inaccurate.

We note that while the proposed rule change would help a limited number of fund of funds, certain of the proposed conditions appear to be quite restrictive. For example, the fifth condition would prevent a fund that is invested in a fund of funds from availing itself of the proposed exception if its fund manager owns an interest in the fund and is a control person, as that term is defined in Form ADV, of the fund's investment adviser — a scenario that is not uncommon. Moreover, FINRA did not include in this condition, a de minimis exception similar to Rule 5131's existing de minimis exception.

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months; (ii) if the person responsible for making the allocation decision knows or has reason to know that the member intends to provide, or expects to be retained by the company for, investment banking services within the next 3 months; or (iii) on the express or implied condition that such executive officer or director, on behalf of the company, will retain the member for the performance of future investment banking services.

We will continue to monitor this issue and will provide an update when appropriate. For more information, please see our September 2013 alert on this issue, which can be found here.

## "BIG BOY" LETTERS

On October 23, 2013, the Sixth Circuit affirmed the Southern District of Ohio's decision granting summary judgment in favor of Credit Suisse Securities (USA) LLC (**"Credit Suisse"**) in Pharos Capital Partners L.P. v. Deloitte & Touche, No. 12-4381 (6th Cir. Oct. 23, 2013). The appeal concerned claims asserted by plaintiff Pharos Capital Partners, L.P. (**"Pharos"**) for fraud, negligent misrepresentation, and violations of the Ohio Securities Act, arising from its failed $12 million private equity investment in National Century Financial Enterprises, Inc. (**"NCFE"**).

In this case, NCFE had hired Credit Suisse as a co-placement agent in connection with NCFE's private offering of convertible preferred stock and subordinated notes. In early 2002, Pharos approached Credit Suisse seeking an investment opportunity in the healthcare industry, and Credit Suisse introduced Pharos to NCFE. Prior to its investment in NCFE, Pharos negotiated and signed a "big boy" letter with Credit Suisse in which Pharos acknowledged certain facts and made particular representations to Credit Suisse regarding its investment, including, without limitation, that it was a sophisticated investor, had substantial adverse information about NCFE and disclaiming reliance on any statement by Credit Suisse. In the Pharos order, the Sixth Circuit affirmed, among other things, that summary judgment was appropriate on the fraud and negligent misrepresentation claims because Pharos expressly disavowed any reliance on Credit Suisse in the "big boy" letter.

The decision is significant for the financial industry because it dismisses claims pursuant to a negotiated agreement that allocates risk among sophisticated parties. With Pharos, the Sixth Circuit has now joined the Fifth, Seventh and Ninth Circuits in enforcing a sophisticated party's express representations that it was not relying on any alleged statements made by another party in connection with a transaction.[26] Notably, the Sixth Circuit order blazes new ground on enforcement of "big boy" agreements that are entered into between placement agents and investors. For more information, please see our October 2013 alert on this issue, which can be found here.

We note that while "big boy" letters may provide some defenses in private actions, they may not provide meaningful protection from SEC enforcement actions based on insider trading.

## PATIENT PROTECTION AND AFFORDABLE CARE ACT

The Patient Protection and Affordable Care Act (**"PPACA"**) requires, among other things, that employers who are subject to the Fair Labor Standards Act (**"FLSA"**) provide a notice to their employees of the availability of health insurance through new Health Insurance Marketplaces. Generally, a company that has more than $500,000 in sales or receipts per year will be subject to the FLSA, and thus will be required to distribute this notice to its employees.

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[26] See, e.g., In re Capco Energy, Inc., 669 F.3d 274, 284 (5th Cir. 2012); Extra Equipamentos e Exportação Ltda. v. Case Corp., 541 F.3d 719, 724 (7th Cir. 2008); and Bank of the West v. Valley Nat'l Bank of Ariz., 41 F.3d 471, 477–78 (9th Cir. 1994).

The notice must be provided to each employee, regardless of full- or part-time status. It does not need to be provided to dependents or other individuals who may be eligible for coverage under the employer's plan but who are not employees. The notice must be provided free of charge, in a manner calculated to be understood by the average employee. First-class mail is acceptable, as is email if the email meets certain DOL electronic communication standards. The initial deadline for providing this notice to employees was on October 1, 2013. Thereafter, it must be provided to new employees at the time of hiring, which the DOL currently considers to be within fourteen days after the employee's start date.

We note that while the regulations regarding this requirement do not specifically identify a penalty for failing to provide the notice, PPACA has a general $100 per day penalty for failure to comply with the PPACA that may apply here.

## FOREIGN CORRUPT PRACTICES ACT

The Foreign Corrupt Practices Act of 1977 (the "**FCPA**") generally prohibits the payment of bribes to foreign government officials to assist in obtaining or retaining business. The FCPA applies to all U.S. persons and issuers of securities regardless of where the bribe is paid, and to any person or entity (i.e., even non-U.S. persons or issuers) who causes, directly or through agents, any act in furtherance of the bribe to take place in the U.S. The FCPA also requires U.S. issuers to maintain accurate books and records of all payments. The sanctions for FCPA violations can be significant. We note that on November 14, 2012, the Department of Justice and SEC released a comprehensive Resource Guide to the FCPA (the "**FCPA Guide**"), which can be found here. Nonetheless, since many issues that may arise in the context of potential FCPA violations are fact-specific and unique (and therefore may not be covered by the FCPA Guide), we suggest that you confer with your regular Bingham counsel with any questions relating to the FCPA.

## EUROPEAN UNION REGULATORY UPDATES

### European Union AIFMD

The AIFMD regulates the hedge fund, private equity and alternative investment fund industry in Europe. It imposes organizational, management and systems requirements on alternative investment fund managers that are either domiciled in the European Union (the "**EU**") or manage investment funds domiciled in the EU ("**AIFM**"). It also establishes minimum standards for pre- and post-sale disclosure and regulatory reporting for non-EU fund managers that actively market their funds to EU investors (the "**Minimum Private Placement Requirements**"). The deadline for EU member states ("**EU Member States**") to transpose the AIFMD into the national laws of EU Member States passed on July 22, 2013. While a majority of EU Member States had transposed the AIFMD into their national laws by the July 22, 2013 deadline, several EU Member States (such as Finland, Italy, Norway and Spain) have yet to do so. The expectation is, however, that all EU Member States will have transposed the AIFMD into national laws at some point during the first half of 2014.

We note that among EU Member States that have transposed the AIFMD into their national laws, there is little conformity in the requirements for non-EU investment advisers to market investment funds under the investment advisers' management. Some, but not all, of the EU Member States have provided for a transitional period ending on July 22, 2014, during which eligible investment advisers (subject to certain conditions, which vary across the EU jurisdictions) may market funds in those jurisdictions subject to the national marketing regime in place prior to the implementation of the AIFMD.

Additionally, a number of EU Member States have imposed marketing requirements that go beyond the Minimum Private Placement Requirements for situations where a transitional period is not available or where the transitional period has expired.

Investment advisers should consider how they will strategically respond to the AIFMD. Questions that investment advisers should be asking include:

- If the investment adviser (or a fund that it manages) is domiciled in the EU, does it need to become authorized pursuant to the AIFMD, or does the investment adviser benefit from a transitional period?
- If the investment adviser is not domiciled in the EU, does it intend to market its funds to investors in the EU? If so, will the investment adviser be willing and able to make the required disclosures to investors and regulators (which may vary between EU jurisdictions), and will the fund have a compliant audited annual report?

We note that some investment advisers that do intend to market their funds to investors in the EU and become subject to the AIFMD are relying on reverse solicitation with respect to EU investors, whereby the potential investor initiates the inquiry regarding the investment. For more information on the AIFMD, please see our alerts, which can be found here.

MiFID II

Directive 2004/39/EC of the European Parliament and of the Council on Markets in Financial Instruments ("**MiFID**"), which came into force on November 1, 2007 and seeks to promote the efficiency and integration of financial markets, is undergoing revisions. In October 2011, the European Commission published its initial proposals to revise MiFID in the form of a draft directive ("**MiFID II**") and a draft regulation ("**MiFIR**"). The final MiFID II and MiFIR texts are currently subject to negotiation through trilogues held by the European Commission, the European Parliament and the Council of Europe. We expect political agreement to be reached on MiFID II and MiFIR by the end of 2013, with the effective date for MiFIR and the deadline for national implementation of MiFID II to be no earlier than 2015.

Although MiFID II and MiFIR have yet to be finalized, the European Parliament and the Council of Europe have each published their respective positions on the draft legislations for the purposes of the trilogues. Based on these proposals, MiFID II and MiFIR will likely, among other major changes:

- Introduce a new regulated trading venue, the "Organised Trading Facility" ("**OTF**");
- Introduce a new regime on the provision of investment services in the EU by third country firms that would effectively require a non-EU investment firm to establish an authorized EU branch

should it intend to provide financial services to EU retail clients and (potentially) register with the European Securities and Markets Authority ("**ESMA**") before providing financial services to non-retail clients (e.g., professional clients and eligible counterparties);

- Require firms that trade derivatives subject to the European Markets Infrastructure Regulation clearing requirement on a regulated trading venue (e.g., a regulated market, multilateral trading facility ("**MTF**") or OTF), and trade certain other liquid financial instruments on a regulated trading venue or a systematic internalizer;
- Require market participants to follow commodity derivatives position limits and position reporting requirements;
- Introduce new rules for firms that conduct algorithmic trading, such as to establish effective systems and controls to ensure the resilience of trading systems on which algorithmic trading is conducted;
- Introduce new product intervention rules for ESMA and national regulators, and remove structured Undertakings for Collective Investment in Transferable Securities ("**UCITS**"), shares in non-UCITS collective investment undertakings, and instruments with an embedded derivative from the category of "non-complex" financial instruments;
- Introduce new corporate governance rules that impose quantitative directorship limits on directors of a firm and the requirement for a firm to establish a nomination committee;
- Expand the existing trade transparency regime to include "equity-like" instruments and non-equity instruments, where such instruments are listed on a regulated market or traded on an MTF or OTF; and
- Require regulated trading venues, and firms in respect of OTC transactions, to publish post-trade data through a newly introduced "Approved Publication Arrangement" ("**APA**"), which will provide the post-trade data to a "Consolidated Tape Provider," which will in turn publish post-trade data received from multiple APAs on a consolidated basis.

<u>MAR</u>

Directive 2003/6/EC of the European Parliament and of the Council on Market Abuse ("**MAD**"), which came into force on April 12, 2003 and seeks to strengthen and harmonize rules on market abuse, is also being revised. To further promote harmonization, in October 2011, the European Commission published its legislative proposal to revise MAD in the form of a draft regulation ("**MAR**"). MAR will be directly applicable in each of the European Member States without national implementation. On June 26, 2013, the European Parliament and the Council of Europe reached political agreement on the contents of MAR. However, as MAR relies on new concepts to be introduced by MiFID II and MiFIR, MAR will only be finalized once MiFID II and MiFIR have also been finalized.

Based upon the political agreement reached in June 2013, MAR will, among other major changes:

- Extend the scope of the existing market abuse regime to cover abusive behavior committed in relation to financial instruments traded on MTFs and OTFs;
- Extend the market manipulation offense to capture cross-market manipulation conducted in relation to (i) related spot commodity contracts, (ii) other financial instruments (e.g., derivatives) having an effect on the price of related spot commodity contracts, (iii) emission allowances, and (iv) financial benchmarks;

- Clarify that intermediate steps in a protracted process can, in itself, constitute inside information;
- Effectively replace the "significant effect on price" test in the determination of inside information with a "reasonable investor" test (i.e., the "significant effect on price" test will be satisfied where it is information that a reasonable investor would likely use as part of the basis of his, her or its investment decision);
- Incorporate a presumption of use when in possession of inside information;
- Extend the existing insider dealing and market manipulation offenses to cover attempted market abuse;
- Introduce prescriptive "wall crossing" requirements for firms conducting market soundings;
- Prescribe the details required to be recorded in the production of "insider lists";
- Prescribe the details required in the notification to national regulators by managers of a firm in relation to related transactions, and the establishment of a de minimis transaction amount reporting threshold;
- Strengthen supervisory and investigatory powers of national regulators; and
- Introduce minimum administrative measures and sanctions to be imposed by the national regulator where market abusive behavior has been determined to have occurred.

Simultaneously with the European Commission's publication of MAR, the European Commission also published a draft directive that compliments MAR by introducing minimum rules on criminal offenses and criminal sanctions for market abuse (**"CSMAD"**). The United Kingdom, which has the right under the Treaty of Lisbon to opt into or out of any European legislative policy relating to matters of justice and home affairs, has exercised its discretion to opt out of CSMAD on the basis that it already has an established criminal market abuse regime.

## CHINA REGULATORY UPDATES

### Securities Investment Funds

The amended Securities Investment Fund Law of the People's Republic of China, which applies to securities investment funds domiciled in China, was passed on December 28, 2012 and became effective on June 1, 2013. To support the amended law's implementation, regulators issued a series of regulations in the ensuing months, including the proposed Interim Administrative Measures for Privately Placed Securities Investment Fund Businesses. Additional new regulations and amendments are expected to be issued.

The new law and regulations contain many significant changes, most notably: (i) privately-placed securities investment funds are now under the supervision of the China Securities Regulatory Commission (**"CSRC"**); (ii) in addition to funds management companies, qualified securities companies, insurance asset management companies and asset management firms are allowed to engage in the publicly-placed funds management business; and (iii) privately-placed securities investment funds are required to make a post-fundraising filing with the Asset Management Association of China.[27] For more information, please see our April 2013 alert on this issue.

QFII Program

China's Qualified Foreign Institutional Investor (**"QFII"**) program allows QFIIs to invest in China's domestic securities markets. In December 2012, China's State Administration of Foreign Exchange (**"SAFE"**) issued revised regulations that: (i) substantially increase QFII repatriation frequency; (ii) provide an opportunity for sovereign wealth funds, central banks and monetary authorities to increase their QFII quotas beyond the current limit of U.S.$ 1 billion;[28] and (iii) streamline management of QFII accounts. These changes may enable QFIIs to provide more attractive client offerings and give QFII managers more options to structure QFIIs offshore according to the laws of the QFII's home country. For more information, please see our December 2012 alert on this issue.

RQFII Pilot Program

China's Renminbi Qualified Institutional Investor (**"RQFII"**) program allows Renminbi (**"RMB"**) raised in Hong Kong by specified financial institutions to be invested in China's domestic securities markets. On March 1, 2013, Chinese authorities issued new RQFII regulations that aim to further promote RMB internationalization, deepen the Chinese Mainland capital markets and support Hong Kong as an international financial center. The new RQFII regulations substantially expand the RQFII program by, inter alia, (i) extending the scope of RQFII eligible institutions to include (a) Hong Kong subsidiaries of Chinese commercial banks and insurance companies (in addition to those of Chinese securities and fund management firms) and (b) other financial institutions that are registered and mainly operate in Hong Kong; and (ii) loosening restrictions on investments by RQFIIs. For more information, please see our March 2013 alert on this issue.

On March 11, 2013, SAFE issued a notice that tightens foreign exchange controls over RQFIIs by introducing into the RQFII program certain restrictions already imposed on QFIIs. Notably, repatriation of funds and products by RQFIIs (other than open-ended funds) are now subject to more limits. For more information, please see our April 2013 alert on this issue.

On October 15, 2013, China and the United Kingdom reached an agreement at the Fifth UK-China Economic and Financial Dialogue pursuant to which China will grant a RMB 80 billion ($13.1 billion) RQFII quota to London-based investors. In addition, on October 22, 2013, China and Singapore announced that they have agreed to extend the RQFII program to Singapore with an aggregate quota of RMB 50 billion ($8.1 billion). Detailed rules governing the London and Singapore RQFII schemes have not been released by the CSRC as of the date of this Annual Review.

[27] According to the website of the Asset Management Association of China, some private fund managers have already registered with the Asset Management Association of China to issue privately placed securities investment funds.

[28] As of September 27, 2013, two QFIIs, Norges Bank and Hong Kong Monetary Authority, have each been granted aggregate quotas of $ 1.5 billion.

## QDII

China's Qualified Domestic Institutional Investor (**"QDII"**) program allows specified Chinese financial institutions to invest client assets in offshore securities markets. Aside from a draft CSRC proposal in March 2013 to amend the rules governing securities company QDIIs (which has not materialized in final rules) and a SAFE regulation in August 2013 seeking to consolidate and simplify foreign exchange administration for all types of QDIIs, there were no significant developments in the QDII program. As of the date of this Annual Review, the rumored Qualified Domestic Individual Investor (**"QDII2"**) program, which would allow qualified domestic individual investors to invest in offshore securities, has not been launched.

## Shanghai's QDLP Program

The Shanghai Qualified Domestic Limited Partner (**"QDLP"**) program seeks to attract internationally recognized hedge fund advisers to establish hedge funds in Shanghai to raise local capital for investment in offshore secondary markets. In September 2013, it was reported in the media that six large international hedge funds have been granted quotas under QDLP program. As of the date of this Annual Review, there has been no official confirmation of these grants. The official stance of the Shanghai regulators on the Shanghai QDLP program has been cautious. However, foreign hedge funds are responding with enthusiasm, particularly with the launch of the Shanghai Free Trade Zone outlined below, as many see opportunities in linking the QDLP program with the Shanghai Free Trade Zone.

## Shanghai Free Trade Zone

On September 27, 2013, China's State Council released the General Plan for the China (Shanghai) Free Trade Zone (the **"Plan"**) to govern the Shanghai Pilot Free Trade Zone (the **"Zone"**). The Plan is intended to encourage foreign investment and innovation in the financial service sector. It lists a number of key programs that will be implemented in the Zone to open up the financial services sector. These programs will include: (i) trial programs to set market-oriented interest rates and allow RMB convertibility in capital accounts; (ii) measures to facilitate cross-border RMB financing; (iii) steps to open the financial services industry to qualified private capital and foreign financial institutions; and (iv) ways to encourage the establishment of foreign invested banks and joint venture banks and to gradually allow foreign enterprises to participate in commercial derivatives transactions within the Zone. The language in the Plan announcing these programs is conceptual in nature, essentially amounting to a general guidance about future intentions. Although some detailed rules have been released for other sectors, detailed rules liberalizing the financial sector in the Zone are still to come. For more information, please see our October 2013 alert on this issue.

## Shanghai Hongkou Hedge Fund Zone

On October 18, 2013, the Shanghai Hedge Fund Zone was formally opened in the Hongkou district of Shanghai. Twelve Chinese hedge funds or hedge fund managers have since moved to the Hongkou district, and, according to the Chinese government's plan, more than fifty Chinese and international hedge funds are expected to move to the new district by 2017. While there have been reports of tax incentives and other cost savings to incentivize hedge funds and hedge fund managers to relocate to the Hongkou district, no details regarding the zone have been officially unveiled as of the date of this Annual Review.

## JAPAN REGULATORY UPDATES

### Amendments to the Regulations on Insider Trading

In 2013, Japanese regulators enacted a series of amendments to existing laws and regulations on insider trading that, among other things:

- Extend criminal liability and administrative penalties to corporate insiders, including the marketing departments of underwriting securities firms that improperly disclose insider information and/or make trading recommendations based on the insider information;[29]
- Increase the administrative penalty imposed on an investment adviser for insider trading from the portion of the management fee directly attributable to the insider trading to three times the aggregate management fees received by the investment adviser for the calendar month in which the insider trading occurred;
- Exempt off-market trades between persons who possess insider information (e.g., trades between two tippees) from insider trading prohibitions;
- Expand the definition of "insider" under the Financial Instruments and Exchange Act of Japan to include the target company, its directors, officers and employees (collectively, the "**Target Company**"), if the Target Company comes into possession of insider information with respect to the tender offer(s) made against the Target Company;[30]
- Establish a system under which a tender offerer that has received insider information regarding a separate tender offer may exempt itself from the usual insider trading prohibitions by making a disclosure in its own tender offer bid statement; and
- Exempt a tippee who receives insider information regarding a tender offer bid from the usual insider trading prohibitions if six months have passed from the date of the receipt of information by the tippee.

More information on the amendments to the Japanese regulations on insider trading can be found in our June 2013 alert.

### Amendments to the Asset Management Regulations

On July 1, 2013, the remaining portions of the amendments ("**Asset Management Amendments**") to the Cabinet Office Ordinance on Financial Instruments Business (the "**Business Ordinance**") came into effect. The Asset Management Amendments were proposed by the Financial Services

[29] Prior to the amendments, administrative penalties and criminal charges with respect to insider trading were imposed only on the parties that made the illicit trades using the insider information. No penalties were imposed on corporate insiders who improperly disclosed insider information, except where the actions of the corporate insiders were deemed to make it an accomplice with the persons making the illicit trades.
[30] Under prior law, the Target Company was generally not subject to the insider trading regulations unless the Target Company had entered into, or negotiated to enter into, a legal agreement with the party making the tender offer.

Agency of Japan (the **"FSA"**) to prevent frauds against pension funds similar to those that occurred in the AIJ scandal.

The Asset Management Amendments will, among other things, require a financial instruments firm to establish certain information provision arrangements, if the firm: (i) engages in a discretionary investment management business (each a **"DIM"**); (ii) manages its customers' assets held in trust by a trust bank or a trust company (each a **"Trust Bank"**); and (iii) invests into the fund securities specified in Article 96(4) of the Business Ordinance (such as units of investment trusts, shares of investment corporations, bonds issued by investment corporations and limited partnership interests (whether domestic or foreign)).

We understand that many foreign fund administrators and/or managers have been contacted by the DIMs and/or Trust Banks that have subscribed their funds to assist such parties in complying with the Asset Management Amendments. Although foreign fund administrators and/or managers are not the direct addressees of the Asset Management Amendments, in practice, it is anticipated that they will need to cooperate with DIMs and/or Trust Banks in the new reporting framework in order to enable their Japanese investors (including pension funds) to invest in relevant funds. For more information on the new requirements, please see our July 2013 alert.

<u>**Amendments to the Rules and Regulations Regarding Short Sale Trades**</u>

On August 26, 2013, the FSA promulgated the final text of the amendments to the existing rules and regulations governing short sale transactions (the **"Short Sale Amendments"**). The Short Sale Amendments became effective on November 5, 2013.

The Short Sale Amendments will, among other things:

- Expand the scope of the rules and regulations governing short sales to short sales made on Proprietary Trading Systems (**"PTS"**);
- Limit the application of the **"Uptick Rule,"** which previously applied to all short sales, to vary depending on whether the security involved in the short sale is listed on one or more exchanges and whether the Uptick Rule is triggered on a "principal" or "non-principal" exchange:
- Expand the types of trades that are exempt from the short sale rules and regulations to include certain hedge sale of ETFs for a merger, share split, etc. and (ii) arbitrage transactions between an exchange and a PTS or between two PTSs; and
- Introduce certain changes to the laws requiring traders to report their Short Sale Balance Ratio in a listed security.

In addition, whereas the sale of a yet settled security on the market was not subject to the short selling rules and regulations, under the Short Sale Amendments, if a broker, acting in collusion with a trader who is seeking to engage in a short sale, buys securities from such trader instead of taking a short sale order (or brokering the trader's order to execute the short sale) from such trader and the broker then sells such unsettled securities on the market (to be settled by securities acquired and delivered by the trader), the trades of both or either of the trader and the broker may be deemed as a short sale.

More information on the Short Sale Amendments can be found in our September 2013 alert.

## ANNUAL COMPLIANCE REVIEW AND OTHER REGULATORY FILINGS

### Offering Document Updates

An investment adviser should periodically review the offering documents (e.g., private placement memoranda, subscription documents, marketing materials, etc.) of the hedge funds and other private funds it manages to determine whether the investment adviser's and/or a private fund's business has undergone any material changes (including, but not limited to, changes to investment objectives/strategies, risk factors, conflicts of interest and/or service provider relationships), or if there have been any regulatory changes (including tax and ERISA) since the documents were last updated. If so, the investment adviser should consider updating the offering documents to reflect any such changes or developments. Given the events in the markets during the past few years, investment advisers should pay particular attention to whether or not their stated investment strategies and related risk factors are still accurate. Consideration should be given as to whether any changes require consent from investors or directors.

### Compliance Policies and Procedures

Each SEC-registered investment adviser is required to review its compliance policies and procedures on an annual basis and should maintain written evidence of the review. The annual review should consider, among other things, any compliance matters that arose during the previous year, any changes in the business activities of the investment adviser and any changes in the Advisers Act or other regulations that might require changes to the policies and procedures.[31]

In light of the SEC's focus in recent years on investment adviser's controls regarding material non-public information and enforcement of insider trading violations, we have found that it is useful to have outside counsel (together with in-house counsel, if applicable) provide training with respect to the prevention of insider trading to all of the investment adviser's personnel. If you would like us to provide such training for your personnel, please contact your regular Bingham counsel.

SEC-registered investment advisers, among other things, should also confirm that each of their access persons[32], and possibly certain other personnel, provides to the investment adviser's chief compliance officer a quarterly transactions report and annual holdings report listing such person's personal security transactions or holdings, as applicable. SEC-registered investment advisers should also consider their other obligations under the Advisers Act, including, but not limited to,

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[31] Newly-registered advisers generally have eighteen months after the adoption or approval of their compliance policies and procedures to complete the initial review.

[32] An "access person" is any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of the investment adviser, or any other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser, who has access to nonpublic information regarding any client's purchase or sale of securities, or nonpublic information regarding the portfolio holdings of any reportable fund, or who is involved in making securities recommendations to clients, or who has access to such recommendations that are nonpublic.

considering the effectiveness of their codes of ethics and conducting any necessary training that may be associated therewith, as well as the effectiveness of any BCPs that they have in place.

SEC-registered investment advisers should also bear in mind that the SEC has, in recent years, brought enforcement proceedings against investment advisers for failure to conduct annual reviews of compliance programs and/or cure deficiencies in compliance programs found during prior examinations.[33] If you would like assistance with your annual review of your compliance program, please contact your regular Bingham counsel.

## Employee Training

In order to encourage a culture of compliance in the work environment, an investment adviser should consider instituting training and/or programs to promote better understanding of the investment adviser's compliance policies and procedures and employee handbook. An investment adviser's fiduciary duties and obligations, avoiding potential conflicts of interest, and the prevention of insider trading and employee harassment are just a few topics for training that investment advisers should consider.

## Custody Rule Compliance

SEC-registered investment advisers that have custody of client securities or assets[34] are subject to the Custody Rule. Unless an investment adviser has account statements delivered to the investors in the private funds it manages on a regular quarterly basis from qualified custodians, the Custody Rule requires that a copy of each fund's audited financial statements, prepared in accordance with generally accepted accounting principles, be delivered to private fund investors within 120 days, or 180 days for funds of funds, after the end of the private fund's fiscal year (if the private fund has a December 31 fiscal year-end, by **April 30** in 2014, or **June 30** in 2014 for a fund of funds).[35] The SEC has issued a FAQ on the Custody Rule, which can be found here.

## Form ADV

Each SEC-registered investment adviser must update its Form ADV Part 1 and Part 2A and file them with the SEC on an annual basis within 90 days after the end of its fiscal year (for investment advisers with a December 31 fiscal year-end, by **March 31** in 2014). In addition, certain Form ADV information must be amended promptly if it becomes inaccurate, or upon any change in the disciplinary history of an investment adviser and/or its personnel. Exempt reporting advisers are subject to similar updating requirements for the parts of Form ADV that are applicable to them. Investment advisers should refer to the Form ADV instructions (which can be found on the SEC's website) or contact counsel to determine whether any of their Form ADV information must be updated.

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[33] For more information on recent SEC enforcement proceedings against registered investment advisers for failures to maintain adequate compliance programs, please see our November 2013 alert.
[34] "Custody" is defined broadly under Rule 206(4)-2 as holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them.
[35] The Custody Rule further requires that the auditor performing such annual audit be registered with, and subject to inspection by, the Public Company Accounting Oversight Board.

If there are any material changes to Part 2A during an investment adviser's fiscal year, that document or a summary of material changes must be delivered to clients within 120 days after the end of the fiscal year (for investment advisers with a December 31 fiscal year-end, by **April 30** in 2014). An update of each of Part 2A and 2B of Form ADV (or a statement summarizing material changes) must generally be delivered to clients promptly upon the disclosure of any additional disciplinary event or upon a material change to the description of any disciplinary event already disclosed. Although "clients" under the Advisers Act are technically the private funds advised by an investment adviser rather than the investors in those private funds, we suggest that Part 2 be delivered to these underlying investors on an annual basis.

The updates to Form ADV Part 1 and Part 2A must be filed on the SEC's electronic IARD system. Although Part 2B is not filed with the SEC, it is required to be maintained in the investment adviser's files.

If an exempt reporting adviser relying on the private fund adviser exemption reports in its annual updating amendment that it has "regulatory assets under management" ("**RAUM**")[36] attributable to private fund assets of $150 million or more, the exempt reporting adviser must register with the SEC unless it qualifies for another exemption from registration. The adviser has up to 90 days after filing the annual updating amendment to apply for SEC registration, and must submit its final report as an exempt reporting adviser and apply for SEC registration in the same filing.

In addition, certain states also require that investment advisers "notice file" by filing their Form ADV with state regulatory authorities, and some states require a paper filing. In general, special attention should be paid to the requirements of any state in which the investment adviser has a place of business or more than five non-exempt clients. State-registered investment advisers should also consider any other requirements in the states in which they are registered.

## Form PF

SEC-registered investment advisers that advise one or more private funds and have at least $150 million in RAUM attributable to private funds are required to file Form PF with the SEC. Investment advisers reporting on Form PF are required to disclose certain information regarding their advisory business and the private funds they advise, including their assets under management.

Generally, investment advisers must file Form PF within 120 days after each fiscal year (for investment advisers with a December 31 fiscal year-end, by **April 30** in 2014). Investment advisers with at least $1.5 billion in RAUM attributable to hedge funds as of the end of any month in the

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[36] An adviser determines its RAUM by calculating "the securities portfolios with respect to which an investment adviser provides continuous and regular supervisory or management services." Advisers are required to include in their RAUM (i) proprietary assets; (ii) assets managed without receiving compensation; and (iii) assets of foreign clients. Advisers are not permitted to subtract outstanding indebtedness in determining RAUM. *All* advisers are required to use the current market value (or fair value) of private fund assets rather than their cost in determining RAUM.
The rule also requires an adviser to a private fund to include in its RAUM (i) the value of any private fund it manages regardless of the nature of the assets held by the private fund and (ii) the amount of any uncalled capital commitments made to the fund. The method for calculating RAUM is set out in Instruction 5.B. to Part 1A of Form ADV.

investment adviser's prior fiscal quarter must file Form PF within sixty days after each quarter and are required to complete additional portions of the form. Investment advisers with at least $2 billion in RAUM attributable to private equity funds as of the last day of the investment adviser's most recently completed fiscal year must also complete additional portions of the form.

For a more detailed explanation of Form PF, please see our November 2011 alert on this issue, which may be found here. Additionally, the SEC has released a FAQ relating to Form PF, which may be found here.

## Form D and Blue Sky Filings

Form D must be electronically filed with the SEC on its filer management system, EDGAR, no later than fifteen calendar days of the initial sale of securities in a Rule 506 offering. If a Form D was filed as of March 16, 2009 or later, and it relates to an offering that is still on going, it must be amended annually, on or before the first anniversary of the most recent previously filed notice. Form D must also be amended as soon as practicable after a change in information on the previously filed notice, or to correct a material mistake of fact or error. For certain other changes such as an increase in the amount sold, an increase in the number of investors, or a change in the address of a related party, the private fund issuer may, but is not required to, amend Form D at any time to reflect any such change.

We note that the SEC amended Form D effective September 23, 2013 to include a check the box for Rule 506(c) offerings and a certification, for all Rule 506 offerings, that the private fund is not disqualified from relying on Rule 506 as a result of the "bad actor" rules, and has also proposed additional amendments as discussed in "Proposed Amendments to Regulation D, Form D and Rule 156" above.

The blue sky laws of many states require that a hard copy of Form D be filed with the relevant state authority within fifteen days following the initial sale of interests or shares in that state. In addition, the blue sky laws generally require that filings previously made be updated from time to time to reflect certain changes, and some states require filings and the payment of renewal fees on an annual basis. In considering blue sky filings, private funds should pay special attention to: (i) new states where they intend to sell (or recently sold) interests or shares; (ii) states where they have sold interests or shares but did not file a Form D; and (iii) states from which investors have made additional investments. The regulatory penalties for failing to make filings on time can be significant and may also result in a requirement to offer rescission to each investor in a state, a payment of a fine or a consent order. Certain self-executing exemptions may no longer be available to private funds that rely on Rule 506(c).

In the past two years, an increasing number of states have been reviewing and commenting on Form Ds filed for Rule 506 offerings. Certain states question whether a related party under Item 3 of the Form D is an investment adviser and if that related party is required to be registered as an investment adviser in the state. Some states have requested information on the date of first sale and the number of investors in the state, and that copies of the offering be provided. Other states have questioned the disclosure in the explanation spaces on Form D.

While these inquiries are contrary to Section 18 of the Securities Act and the premise of covered securities not being subject to state regulation, the states are citing their authority under broker-dealer and investment adviser regulations and anti-fraud statutes. It is likely that more states will begin to ask questions on the Form Ds filed in their respective states.

## Other Regulatory Filings

There are several regulatory filings that investment advisers (whether SEC-registered or not) may be required to make in light of certain activities, which may include:

- ***Form 13F.*** An investment adviser is required to file a Form 13F with the SEC if it exercised investment discretion over $100 million or more in Section 13(f) securities on the last trading day of any month in the prior calendar year. Form 13F must be filed within forty-five days after the last day of the calendar year (for the coming year, not later than **February 14, 2014**) and again within forty-five days after the last day of each of the three calendar quarters thereafter.

- ***Schedule 13D/13G.*** If an investment adviser directly or indirectly "beneficially owns" (through fund(s), client account(s), proprietary account(s) or otherwise) more than 5% of a class of publicly-traded securities, the investment adviser (and possibly others[37]) is required to file either a Schedule 13D or Schedule 13G with the SEC. "Beneficial ownership" generally means the direct or indirect power to vote and/or dispose of such securities. This calculation also takes into account securities over which beneficial ownership can be acquired within sixty days (such as through the exercise of rights under convertible securities or other contractual arrangements). Unless qualified to file a Schedule 13G, an investment adviser (and possibly others) must file a Schedule 13D within ten days of acquiring beneficial ownership of more than 5% of such securities, which must be amended promptly to reflect material changes, including, but not limited to, an acquisition or disposition equal to 1% or more of such securities.

  Schedule 13G may generally be filed by a person or entity that beneficially owns less than 20% of the outstanding shares of a class of such securities in the ordinary course of business and not for the purpose of changing or controlling the management of the issuer of such securities. A "passive investor" must file Schedule 13G within ten days of crossing the 5% beneficial ownership threshold. "Qualified Institutional Investors" ("**QIIs**") (including SEC-registered investment advisers) also are permitted to file on Schedule 13G.[38] A QII must file a Schedule 13G within forty-five days after the end of the calendar year in which more than 5% beneficial ownership of such securities was obtained (if the beneficial ownership remains above 5% as of year-end), or within ten days of month end if beneficial ownership exceeds 10% at such month end. Schedule 13G must be amended periodically per rules that vary based on the type

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[37] A list of Section 13(f) securities is available shortly after the end of each calendar quarter on the SEC's website. Section 13(f) securities primarily include U.S. exchange-traded stocks, shares of close-end investment companies and shares of ETFs. Certain convertible debt securities, equity options, and warrants also appear on the official list.
[38] This exemption applies only to filers that fall into certain categories of institutional investors. It is *not* applicable to other investors, such as private funds or groups of private funds advised by the investment adviser that may have an independent requirement to file are permitted to file.

of filer. In addition, any person that has previously filed a Schedule 13G must file a Schedule 13D within ten calendar days if its passive investment purpose changes, and a passive investor that has previously filed a Schedule 13G must file a Schedule 13D within ten calendar days after acquiring more than 20% of the class of such securities. **The statutes, rules and SEC and court interpretations regarding Schedule 13D and Schedule 13G are very complicated, and we urge investment advisers to seek guidance from counsel with respect to compliance with applicable statutes, rules and interpretations.**[39] Investment advisers should also note that in some cases, one may need to consider non-equity investments in evaluating filing requirements.

- ***Form 13H.*** Rule 13h-1 of the Exchange Act[40] imposes initial and ongoing filing obligations on "large traders"[41] and subjects the U.S.-registered broker-dealers that service large traders to certain recordkeeping, monitoring and reporting requirements. A trader may also voluntarily file Form 13H. The purpose of Rule 13h-1 is to assist the SEC in its efforts to identify the most significant participants in the U.S. securities markets and to gather information quickly on their trading activity.

  Those who meet the "large trader" definition must file Form 13H "promptly" after meeting the threshold (generally within ten days). Thereafter, a large trader must submit an annual filing on Form 13H within forty-five days of the end of the calendar year (by **February 14** in 2014) and must submit any amendments promptly after the end of any calendar quarter in which information previously provided becomes inaccurate. Broker-dealers must maintain the required records, monitor large trader activity and be able to respond to requests from regulators with required information, including with respect to "unidentified large traders."[42] For more information on Form 13H, please see our August 2011 alert on this issue, which can be found here.

- ***Forms 3, 4 and 5.*** An investment adviser (and possibly others) may be required to file certain forms if it directly or indirectly beneficially owns more than 10% of any publicly registered class of equity security of an issuer, or if it (or an employee or other representative acting on behalf of the investment adviser) serves as an officer or director of the issuer. Form 3 must be filed within ten days after exceeding the 10% threshold or becoming an officer or director of the issuer; Form 4 generally must be filed by the end of the second business day after executing a transaction in any equity securities of the issuer; and Form 5 must be filed within

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[39] Please see our alert summarizing the CSX decision (CSX Corporation v. The Children's Investment Fund Management (UK) LLP et al. (S.D.N.Y. No. 08 Civ. 2764)) for further details, which may be found here.
[40] See Large Trader Reporting, SEC Release No. 34-64976, available here.
[41] A "large trader" is a person that "[d]irectly or indirectly, including through other persons controlled by such person, exercises investment discretion over one or more accounts and effects transactions for the purchase or sale of any NMS security for or on behalf of such accounts, by or through one or more registered broker-dealers, in an aggregate amount equal to or greater than the identifying activity level." "Identifying activity level" is defined as aggregate transactions in NMS securities of at least 2 million shares or $20 million during any calendar day, or 20 million shares or $200 million during any calendar month.
[42] Upon receiving a large trader's Form 13H, the SEC will assign the large trader a unique large trader identification number ("**LTID**"). The large trader will be required to provide its LTID to each of its broker-dealers and identify to the broker-dealers all of its accounts to which the LTID applies.

forty-five days after the end of the issuer's fiscal year to report exempt and other transactions that were not previously reported. These rules also apply to securities that are exchangeable or convertible into the issuer's equity securities. Securities held by certain specified types of institutions in the ordinary course of business, and not for the purpose of changing or influencing control of an issuer, need not be counted in determining if an investment adviser has reached the 10% threshold and, accordingly, certain investment advisers may not be required to file these forms. **Investment advisers and others who are required to file these forms are subject to disgorgement of profits (or deemed "profits" calculated in accordance with a rigid formula) resulting from purchases and sales (or other opposite-direction transactions) within any six-month period. We suggest that such persons seek guidance from counsel *prior to* becoming subject to these reporting requirements.**

- *TIC Form SLT.* An investment adviser may be required to complete Form SLT if it is a U.S. individual or entity (i) who qualifies as a U.S.-resident custodian, issuer and/or end-investor (e.g., funds), and (ii) whose consolidated long-term reportable securities[43] exceed $1 billion as of the last business day of the reporting month. Securities that must be reported on Form SLT are foreign-resident holdings of U.S. securities and U.S.-resident holdings of foreign securities. Equity interests or other securities issued by funds (such as interests issued by a non-U.S. master fund to a U.S. feeder fund, interests issued by a U.S. fund to a non-U.S. investor or interests issued by a U.S. master fund to a non-U.S. feeder fund) would generally qualify as reportable securities. Where securities reportable on Form SLT are held by a U.S.-resident custodian, however, a Form SLT report covering these securities would be due from the custodian and not the beneficial owner of the securities.

  Form SLT must be filed as of the last business day of the month in which the $1 billion threshold is exceeded and monthly thereafter for the remainder of the calendar year. Reporters must submit Form SLT to the Federal Reserve Bank of New York no later than the twenty-third calendar day of the month following the applicable reporting date (or the next business day, if the filing date falls on a weekend or holiday).

- ***Other U.S. and Foreign Filing Requirements.*** Investment advisers should consider whether other regulatory filings are required based on their operations and investments, including, but not limited to, annual filings that may be required under federal, state or foreign law, as applicable. For example, an investment adviser may be required to file a large position report with the Department of Treasury if it holds or controls a significant amount of certain U.S. Treasury securities or may be required to file forms with the Bureau of Economic Analysis if it has direct investment. An investment adviser that is considering acquiring a large amount of voting securities of an issuer should consider Hart-Scott-Rodino requirements that may apply, depending on the value of the acquisition and/or the size of the parties involved. Also, investment advisers that invest in securities in foreign jurisdictions should consider the filing

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[43] Long-term reportable securities include equity securities, including common stock, preferred stock, limited partnership interests and debt securities. The following are not long-term reportable securities: direct investments, derivatives, currencies, short-term securities (original maturity date of one calendar year or less), loans (directly negotiated between lender and borrower), repos and securities lending arrangements.

requirements in each jurisdiction in which they invest. Many foreign jurisdictions require filings similar to Schedule 13D/13G that are based on beneficial ownership percentages of an issuer's securities.

## Other Annual Requirements

SEC-registered and unregistered investment advisers are subject to several other annual requirements and obligations, including those set forth below. Although these obligations need not be completed immediately, investment advisers should confirm that these activities are on their annual compliance calendar.

- ***Privacy Policy.*** A copy of an investment adviser's privacy policy must be sent to each of its individual clients once within every twelve-month period, even if the privacy policy has not changed. In addition, if an investment adviser's policies and procedures relating to maintaining privacy of client information have changed and such changes lead to the disclosure of information not described in previous policies or lead to the delivery of information to a third-party not previously disclosed, the privacy policy must be updated.

- ***New Issues.*** If funds managed by an investment adviser invest in "new issues" (whether directly or through an investment in another fund), the investment adviser must obtain an annual representation from all investors in the funds it manages as to their eligibility to participate in profits and losses from new issues. This can be accomplished by requesting that each investor inform the investment adviser of any changes in the investor's status from its representation in its subscription agreement with the fund. The investment adviser must keep a record of all information relating to whether an investor is eligible to purchase new issues for at least three years.

- ***Anti-Money Laundering.*** Investment advisers to hedge funds and other private funds should review and update their anti-money laundering policies and procedures at least annually to ensure that these policies and procedures meet the trade and economic sanctions programs administered by the Department of Treasury's Office of Foreign Assets Control. Investment advisers should also provide periodic employee training so that employees understand the investment advisers' anti-money laundering obligations and practices. Finally, investment advisers should ensure that their compliance program complies with the anti-money laundering requirements of any applicable non-U.S. jurisdictions.

## Electronic Communications and Social Media

The ubiquitous use of electronic communications and social media in the workplace means that investment advisers should consider establishing policies and procedures that govern their use. Such policies and procedures may regulate, without limitation, email communications and employer-provided electronic devices, prohibited communications using the employer's electronic facilities, permitted disclosures on social and business media websites, electronic delivery of required disclosures, electronic security, reporting breaches of information security and electronic monitoring. Investment advisers may also need to consider state-specific regulations regarding electronic communications and social media.

Moreover, investment advisers to hedge funds and other private funds that are considering engaging in general solicitation in reliance on Rule 506(c) should bear in mind that general solicitations conducted via electronic communications and social media are subject to the requirements of Rule 506(c) and, to the extent applicable, the Other Important Regulatory Considerations.

## Liability Insurance

In light of the increasing number of investor lawsuits in recent years, as well as the increasing review and scrutiny by regulatory and governmental authorities of the hedge fund industry generally, investment advisers may want to consider whether management liability insurance should be obtained, depending on the exposure of their current business. Management liability insurance generally includes coverage for directors' and officers' liability, fiduciary liability, errors and omissions liability and employment practices liability.

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This Annual Review is not intended to provide a complete list of an investment adviser's obligations relating to its compliance with applicable rules and regulations or to serve as legal advice and, accordingly, has not been tailored to the specific needs of a particular investment adviser's business. We encourage you to contact us if you would like to discuss whether there are additional items that you should consider or if you have any questions about any of the items covered herein. This Annual Review does not purport to be comprehensive and should be used for information purposes only.

This Annual Review was prepared by Robert G. Leonard, Michael F. Mavrides, Erica L. Moscarello and Joyce Y. Ng, with contributions from Brian D. Beglin, Charles R. Bogle, Anthony J. Carbone, Jean Cogill, Richard A. Goldman, Steven W. Hansen, Barry N. Hurwitz, Amy Natterson Kroll, Christopher Leonard, Monica L. Parry, Joshua B. Sterling, Stephen C. Tirrell, Christopher P. Wells, Susan M. Cohen, Koji Yamamoto, Smriti Kodandapani, Christopher Poon, Thomas M. Schiera and Meredyth A. Whitford.

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**Circular 230 Disclosure:** Internal Revenue Service regulations provide that, for the purpose of avoiding certain penalties under the Internal Revenue Code, taxpayers may rely only on opinions of counsel that meet specific requirements set forth in the regulations, including a requirement that such opinions contain extensive factual and legal discussion and analysis. Any tax advice that may be contained herein does not constitute an opinion that meets the requirements of the regulations. Any such tax advice therefore cannot be used, and was not intended or written to be used, for the purpose of avoiding any federal tax penalties that the Internal Revenue Service may attempt to impose.