Proskauer» Built to Serve Asset Managers

2022 Proskauer Annual Review and 2023 Outlook for Investment Advisers to Hedge Funds, Private Equity Funds and Other Private Funds

2022 Proskauer Annual Review and 2023 Outlook for Investment Advisers to Hedge Funds, Private Equity Funds and Other Private Funds

The following annual review (Annual Review) is a summary of some of the significant changes and developments that occurred in the past year and certain recommended practices that investment advisers/investment managers (collectively, advisers) to hedge funds, private equity funds and other private funds (collectively, private funds) should consider when preparing for 2023.

Acknowledgments

This Annual Review is a service to our clients and friends. It is designed only to give general information on the developments actually covered. It is not intended to be a comprehensive summary of recent developments in the law, treat exhaustively the subjects covered, provide legal advice or render a legal opinion.

This Annual Review was prepared by Robert G. Leonard, Robert H. Sutton, Jeffrey D. Greenhouse, Kimmi H. Pham, Mark S. Audet, Naji Massouh, Andrew M. MacKinlay, Celeste Kim, Chloe T. Magee, Danyelle J. Everett-O'Neill, Kali A. Froh, Michael J. Keating and Robert S. Hillson, with contributions from:

Joshua A. Apfelroth, Martin J. Bienenstock, Ryan P. Blaney, Allan S. Bloom, Ira G. Bogner, Timothy E. Burroughs, Benjamin J. Catalano, Astrid Champion, Yuna L. Choi, Wai L. Choy, John E. Failla, Jonathan R. Gartner, Robert E. Gaut, Amy B. Gordon, Mike Hackett, Colleen M. Hart, Stephanie E. Heilborn, Lijuan Hou, Vincent Indelicato, John R. Ingrassia, Reuven C. Klein, Lucas Kowalczyk, Nathan R. Lander, Kirsten E. Lapham, Jeremy C. Leifer, Steve Ma, Michael F. Mavrides, Shannon D. McGowan, Jonathan P. Mollod, James G. Muller, Ekaterina P. Napalkova, Mario Gomez Carrera Neto, Jeffrey D. Neuburger, Joshua M. Newville, Amanda H. Nussbaum, Daniel J. Paulos, Robert E. Plaze, Seetha Ramachandran, Yong Ren, Jonathan E. Richman, Angela H. Roh, Seth J. Safra, Adam W. Scoll, Michael Singh, Elanit Snow, Jeanette Stecker, David B. Teigman, Vincent J. Tennant, Elias A. Tsouristakis, Amar A. Unadkat, John Verwey, Hadassa R. Waxman, Susan L. Wiener, Jonathan M. Weiss, Christopher M. Wells, Ashley M. Weringa, Fabio A. Yamada, Gawa (Jiahua) Zeng, Alexa A. Adams and Tara R. Shecter.

Proskauer

Table of Contents

Page

SEC Examination Update

The Securities and Exchange Commission's (the "SEC" or the "Commission") Division of Examinations (the "Exams Division") reported on March 30, 2022 that it completed 2,251 examinations of investment advisers in its fiscal year 2021 (which ran from October 1, 2020 to September 30, 2021), representing approximately 15% of the 14,800 registered investment advisers that it regulates, which is generally consistent with prior years. The Exams Division reported that in fiscal year 2021 it issued deficiency letters in approximately 70% of the examinations it conducted, and referred approximately 9% of its examination findings to the SEC's Division of Enforcement (the "Enforcement Division").[1] In the SEC's fiscal year 2023 budget request, the Exams Division sought funding to add an additional 90 new staff to its more than 1,000 current employees, with its justification including the need to increase examination coverage.[2] In May 2022, Richard Best, most recently the Director of the SEC's New York Regional Office, was appointed Director of the Exams Division, replacing Peter Driscoll after his more than four-year tenure as Director of the examination program.

Examinations in 2022, on the whole, continue to be conducted remotely with SEC staff largely working remotely and in a voluntary return to the office status.[3] As has been customary since 2020, most exams begin with a telephone call announcing the exam, followed quickly by a letter requesting documents within approximately 2 weeks, and then videoconferences or telephone calls with selected personnel of the adviser. The traditional on-site portion of an examination generally has not yet returned to the exam process. As was the case prior to 2020, the duration of exams is variable, with some lasting only several months (particularly for newly-formed advisers with relatively small operational footprints), the bulk lasting six to nine months, and some lasting a year or more (especially in cases of particularly large or complex advisers, or where the exam staff believes material violations have occurred).

For 2023, we expect to see the Exams Division slowly move toward exams having some in person component. We also expect to see the staff refer to the Enforcement Division some borderline matters which, in the past, would have been addressed in a deficiency letter.

The examination process continues to be targeted, with staff focusing on particular risk areas relevant to the adviser under examination. The Exams Division's 2022 Examination Priorities continued the staff's tradition of affirming many common areas of interest, while also highlighting five "significant focus" areas, including private funds. Our April 2022 Alert provides some additional background on this annual announcement. The 2022 Examination Priorities, together with the Exams Division's January 2022 Private Fund Risk Alert and public statements of senior staff, confirm many of the key areas of focus that we have seen in recent examinations, including:

- **Conduct Inconsistent with Disclosures and Conflicts of Interest – Potential Issues can Include:**
    - informed consent from fund investors or Limited Partner Advisory Committees ("LPACs") as required by fund governing documents;

[1] *See* 2022 Examination Priorities Report (the Exams Division does not identify investment adviser/investment company program deficiency letter and enforcement referral percentages. Percentages shown are estimates calculated using same year 2021 deficiency letters (2,100), enforcement referrals (190), and total examinations (3,040) reflecting the entire examination program (investment advisor, investment company, broker-dealer, transfer agents, municipal advisers, et al.). Further, these estimates do not account for 2021 deficiency letters or enforcement referrals that were a result of examinations conducted in prior years).

[2] *See* FY 2023 Congressional Budget Justification *at* 28 ("Additional resources are critical and necessary to help the Exams Division address the ongoing disparity between the number of exam staff and the size of the SEC-regulated community.").

[3] *See* SEC Union NTEU Chapter 293 Update (July 27, 2022) (SEC Union and Chair Gensler agree to a mandatory return to office starting in January 2023).

- “key person” process upon departure of adviser principals;
- accuracy of fee calculations (e.g., post-commitment period management fees, fund extension terms, and the impact of valuation practices);
- allocation of expenses between the adviser and clients or co-investors;
- allocation of investment and trading opportunities;
- side-by-side management of different client accounts, or different client accounts and proprietary accounts, using the same or similar strategies; and
- arrangements with or services provided by affiliated entities or service providers (and where the approval of any board of directors, advisory board or other third-party consent is requested, the accuracy of relevant disclosures).

> **Marketing Materials and Performance Presentations** – See “Review of Marketing Materials – Key SEC Considerations” section in the Annual Review below for a detailed discussion of the new requirements imposed by amended Rule 206(4)-1 (the “Marketing Rule”) under the Investment Advisers Act of 1940 (the “Advisers Act”). Recently, the Exams Division’s Marketing Rule Risk Alert announced that the staff will conduct targeted exams to test compliance with the Marketing Rule, following the mandatory compliance date of November 4, 2022, focusing on:

- Marketing Rule policies and procedures;
- backup support for factual statements;
- compliance with the rule’s requirements for performance advertisements (i.e., net returns, related performance, extracted performance, predecessor performance, and hypothetical performance); and
- books and records, as required by the corresponding amendments to Rule 204-2 under the Advisers Act.

> **Material Non-Public Information (MNPI)** – See the Exams Division’s April 2022 MNPI Risk Alert, noting the most commonly cited deficiencies by the staff, related to:

- administration of code of ethics as required by Rule 204A-1 under the Advisers Act (the “Code of Ethics Rule”);
- relationships with fund investors whom the SEC refers to as “Value-Added Investors” or “Strategic Investors” (e.g., corporate executives or financial professional investors that have information about investments);
- use of “expert networks”; and
- use of alternative data (see more below).

> **ESG** – The Exams Division continues its focus on environmental, social or governance (“ESG”) practices among investment advisers, which began in 2019 with a series of ESG-focused examinations followed by the Exams Division's April 2021 Risk Alert on this topic.[4] Its focus areas include:

- consistency of investment and trading activities with any applicable governing documents and marketing materials for the stated strategy;

[4] *See* ESG Funds Draw SEC Scrutiny, The Wall Street Journal (Dec. 16, 2019).

- the firm's use of ESG-related terminology, particularly as it relates to adherence with various ESG frameworks or standards; and
- a review of the firm's written policies and procedures and their implementation, with the expectation that there is compliance oversight of both (i) ESG investing practices and (ii) ESG-related disclosures.

- **Cybersecurity** – Questions from the Exams Division can include:[5]
    - steps taken to safeguard client assets, accounts and information and prevent account intrusions;
    - due diligence and oversight of vendors and service providers;
    - actions taken in response to events such as ransomware attacks, phishing or account intrusions;
    - controls regarding remote work by employees, including access to online and mobile applications and investor account information;
    - business continuity and disaster recovery plans; and
    - internal written policies and guidelines.
- **Alternative Data** – Questions from the Exams Division can include:
    - controls and compliance policies and procedures around the creation, receipt and use of alternative data; and
    - due diligence and oversight of alternative data providers. For more detail, see the "Alternative Data" section in the Annual Review below.

SEC Enforcement Update

- **SEC Enforcement**

Over the past year, the Commission has fully settled into its enforcement priorities for private funds. Taking its cues from Chair Gensler, the Enforcement Division has shown it intends to display an aggressive approach. As its fiscal year drew to a close, the Enforcement Division announced a flurry of enforcement settlements involving private fund advisers, imposing over $1 billion in combined penalties against financial institutions for text message recordkeeping, and continued to pressure crypto and crypto-adjacent entities through enforcement actions, either pending or threatened. We believe that enforcement risks for private fund advisers are now the greatest they have been since 2015.

The SEC's enforcement approach for private funds is driven not only by the general desire to get tough on "Wall Street" but also by a focus on investor protection. Chair Gensler stated in recent congressional testimony that private fund advisers "touch so much of our economy" because investors in those funds include retirement plans, university endowments, and others; while the funds themselves support "entrepreneurs, small business owners, and managers of late-stage companies." Since 2016, the

[5] *See* Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies, Investment Adviser Release, No. 5956 at 15 (Feb. 9, 2022) (identifies five categories as essential components to cybersecurity compliance programs). *See also* "SEC Policy and Rulemaking Updates" in the Annual Review below for additional information regarding the SEC's cybersecurity rule proposals.

number of private funds managed by SEC-registered advisers has increased 40 percent, to 50,000 funds. The Commission wants to drive "fairness" in the growing space through enforcement.

Conflicts of Interest. Through public statements, proposed rules under the Advisers Act, and recent enforcement actions, the Commission staff has prioritized disclosure of fees and conflicts of interest by private fund advisers. As Chair Gensler noted, the Commission has proposed a number of rules "to enhance transparency for private fund investors, such as with respect to advisers' fees, performance metrics, and side letter arrangements." Particularly with respect to undisclosed financial interests, the SEC is pushing to bring more enforcement cases in this space.

From Exams to Enforcement. Under former Chair Clayton, the SEC relied more heavily on exams by the Exams Division – through deficiency notices and remediation, rather than enforcement actions – to address perceived private fund compliance violations. The rationale was that the examiners could correct behavior and guide private fund advisers through deficiency letters, while reserving enforcement resources for the more egregious cases. That has changed. Issues involving conflicts of interest or disclosure deficiencies by private fund advisers are now more likely to be referred to the Enforcement Division for further investigation.

Electronic recordkeeping. Recent cases announced in September 2022 against large broker-dealers involving failure to retain text messages were a shot across the bow, as one of those matters included charges under the Advisers Act's recordkeeping provisions against a registered adviser. The SEC noted in that settlement order:

- Rules adopted under Section 204 of the Advisers Act, including Rule 204-2(a)(7), require that advisers preserve in an easily accessible place originals of all written communications sent relating to, among other things, any recommendation made or proposed to be made and any advice given or proposed to be given.
- Junior- and senior-level employees of the adviser, including supervisors, regularly used personal mobile devices and email accounts, as well as unauthorized text and mobile messaging applications, for business communications with colleagues, clients and others; however, the firm failed to maintain those communications as required by federal securities laws.
- Because text messages among the investment team that arguably pertained to recommendations or advice to the client (e.g., the fund) were not retained, the SEC could allege violations of Section 204 and Rule 204-2(a)(7), as well as a failure to reasonably supervise employees.
- The firm was therefore censured, fined over $100 million for recordkeeping and supervisory violations, ordered to cease and desist from further violations, and agreed to retain a compliance consultant to revise its policies and procedures on preservation of electronic communications and to report any discipline for employee violations for two years.[6]

It was a prelude to similar settlements by the SEC against 11 other large broker-dealers (16 firms with their affiliates) involving remedies and fines totaling $1.1 billion announced in late September. A myriad of smaller firms face similar scrutiny in upcoming SEC and the Financial Industry Regulatory Authority ("FINRA") examinations. The focus and size of the penalties demonstrate the importance the SEC places

[6] The firm contemporaneously entered into a settlement with the CFTC and agreed to pay a fine of $75 million for similar violations under the CEA.

on recordkeeping as a core means of monitoring compliance with the broad spectrum of securities laws (the settlements did not allege sales practices violations or other misconduct). SEC officials said that in some cases the use of personal devices and applications resulted in incomplete responses to information requests and subpoenas that inhibited Commission's ability to conduct investigations. Some communications applications can be set to delete messages automatically after they are read. The use of private devices, networks and applications also can increase the potential for cybersecurity attacks that compromise the security or integrity of firm and customer data.

The actions are a warning to all broker-dealers and investment advisers to reassess compliance with recordkeeping requirements attendant to employee use of personal computers, mobile devices and the wide variety of communications platforms for business purposes. Many companies initially prohibited the use of personal devices for business, but those restrictions gradually gave way to broader BYOD (bring-your-own device) policies and permissions on communications. But business communications became harder to monitor and control during the COVID-19 pandemic where most employees were working from home. See our Client Advisory on facilitating home office arrangements here. Now with the return to work, firms are expected to reexamine their policies and controls for compliance with recordkeeping requirements.

Given the challenges of monitoring and recording communications on an array of devices and platforms, some firms may elect to return to limiting business communications to firm-issued computers and devices. Firms will be need to review email and messages on their platforms for indications employees are engaging in business communications away from them — such as automated email text reviews that search for terms like "get in touch with me on my WhatsApp account." Those platforms also should include enterprise-level controls to prevent improper access to or transmission of business-related documents and information.

The Enforcement Division is continuing to investigate private fund advisers for their employees' use of text messaging apps. If those messages are considered required records, and they are not being monitored and retained by the adviser, there is an increased risk of enforcement. At the time of publication of this Annual Review, the Enforcement Division is in the middle of a sweep of large private fund advisers regarding their employees' use of "off-channel" communications (e.g., text messages from personal phones, use of WhatsApp and other written/electronic communications that are not typically captured and/or monitored by advisers). This is occurring notwithstanding that private fund advisers have become accustomed to the staff of the Exams Division examining the use of off-channel communications over the past number of years.

Further areas of focus are outlined below.

> **Cryptocurrencies**

The SEC and other federal authorities have been busy investigating new types of digital assets and related business. Chair Gensler has made it abundantly clear that he views regulation and enforcement surrounding cryptocurrencies as a major priority, stating in testimony that: "of the nearly 10,000 tokens in the crypto market, I believe the vast majority are securities." Because of this status, "many crypto intermediaries — whether they call themselves centralized or decentralized (e.g., DeFi) — are transacting in securities and have to register with the SEC in some capacity." For private fund advisers that trade crypto or invest in crypto-adjacent businesses, we have seen an increasing number of investigations and scrutiny.

Although many have criticized the Commission for regulating crypto through enforcement rather than constructive guidance, SEC Enforcement Director Gurbir Grewal responded that a failure to prosecute violations in the crypto space would constitute an "abdication" of the SEC's responsibilities:

> "[W]hat's interesting to me in the context of today's remarks is that the argument is generally not that we have somehow unfairly targeted crypto to the exclusion of other products or markets. Instead, it often seems critics are upset because we're not giving crypto a pass from the application of well-established regulations and precedents."

The Enforcement Division has indeed been actively applying traditional securities law concepts in the space, filing a variety of actions. Some recent examples:

- charging the promoters of an "Automated Cryptocurrency Fund" with fraud and registration violations;
- prosecuting an alleged pump-and-dump scheme involving crypto securities;
- pursuing crypto issuers for failing to register initial coin offerings ("ICO");
- resolving a case against crypto "brokers" for an unregistered offering; and
- settling with Kim Kardashian for violating the anti-touting rules by promoting a crypto asset without disclosing compensation she received.

One case that demonstrates the SEC's reach is its recent litigated enforcement action involving Hydrogen Technology Corp. ("Hydrogen"), which conducted an initial coin offering for its Hydro token ("Hydro") in 2018. In addition to charging Hydrogen and its former CEO, the SEC also charged a crypto asset "market maker" and its CEO for manipulative trading of Hydro. The SEC alleged that the market maker engaged in matched trades of Hydro tokens using automated software (or a "bot"), to create the false appearance of robust trading activity and to artificially prop up the price of the token. The SEC alleged that Hydro was a security, and thus the standard antifraud provisions of the securities laws applied, prohibiting manipulative conduct in the purchase or sale or in the offer of securities. Although the CEO of the market making firm consented to a judgment, the matter is otherwise pending.

> SPACs

Although the market for special purpose acquisition companies ("SPACs") has cooled, the SEC is examining historical practices by advisers in the space, particularly those who sponsored SPACs during the recent SPAC boom. The Enforcement Division is particularly interested in SPAC sponsors that participated in the equity of a SPAC, through founder shares or a "promote," focusing on potential conflicts of interest.

In September 2022, the SEC settled its first SPAC enforcement action against a private fund adviser. The SEC alleged that the adviser failed to adequately disclose conflicts of interest regarding its personnel's ownership of SPAC sponsor shares, where a private fund managed by the adviser also invested in the SPACs. Because the private fund's investment supported the SPACs and helped the SPACs complete business combinations, the SEC asserted that beneficial ownership of founder shares by the adviser's employees was a conflict of interest requiring disclosure.

We understand that the Enforcement Division's Asset Management Unit is continuing to look at historical practices by private fund advisers who sponsored SPACs. The Enforcement Division's focus has extended beyond the SPACs themselves for disclosure violations, although those types of matters continue to progress (for example, see the recent civil and criminal matters involving Nikola and its former CEO).

> **Trading Violations**

The SEC continues to bring enforcement actions in connection with trading violations. In May 2022, the SEC announced that it settled charges against Maplelane Capital for providing inaccurate information to its executing brokers on hundreds of orders involving 29 public companies. According to the SEC, at times when the adviser's net aggregate position was not net long at the time that it submitted sell orders, Maplelane incorrectly identified short sale orders to its executing brokers as long sale orders. That incorrect identification of sell orders as long sales, instead of short sales, caused Maplelane's executing brokers to violate Regulation SHO Rules 200(g) and 203(b) (Regulation SHO's marking and locate requirements). The SEC imposed penalties for causing violations of Regulation SHO, Rule 204-2 under the Advisers Act (the "Books and Records" rule), and Rule 206(4)-7 under the Advisers Act (the "Compliance Rule").

The SEC issued an order in June 2022 stating that it had settled with a hedge fund adviser for violating Rule 105 of Regulation M of the Securities Exchange Act of 1934 ("Exchange Act"). Specifically, the company short sold American depositary shares ("ADSs") of a company, then purchased that company's ADSs in their public offering three days later, in violation of the rule's restrictions against purchasing securities in a public offering within five days of short selling those securities. The adviser agreed to a cease-and-desist order, pay disgorgement with prejudgment interest and a civil money penalty.

> **Fees and Expenses**

Fee and expense allocations by advisers continue to be an annual focus of the SEC's enforcement efforts.

In September 2022, the SEC announced settled charges against a private equity firm for failing to adequately disclose information concerning management fee offsets relating to placement agent fees. According to the settlement order, the adviser received an advance from the private fund to pay placement agent fees (which was allowed under the private fund's organizational documents), but failed to promptly offset that amount against management fees, as required by the governing limited partnership agreement. Although the adviser ultimately repaid the offset amount with interest, the SEC asserted that the failure to adequately disclose the outstanding obligation to investors constituted a violation of Section 206(2) of the Advisers Act.

Also in September 2022, private equity advisers Hudson Advisors and Lone Star Global settled SEC allegations that they failed to fully disclose the manner in which Hudson charged fees for certain ancillary and underwriting services to private funds it managed. For over ten years, Hudson charged those fees on a cost plus margin basis, but also included as a cost the anticipated U.S. income tax liability of its founder attributable to those fees. The SEC took the position that the failure to disclose the inclusion of this cost component (or the basis for it) violated the Compliance Rule as well as certain antifraud provisions.

In September 2022, the SEC also reached an enforcement settlement with venture capital firm Energy Innovation Capital Management, an exempt reporting adviser ("ERA"), for charging excess management fees to two venture capital funds it advised. According to the order, over a two-year period the adviser overcharged management fees by making a number of errors in its favor, including: (i) failing to adjust calculations for portfolio companies subject to write-downs; (ii) inaccurately calculating fees based on aggregated invested capital at a portfolio company level instead of at the portfolio company security level;

(iii) including accrued but unpaid interest as part of the fee basis; and (iv) failing to begin the post-commitment management fee period at the correct date. This case is a reminder that the SEC can and will enforce violations of the antifraud provisions against ERAs.

The SEC reached a settlement with venture capital adviser Alumni Ventures Group and its founder in March 2022 for a series of violations relating to management fees and commingling private fund assets. The SEC alleged that the adviser made misleading statements regarding management fees, indicating that it charged an "industry standard" 2 and 20 fee, while its typical practices was instead to charge a 20% fee for the 10-year life of the fund upfront, as well as a separate performance fee. This accelerated collection practice served to generate an undisclosed, interest-free loan from the private funds to the adviser. The SEC further alleged that the adviser failed to disclose conflicts of interest relating to inter-fund loans and cash transfers between separate private funds it advised.

The SEC in June 2022 charged private equity adviser Energy Capital Partners Management LP with undisclosed allocation of disproportionate deal-related expenses to a private fund it advised, failing to disclose that other private funds and co-investors would not pay a proportionate share of expenses. Although an LPAC existed, the adviser did not disclose the disproportionate allocation to the LPAC or seek its consent to the conflict. The SEC noted that the adviser's remedial efforts included repaying over $3 million in deal-related expenses to the relevant private fund.

In December 2021, the SEC settled a matter involving offsets for portfolio company fees paid to a private equity adviser. The SEC asserted that the adviser failed to fully offset eligible portfolio fees for certain investments — in particular, for partial dispositions of investments — in violation of the private fund's applicable governing documents. The SEC also noted that the adviser had circulated offering and governing documents with inconsistent provisions relating to the offset calculation methodology. Although the adviser took steps to remediate the discrepancies and repay the offset amounts, the SEC imposed a penalty for violating certain antifraud provisions and the Compliance Rule.

> **Conflicts of Interest**

The SEC announced a settlement in September 2022 against SparkLabs Management and its founder for undisclosed conflicts of interest relating to a series of inter-fund loans that the adviser arranged for its venture capital funds. SparkLabs, an ERA, directed private funds it managed to make over 50 inter-fund loans, some of which were at below-market rates or violated limitations in the private funds' partnership agreements, per the SEC's order. The adviser did not disclose or obtain consent from any limited partner advisory committee for these loans, notwithstanding the conflicts of interest they created vis-à-vis various private fund clients.

In May 2022, the SEC reached a settlement with Virtua Capital Management, a real estate fund adviser, as well as its principals, for failure to adequately disclose conflicts of interest relating to seven private funds it managed. Virtua affiliates managed numerous real estate projects, and the private fund assets were invested primarily in those affiliated real estate investments. The SEC asserted that the practice of investing nearly exclusively in affiliate projects presented conflicts of interest that were not adequately disclosed. In addition, although the offering documents disclosed some fees paid to affiliates, the SEC alleged that other fees were not disclosed. The allocation of private fund assets to investments affiliated with the adviser is a classic conflict of interest from the SEC's perspective.

> **Valuation**

In February 2022, the SEC filed a complaint against the founder of Infinity Q, alleging that he engaged in a fraudulent scheme to overvalue assets held by the Infinity Q Diversified Alpha mutual fund and the

Infinity Q Volatility Alpha private fund. According to the complaint, he executed the scheme by altering inputs and manipulating the code of a third-party pricing service used to value the funds' assets. In September 2022, the SEC reached a settlement with an individual who was Infinity Q's former Chief Risk Officer, head of operations, and Chief Compliance Officer for misconduct concerning the alleged $1 billion overvaluation scheme. The order alleged that he failed to appropriately discharge responsibilities in the face of multiple red flags regarding valuations. He also allegedly misrepresented that the pricing service was "independent" of Infinity Q when, in fact, the founder exercised control over the pricing service, and later misled the auditors for the funds.

> Fraud and Misleading Disclosures

The SEC brought a handful of matters involving more egregious conduct and fraud.

In May 2022, the SEC filed an action for fraud against EIA All Weather Alpha Fund I Partners and its owner for engaging in a multi-year scheme involving misappropriation and misuse of investor funds. The complaint alleged fraud, including misappropriation of private fund assets and use of new investor money to make Ponzi-like payments to other investors in the private fund. Given the nature of the charges, the SEC sought and obtained a temporary restraining order and an asset freeze.

In December 2021, the SEC brought fraud charges against Peachcap Tax & Advisory and its principal, who allegedly defrauded a hedge fund they managed, which ultimately led to a 90% loss of value of the private fund.

> Custody Rule and Form ADV

In actions that serve to remind private fund advisers that the rulebook is being enforced, in September 2022, nine advisers were charged with (i) violations of Rule 206(4)-2 of the Advisers Act (the "Custody Rule"), (ii) Form ADV violations, or (iii) a combination of both. The Custody Rule violations arose from the failure to have independent audits of funds performed or delivered to investors in a timely manner. The Form ADV violations primarily arose from the failure to report on Form ADV that financial statement audits were late, or to update the form when audits had been completed.

These actions followed two other actions against small private fund advisers for Custody Rule violations for failure to obtain or distribute private fund audits.

> Pay-to-Play Rule

The SEC dusted off the Pay-to-Play Rule to remind the industry that it does monitor political contributions by private fund adviser employees. In September 2022, it reached settlements with four advisers for violating the rule by continuing to receive fees from government entities following campaign contributions made by employees to candidates for office or elected officials. Notably, in all of these instances the contributions were small, and there was no allegation that any contribution impacted an investment decision. Nevertheless, the SEC brought enforcement actions with penalties in amounts that were many multiples of the political contributions at issue.

SEC Policy and Rulemaking Updates – "The Year of Rule Proposals"

At the end of 2021, the SEC filled two important senior positions in the agency's policymaking divisions. William Birdthistle, most recently a professor at Chicago-Kent College of Law, was appointed as Director of the Division of Investment Management, and Haoxiang Zhu, a professor of finance at the Massachusetts Institute of Technology, was appointed as Director of the Division of Trading and Markets.

These two appointments, along with Chair Gensler's own rulemaking priorities, gave way to an active 2022.

The SEC's rulemaking activity in 2022 was substantial, with several rule proposals having potential to significantly alter the investment management industry, and moreover, the private fund industry. The Division of Investment Management and Division of Trading and Markets, collectively, introduced more than a dozen proposals that are relevant to private funds and their sponsors. The most notable rule proposal, described directly below, relates directly to private funds and, if adopted, would create a new regulatory paradigm for the private fund industry. Additionally, the rules proposed in 2022 share several common themes, which largely center on heightened reporting obligations, in terms of both increased transparency and shortened reporting timelines. The rule proposals introduced in 2022 demonstrate a notable shift in expectations, with several of the rule proposals seeking to require advisers to report information to the SEC within days versus weeks or months under the current reporting environment (see *Modernization of Beneficial Ownership Reporting*, *Amendments to Form PF (One and Two)*, and *Cybersecurity Risk Management for Investment Advisers*). It is expected that this collection of proposed regulations could be finalized during the first half of 2023, if not sooner.

> Proposed Rules

Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews

On February 9, 2022, the SEC proposed new rules and amendments to existing rules (the "PFA Proposed Rules") under the Advisers Act that would impose significant requirements and restrictions for private fund advisers — in many cases regardless of the adviser's registration status — pertaining to, among other things, the following topics:

- quarterly statements to private fund investors;
- private fund financial statement audits;
- adviser-led secondaries transactions;
- prohibitions on certain adviser practices and activities;
- conditions to providing preferential treatment to private fund investors; and
- annual reviews under the Advisers Act's compliance program rule.

As noted in our February 16, 2022 post on this matter, several of the proposals in the PFA Proposed Rules represent a significant deviation from the traditional paradigm of the Advisers Act as a disclosure-based regime with respect to conflicts of interest, prescribing and prohibiting specific actions by advisers in lieu of focusing on the quality of advisers' disclosures and/or negotiations between advisers and private fund investors. If adopted, the PFA Proposed Rules would have notable implications for private fund advisers.

Current Status and Timing

The initial comment period for the PFA Proposed Rules was due to expire April 25, 2022. However, after a wide-spectrum of commentators — including those representing private fund investors, private fund advisers and members of Congress — wrote to the SEC requesting additional time, the SEC re-opened the comment period through June 13, 2022.

If adopted, the PFA Proposed Rules would provide a one-year transition period for compliance following each rule's effective date (which effective date would be 60 days after publication of such rule in the

Federal Register). The PFA Proposed Rules do not include a "grandfathering" provision, which would be significant if the PFA Proposed Rules were to be adopted and deemed to apply to existing private funds (i.e., as opposed to only contractual arrangements and practices entered into after the transition period has expired). To the extent a grandfathering concept is not ultimately included in the final rules, private fund advisers and investors should anticipate a comprehensive review of all existing contractual arrangements, which could potentially result in an unprecedented volume of modifications to the governing documents of existing private funds and a general "unwinding" of several commercial practices that have widely been considered market standard since the inception of the private funds industry.

The SEC has not announced when final rules are expected to be adopted.

Overview

Quarterly Statements (in scope: all SEC-registered investment advisers (each an "RIA") with private fund clients)

The PFA Proposed Rules would require RIAs to provide quarterly statements to private fund investors with detailed information on: (1) private fund fees and expenses by specific category; (2) compensation received by private fund advisers and related persons relating to the management of private funds (e.g., management fees, carried interest and other performance compensation, and portfolio company remuneration) and any related management fee offsets; and (3) fund performance.

The proposed performance-related requirements would vary depending on whether the RIA determines the private fund is a liquid fund or an illiquid fund (i.e., defined based on features that generally differentiate hedge and private equity funds). Fund performance for illiquid funds would be required to include gross and net internal rates of return and multiples of invested capital, computed without the impact of any fund-level subscription facilities. The quarterly statement would be in table format, required to include disclosure on how calculations were made (including cross-references to fund governing documents) and due within 45 days of the end of each quarter.

Key Open Question(s) to Consider/Commentator Feedback:

- The proposing release indicated that RIAs would be required to list each specific category of expense as a separate line item, rather than be permitted to group fund expenses into "broad categories." It is unclear, however, from this proposal's description of expense "categories", precisely what level of an expenses breakdown is necessary (e.g., whether legal expenses would need to be broken down between deal, organizational, operational, etc.).
- Investors and/or investor groups noted that some institutional investors have negotiated for fee and expense reporting at the portfolio investment level (rather than just at the fund level as required by the PFA Proposed Rules). They expressed the view that the PFA Proposed Rules should not become a de facto maximum compliance standard.

Annual and Liquidating Audits of Private Funds (in scope: all RIAs with private fund clients)

Under the PFA Proposed Rules, an RIA would be required to prepare and deliver annual financial statements in accordance with U.S. Generally Accepted Accounting Principles ("GAAP") (or in the case of private funds formed or with a general partner or other manager with a principal place of business outside the U.S., substantially similar to GAAP with a reconciliation) for each private fund it advises and to obtain annual and liquidation audits of such financial statements. Accordingly, the PFA Proposed Rules would effectively eliminate the ability of private fund advisers to avoid annual audits by choosing the alternative "surprise examination" approach to compliance under the Custody Rule. The audit must be performed by an auditor registered with the Public Company Accounting Oversight Board ("PCAOB") and, in a deviation from existing annual audit requirements under the Custody Rule, the auditor must agree in writing with the adviser to inform the SEC directly if it issues a modified opinion or resigns or is dismissed from the engagement. The proposal does not specify the timing for delivery of the financial statements (other than "promptly" following completion of the audit), although the Custody Rule separately requires that audited financial statements be delivered within 120 days from fiscal year end (or 180 days for funds of funds).

Key Open Question(s) to Consider/Commentator Feedback:

> As currently written, the proposed new audit rule would only apply to RIAs to private funds; for most RIAs to private funds who currently make use of GAAP-compliant audited financials for purposes of Custody Rule compliance, this would not result in any meaningful change in practice. However, the SEC in its proposing release asked for input as to: (1) whether the new rule and requirements should apply to all advisers to private funds, rather than just to RIAs; and (2) similarly, whether the new rule and requirements should also apply to all pooled investment vehicle clients of an adviser, rather than just in the context of those vehicles meeting the Advisers Act's definition of a private fund.

Adviser-Led Secondaries (in scope: all RIAs with private fund clients)

The PFA Proposed Rules would mandate additional requirements for RIAs regarding "adviser-led" secondary transactions with respect to any private fund. The adviser would be required to distribute, prior to the transaction's closing date, the following to the private fund's investors: (1) a fairness opinion from an independent opinion provider; and (2) a summary of any material business relationships the RIA or any of its related persons has or has had with the independent opinion provider within the past two years.

Key Open Question(s) to Consider/Commentator Feedback:

> Similar to the recent SEC proposals with respect to Form PF, "adviser-led" secondary transactions would not be limited to GP-led continuation fund transactions, but would also include certain types of secondary transactions that have historically presented fewer conflicts of interest with respect to pricing, such as normal course tender offers and "LP stake" secondary transactions initiated by the sponsor. Moreover, there would be no exception to the fairness opinion requirement for (1) adviser-led transactions where pricing is established pursuant to a competitive auction presented to multiple secondary buyers, a concurrent acquisition by a third party strategic buyer or similar processes that are commonly used to establish fair pricing in the secondary industry or (2) adviser-led secondary transactions where investors are provided a status quo option to decline participation but remain invested on substantially the same terms as prior to the secondary transaction.

> One investor group commented that "[o]ther methods, such as through a partial disposition to a third-party or an arms-length transaction through a minority stake sale to another adviser and independent of the proposed secondary are perceived to yield more valuable information on the fairness of the pricing offered."

Prohibited Activities (in scope: all advisers to private funds, regardless of registration status)

> The PFA Proposed Rules notably include the following prohibitions on certain practices by all private fund advisers (whether or not registered):

- The PFA Proposed Rules would prohibit charging certain fees and expenses, specifically (1) "accelerated monitoring fees" and other fees for services that are not provided, (2) fees and expenses associated with the examination or investigation of an adviser or its related persons by any governmental or regulatory authority and (3) regulatory or compliance fees and expenses of the adviser or its related persons. The prohibition on charging expenses relating to governmental or regulatory examinations or investigations is not limited to SEC examinations or investigations and there is no exception to the prohibition on charging regulatory or compliance fees and expenses (including registration or start-up expenses), including for first-time fund advisers.
- The PFA Proposed Rules would prohibit using certain exculpatory and indemnification provisions to shield the adviser or provide for indemnification in a matter involving the adviser's negligence, including a breach of fiduciary duty. As currently drafted, the PFA Proposed Rules would prohibit all advisers from requiring any reimbursement or limitation on liability for actions arising from certain standards of conduct that have historically been commercially standard in the private funds industry, and generally not subject to material commercial objections from institutional and other investors.
- The PFA Proposed Rules would prohibit reducing general partner clawbacks by the amount of any actual, potential or hypothetical taxes incurred by the adviser and its related persons.
- The PFA Proposed Rules would prohibit borrowing or receiving any credit extension from a client, although it is unclear how the restriction on borrowings and extensions of credit may impact certain traditional terms of a private fund (e.g., payment of placement fees and/or organizational expenses that are subject to management fee offset; tax distributions that are an advance against subsequent distributions; general partner "cashless" contribution obligations). The SEC has specifically asked for comment on whether tax distributions should be excluded from this prohibition.
- The PFA Proposed Rules would prohibit non-pro rata allocations of certain deal-related expenses and fees among private funds or other clients of the adviser participating or proposing to participate in the same investment. The proposing release specifically highlights co-investments and generally would require co-investors that have executed a binding agreement to participate in a co-investment to be charged their pro-rata share of broken deal expenses. The SEC was silent on which party should bear a broken deal expense if a co-investor were commercially unwilling to bear such broken deal expenses, even where such co-investor is deemed to be needed to consummate the transaction.

Key Open Question(s) to Consider/Commentator Feedback:

- In connection with the proposed prohibition against reducing adviser clawbacks by the amount of certain taxes, the SEC asked in its proposing release whether the new rules and regulations would achieve the intended effect of ensuring that investors receive their full share of profits (e.g., would a prohibition on the use of deal-by-deal, American-style waterfalls be more effective?) and what other implications might the prohibition have on the industry (e.g., attracting and retaining investment professionals).
- Certain investors and/or investor groups noted that this part of the proposed rule would have the unintended consequence that future funds (especially for advisers less able to bear the risk of clawback without adjustment for taxes) will eliminate any clawback, limit clawback events or slow distributions over time.

Preferential Treatment (in scope: all advisers to private funds, regardless of registration status)

This part of the PFA Proposed Rules, if adopted, would significantly impact private fund "side letter" practices.

The PFA Proposed Rules would prohibit preferential treatment of certain investors by all private fund advisers (whether or not registered) relating to redemptions and providing information regarding private fund portfolio holdings or exposures if the adviser reasonably expects such preferential treatment to have a material, negative impact on other investors in that private fund or in a substantially similar pool of assets.

The PFA Proposed Rules would also condition other types of preferential treatment afforded investors on the adviser's disclosing to prospective investors specific information regarding the preferential treatment and disclosing annually to existing investors any preferential treatment not previously disclosed.

The preferential treatment would need to be described specifically to convey its importance. The SEC indicated, for example, that if an adviser provides an investor with lower fee terms in exchange for a significantly higher investment than that made by others, the SEC does not believe that mere disclosure that some investors pay a lower fee is specific enough. Rather, the adviser must describe the lower fee terms, including the applicable rate (or range of rates), to satisfy the requirement. The SEC also indicated that an adviser could comply with the proposed disclosure requirements by providing copies of side letters (with identifying information regarding the other investors redacted) or could provide a written summary of the preferential terms provided to other investors in the same private fund, provided the summary specifically describes the preferential treatment. While some variation of this disclosure, typically on a more limited basis (e.g., based on level of capital commitment), is common in the private equity space, it would deviate from current hedge fund market practices.

According to the SEC, whether a term is "preferential" is a matter of facts and circumstances.

Key Open Question(s) to Consider/Commentator Feedback:

A number of investors and groups representing investors noted that, while they generally supported increased transparency, this part of the proposal could have unintended consequences. They noted that, among things:

> The uncertainty of the SEC’s “facts and circumstances” approach to determining what may be a “material, negative” impact will discourage private funds from entering into institution-specific side letters that are necessary for many institutional investors to participate in the investment, even if these institution-specific side letters would not harm other investors.

> Certain institutional investors are required by their sponsoring state legislation to negotiate “individual liquidity options”, which would not be permitted under the PFA Proposed Rules.

> With respect to a closed-end fund, the requirement to provide written notice of preferential terms to prospective investors would be procedurally misaligned with the Most Favored Nation (MFN) process that runs after the private fund has closed.

> Certain investor groups maintained that side-letter provisions that favor large, “anchor” investors are necessary to the capital raising process.

Annual Review (in scope: all RIAs, regardless of whether they have any private fund clients)

The SEC's proposal would amend the compliance program rule under the Advisers Act to require all RIAs (whether or not they advise private funds) to document the annual review of their compliance policies and procedures in writing.

Environmental, Social, and Governance Disclosures for Investment Advisers and Investment Companies

On May 25, 2022, the SEC proposed rule amendments for advisers to private funds that consider ESG as part of one or more significant investment strategies. The proposed rules would require advisers employing ESG strategies to report additional information about those strategies to the SEC and provide additional, more detailed disclosure to clients.

The proposed rules are part of a larger effort by the SEC in 2022 to address the growth in ESG-focused investing, and concerns about the claims made by advisers about their ESG strategies that may not conform to their actual practices, a practice that has become known as "greenwashing." The SEC's consideration of the rule proposals came shortly after the SEC settled its first ESG-related enforcement action against an adviser to mutual funds, alleging that the adviser misled investors into believing that all of the funds were being managed in accordance with certain ESG principles.

The proposal marks a continuation of the SEC's focus on ESG practices among advisers that began in 2019 with a series of ESG-focused examinations and was followed by a 2021 Exams Division Risk Alert on this topic. Recently, the SEC has begun another sweep examination of ESG practices by advisers to mutual funds.

Form ADV does not currently require adviser to provide detailed reporting or client disclosure about ESG or any other strategy employed by the adviser. The SEC's proposing release explained that the SEC believes that ESG-focused investors may need more specific disclosure because they face special risks of being misled by advisers about their ESG policies. In other words, the agency believes that investors currently may be susceptible to misleading claims about ESG, given the ill-defined nature of ESG strategies and the varying degrees of commitment of advisers pursuing such strategies.

The proposed rules would apply to all advisers registered with the SEC under the Advisers Act and ERAs that "consider" ESG factors as part of one or more "significant" investment strategies provided to clients. Many, if not all, advisers consider some aspects of ESG in selecting investments within an investment strategy primarily focused on achieving positive returns for clients.

Environmental, Social or Governance Factors

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

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

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

Contributing to the chaos are disagreements over what ESG investing seeks to achieve. For some, ESG factors are simply a way to better evaluate the financial strength of a company and its ability to maximize shareholder returns. For others it is designed more to transform business by creating portfolios designed to do good for the world. In a significant public letter in 2018, Laurence D. Fink, Chief Executive of BlackRock, wrote that “every company must not only deliver financial performance, but also show how it makes a positive contribution to society.” A less sanguine view is that ESG investing is ultimately futile because companies that wish to be regarded as favorable to ESG investments will simply sell their unfavorable assets to other companies or investors who are not sensitive to ESG considerations.

The SEC’s Proposed Approach

In its rule proposals, the SEC sidesteps these issues. It acknowledges that there are many approaches to ESG investing and seeks to organize the universe of ESG strategies not by their substance but by the nature of the adviser’s commitment to incorporating ESG into its investment strategy. The SEC would thus require advisers to group the ESG strategies they employ into three buckets and, in the case of RIAs, describe the strategies to their clients:

- “ESG Integration” strategies consider one or more of the ESG factors, but ESG is not dispositive to an investment decision. These strategies incorporate ESG considerations into the investment process alongside traditional factors and analysis that make up the investment strategy.
- “ESG Focused” strategies, according to the SEC, use one or more factors “as a significant or main consideration in either selecting investments or in engaging with portfolio companies.” This might include an adviser that selects companies for investments because of their favorable ESG characteristics, as well as a company that does not have favorable ESG characteristics but the adviser plans to engage with the company (through proxy voting or direct engagement) to enhance its ESG characteristics.
- “ESG Impact” strategies are those that have “a stated goal that seeks to achieve a specific ESG impact or impacts that generate specific ESG-related benefits.” The SEC treats ESG Impact strategies as a subset of ESG-Focused strategies.

The SEC proposed to amend Part 1A of Form ADV to obtain a “census” of advisers that use ESG factors, including their use of ESG consultants. The new reporting would include whether the adviser’s strategy involves “ESG Integration,” “ESG Focused” or “ESG Impact.” An adviser that considers ESG factors must report which ESG factor(s) it considers (i.e., “E,” “S,” or “G.”). If the adviser follows one or more third-party frameworks to pursue its ESG strategies, those framework(s) would have to be identified. The new reporting appears primarily designed to permit the SEC examiners to identify advisers pursuing ESG strategies in order to identify candidates for future ESG-focused examinations.

The SEC also proposed to amend Part 2 of Form ADV to require an adviser to disclose ESG factors, if any, it considers for each significant investment strategy and how the adviser incorporates the factors including which factors (i.e., E, S and/or G) it incorporates when advising its clients. Thus, an adviser that employed an ESG strategy for selecting or excluding certain securities would need to disclose the criteria or methodology it employs, including any internal or third-party framework, screen or index.

Industry comments on the proposed amendment to Form ADV expressed almost uniform concern about the requirement to report and disclose ESG strategies based on the "significance" of the strategy and without any consideration as to whether ESG considerations are material to the strategy. Some suggested that because the SEC rulemaking is primarily concerned with the misleading marketing of ESG strategies, reporting and disclosure requirements should turn on whether an adviser markets itself (or a fund) based on an ESG strategy.

Private Funds

Only a portion of the proposed amendments would directly affect advisers to private funds. ERAs are not required to prepare or deliver a brochure and, thus, would not be directly affected by the proposed Part 2 brochure amendments.

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

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

Amendments to Form PF (One and Two)

The SEC proposed amendments to Form PF and related rules (the "Form PF Proposed Amendments") under the Advisers Act on January 26, 2022 ("January Proposal"), and again jointly with the Commodity Futures Trading Commission (the "CFTC") on August 10, 2022 ("August Proposal"). Form PF is the confidential reporting form used by certain advisers to private funds to report information to the SEC and the Financial Stability Oversight Counsel ("FSOC") about private funds. The SEC stated that the Form PF Proposed Amendments are designed to further improve the FSOC's capabilities to monitor systemic risk and to gather additional information for regulatory purposes, including enforcement, examinations and rulemaking.

Background

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

Please see "Annual and Other Periodic Filing Requirements" for a description of Form PF's current reporting requirements.

In the release for the January Proposal, the SEC and FSOC observed that since 2011, assets of private funds reported on a Form PF have grown considerably, from $5 trillion in 2013 to $11 trillion at the end of 2020. Based on that growth and their experience over the past 11 years, including the market volatility occurring in March 2020, the SEC and FSOC have asserted that they need both more data and more current data to monitor systemic and other risks.

January Proposal

The January Proposal would significantly increase the reporting requirements for private fund advisers that currently file Form PF. If adopted, the amended Form PF would:

- Require "Large Hedge Fund Advisers"[7] and private equity advisers that have at least $150 million of private equity fund assets under management to file new, complicated and detailed Section 5 and Section 6 reports, respectively, with the SEC within one business day of the occurrences of certain specified events;'
- Lower the threshold for a private fund adviser reporting as a Large Private Equity Adviser from $2 billion to $1.5 billion in private equity fund assets under management;
- Increase the amount of information reported by Large Private Equity Advisers under Section 4; and
- Expand reporting for "Large Liquidity Fund Advisers".[8]

Overview

Current Event Reporting

The January Proposal would require a private fund adviser to file reports as to certain events within one business day of the occurrence of any of such events, which would be the close of the business day following the day the event occurred. The January Proposal release explains that the information the SEC and FSOC currently receive from the Form PF is stale and is often submitted months after the occurrence of an event that may have systemic significance. Each section would provide private fund advisers with the ability to provide a narrative explanation of their responses if they believe additional information would be useful. A private fund adviser would file a current report as a stand-alone document, allowing them to avoid re-filing an entirely new Form PF.

Large Hedge Fund Advisers

Section 5 to Form PF, which would require Large Hedge Fund Advisers to file a new report within one business day of the occurrence of nine triggering events by a Qualifying Hedge Fund[9]:

---

7 A private fund adviser with at least $1.5 billion in regulatory assets under management ("RAUM") attributable to hedge funds as of any month-end during the preceding fiscal quarter is subject to more comprehensive quarterly reporting requirements with respect to hedge funds under its management.

8 A private fund adviser with at least $1.0 billion in RAUM attributable to private liquidity funds and registered money market funds as of any month-end during the preceding fiscal quarter will be subject to more comprehensive quarterly reporting requirements with respect to private liquidity funds and registered money market funds under its management.

9 A "Qualifying Hedge Fund" is a hedge fund, individually or in combination with any feeder funds, parallel funds and/or dependent managed account, having a net asset value of at least $500 million.

- *Extraordinary Investment Losses*. A cumulative loss of 20% or more in a Qualifying Hedge Fund's net asset value ("NAV") based upon the fund's most recently reported NAV figures (e.g., the NAV reported on the last filed Form PF) over a rolling 10 business day period. A single day loss of 20% would also have to be reported, as well as cumulating losses (net of any daily gains) over the 10-day period. The report would require disclosure of the beginning and end dates of the loss period and the dollar amount of such losses over the loss period.

- *Significant Margin and Default Events*. Any of the following three types of margin events:

    - A Qualifying Hedge Fund experiences a cumulative increase in margin, collateral or an equivalent of more than 20% of the fund's most recent reported NAV figures over a rolling 10 business day period, even if the increase occurs as a result of a new business line, new prime brokerage relationships or regulatory changes. The report would require disclosure of the beginning and end dates involved, the cumulative dollar amount of the increase, the identities of the counterparties requiring the increase, and the identification of any of six applicable specified reasons (including "other") for the increase.
    - A Qualifying Hedge Fund's margin default or its inability to meet a margin call (after the expiration of any applicable cure period, unless the fund would not expect to be able to meet the call during such cure period). A report would not be required to be filed, however, if there is a dispute regarding the amount and appropriateness of the margin call so long as the fund has sufficient assets to meet the greatest of the disputed amount. The report would include the date of the notification of margin default or determination, the dollar amount of the margin, collateral or equivalent involved, the identity of the counterparty and the identification of any of four applicable specified circumstances (including "other") for the default or determination.
    - A margin default by a Qualifying Hedge Fund's counterparty where the counterparty (regardless of whether the counterparty is a broker-dealer or bank) (i) does not meet a call for margin, collateral or equivalent or fails to make other payments, in the time and form contractually required (taking into account any contractually agreed cure period), and (ii) the amount involved is greater than 5% of the most recent reported NAV figures of the fund. The report would disclose the date of the default, the dollar amount of default and the name of the counterparty defaulting. Reasons for the counterparty default would not be required.

- *Material Change to a Prime Broker Relationship*. A material change to a Qualifying Hedge Fund's prime broker relationship, including (i) imposition of material trading limits or investment restrictions on the fund (including requests to reduce or unwind positions), and (ii) termination of the prime brokerage arrangement. The report would include the date of the material change, the name of the prime broker and the identification of the private fund adviser's current understanding of the change in the prime broker relationship and, if applicable, which party terminated the relationship.

- *Decline in Unencumbered Cash*. A decline in a Qualifying Hedge Fund's unencumbered cash (as defined in Form PF Glossary of Terms) by more than 20% of the fund's most recent reported NAV figures over a rolling 10 business day period. The report would identify the last day of the 10-day period and the identification of any of five specified reasons (including "other") for the decline.

- *Operational Disruptions*. A significant disruption or degradation of a Qualifying Hedge Fund's "key operations", whether as a result of an event at a service provider to the fund or the private fund adviser, necessary for (i) investment, trading, valuation, reporting and risk management functions of the fund, or (ii) the operation of the fund in accordance with the federal securities laws and regulations. The January Proposal states that "[w]hen evaluating a …fund's key operations that are reasonably measurable, a 'significant disruption or degradation' means a 20% disruption or degradation of normal volume or capacity". The SEC gave, as examples, a cybersecurity event and a severe weather event causing a power outage. The report would identify the estimated date the event first occurred, the date the event was discovered and the private fund adviser's current understanding of any of six possible causes of the event (including "other").

- *Significant Redemptions*. Cumulative requests for redemptions exceeding 50% (it is unclear whether the correct measurement is "exceeding 50%" or "equal to or more than 50%" as the January Proposal and text of the form requiring the disclosure states the former and the introduction in the section of the form states the latter) of a Qualifying Hedge Fund's most recent reported NAV figures (after netting subscriptions and other contributions from investors, either received or contractually committed, but not taking into account gates at the fund and/or investor level or other fund terms designed to address significant redemptions). The report would identify the date on which redemptions requests "exceed" 50%, the net value of redemptions paid between the last filed Form PF and the date of the current report and the percentage of the fund's most recent reported NAV figures for which redemptions have been requested. The report also requires the private fund adviser to indicate whether the investors in the fund have been notified that the fund will liquidate.

- *Inability to Satisfy Redemption*. A Qualifying Hedge Fund is: (i) unable to pay redemption requests; or (ii) suspends redemption requests for more than five consecutive business days. The report would disclose (i) the date on which the fund was unable to pay redemption requests or suspends redemptions, (ii) the percentage of the fund's most recent reported NAV figures for which redemptions have been requested and not yet paid, and (iii) whether the investors had been notified that the fund will liquidate.

<u>Key Open Question(s) to Consider</u>

- Many Qualifying Hedge Funds have Level 2 and 3 assets, which are valued quarterly (or possibly monthly). It is unclear how private fund advisers could produce reports within one business day that would be accurate.
- A number of the items will likely require Large Hedge Fund Advisers to file reports of events at Qualifying Hedge Funds that do not implicate market stress (e.g., an increase in margin because of a change in investment strategy or addition of new prime broker). Should the SEC, therefore, narrow the reporting requirements when it adopts the amendments to eliminate the number of "false positives" that will clog the data the SEC and FSOC receive and reduce reporting burdens on private fund advisers?
- Unlike mutual funds, hedge funds successfully employ gates and other mechanisms to mitigate the adverse impact on fund portfolios of heavy redemptions and thus systemic risks they may present. Accordingly, one could question what purpose is served in requiring

Qualifying Hedge Funds that employ such mechanisms to report notices of large redemptions requests that may, for example, be deferred over a number of redemption windows.

Private Equity Funds

The January Proposal would add a new Section 6 to Form PF, which would require private fund advisers to private equity funds to file current reports within one business day of the occurrence of one or more of the three reporting events described below. The section must be filed by private equity fund advisers that have at least $150 million of private equity fund assets under management.

Like Section 5, a private equity fund adviser may provide a narrative explanation of its responses, and would only file a current report as a stand-alone document rather than re-filing its entire Form PF. Unlike Section 5, the SEC and FSOC's purpose here does not appear to be limited to gathering information for analysis of systemic risk, but focuses on certain regulatory concerns regarding transactions involving potential conflicts of interest. Thus, a current report by a private equity fund adviser may, if the amendments are adopted as proposed, prompt an SEC examination.

The three situations where a private equity fund adviser would be required to file a new Section 6 within one business day of the event occurring are:

- *Adviser-Led Secondary Transactions*. Private fund advisers would be required to report the completion of an "adviser-led secondary transaction." An "adviser-led secondary transaction" would be defined as any transaction initiated by the private fund adviser or any of its related persons that offers private equity investors the choice to (i) sell all or a portion of their interests in the private fund, or (ii) convert or exchange all or a portion of their interests in the private fund into an interest in another vehicle advised by the private fund adviser or any of its related persons (typically referred to as a "continuation fund"). Unsolicited requests made by an investor to the private fund adviser to participate in a secondary transaction would be excluded from this reporting. The report would require a disclosure of the completion date of the transaction and a description of the transaction.

- *General Partner or Limited Partner Clawback*. Private fund advisers would be required to report upon implementation of a general partner clawback, which the SEC would define as any obligation of the general partner to return performance compensation to a fund under its governing agreements. A limited partner clawback would be defined as an obligation of the limited partners to return some or all of the distributions made by the fund to the limited partners that are in excess of 10% of the fund's aggregate capital commitments. The report would require disclosure of the effective date of the clawback, the type of clawback (general partner/limited partner) and the reason for the clawback. The SEC explained that it believed such clawbacks, if reported by multiple private funds, could indicate systemic stress.

- *General Partner Removal, Termination of the Investment Period or Termination of a Fund*. Private fund advisers would be required to report when a fund receives notification that fund investors have (i) removed the adviser or an affiliate as the general partner (or similar control person) of the fund; (ii) elected to terminate the fund's investment period, or (iii) elected to terminate the fund, in each case as contemplated by the fund's governing documents. The report would disclose the effective date and description of the event.

Reduction in Large Private Equity Adviser Reporting Threshold

The SEC also proposed to lower the reporting threshold for Large Private Equity Advisers from $2 billion to $1.5 billion in private equity fund assets. The SEC explained that a threshold of $1.5 billion would result in the same proportion of private equity fund assets being reported (75%) today as when Form PF was first issued in 2011, and thus provide the SEC and FSOC with a data set of equivalent usefulness to monitor the private fund industry.

Large Private Equity Adviser Reporting

The SEC proposed a number of changes to the existing section of Form PF that requires Large Private Equity Advisers to private equity funds to identify other information about the private equity funds they manage on an annual basis. Among the proposed changes are:

> *Private Equity Fund Strategies (new Question 68).* The January Proposal would require private fund advisers to identify the investment strategies pursued by the fund from a list of 14 strategies commonly employed by private equity funds (e.g., buyout, secondaries, real estate). If the fund engages in multiple strategies, the private fund advisers would be required to provide a good faith estimate of the percentage of the fund’s deployed capital represented by each. This new information is designed to give the SEC and FSOC a sense of how private equity capital is used and to allow for a more informed analysis of the Form PF data (e.g., the SEC could screen for events affecting one segment of the private equity industry).

> *Restructurings and Recapitalizations of Portfolio Companies (new Question 70)*. Private fund advisers would be required to identify any portfolio company that was restructured or recapitalized after the end of the fund’s investment period, and the date of the restructuring. Although not clear from the January Proposal, the new item is designed to provide regulators with information about the market environment in which private funds operate, for systemic as well as compliance purposes.

> *Investments in Different Levels of Capital Structure (new Question 71)*. A private fund adviser would be required to report whether funds advised by the private fund adviser or related persons are invested in different levels of a portfolio company’s capital structure. More specifically, the private fund adviser would report whether the reporting fund held an investment in one class, series or type of securities (e.g., debt, equity, etc.) of a portfolio company while another fund advised by the same private fund adviser or related person concurrently holds an investment in that portfolio company through a different class or series of securities. The January Proposal explains that this reporting requirement is designed to be used by SEC compliance examiners to identify significant conflicts of interests.

> *Fund and Portfolio Company Level Borrowing (new Questions 72 and 74)*. The January Proposal would require private fund advisers to disclose information about borrowing at the fund level and whether the fund or any related person has provided financing at the portfolio company level.
  - If such borrowing is permitted at the fund level, a private fund adviser would be required to disclose (i) information on each borrowing or other cash financing available to the fund, (ii) the total dollar amount available for such borrowing, and (iii) the average amount borrowed by the fund over the reporting period.

- o Private fund adviser would also be required to report whether they or any of their related persons provide financing or other extensions of credit to their portfolio companies.

> *Events of Default and Geographic Breakdown of Fund Investments*. (amends several Questions) The January Proposal would require private fund advisers to provide more granular information concerning (i) the nature of reported events of default under the applicable borrowing agreement (such as whether such default is that of the fund, a connected counter party, or a default relating to a failure to uphold terms (other than payment)), and (ii) a geographical breakdown of investments by a fund, which will identify the fund's greatest country exposures based on percent of NAV.

Large Liquidity Fund Advisers Reporting

The January Proposal would significantly revise and expand the reporting requirements for Large Liquidity Fund Advisers to mirror the reports money market funds must file through Form N-MFP, which the SEC has recently proposed to amend. The proposed revisions will adapt the form's data requirements to categories of data the Federal Reserve Board uses in its internal reports and analysis, and are designed to provide FSOC (primarily the Federal Reserve Board) with a more complete picture of the short-term financing markets and in doing so, improve their ability to facilitate oversight of those markets and their participants.

August Proposal

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

Proposed Amendments Applicable to all Form PF Filers: General Instructions

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

> *Master-feeder and Parallel Fund Structures*. Data reported on a master-feeder structure (and a parallel fund) would generally have to be reported separately for each component rather than in aggregate as currently permitted. An exception would be when a single feeder invests all of its assets in a single master fund and or cash and cash equivalents (a "disregarded feeder fund"). A private fund adviser would continue to aggregate a master-feeder structure for purpose of determining reporting thresholds, e.g., whether a particular hedge fund is a "large hedge fund."

> *Parallel Managed Account*. The SEC would require private fund advisers to exclude reporting of parallel managed account, which are separately managed accounts or other

pools of assets that pursue substantially the same investment strategies. Form PF currently permits (but does not require) private fund advisers to report such accounts, and the SEC explained that the data from them has diminished the value of the fund data because the characteristics of these accounts are different from private funds. The value of parallel managed accounts would, however, continue to be reported on the form in a separate Question 16, and counted to determine whether the private fund adviser (or fund) meets the Form PF reporting threshold, e.g., whether the private fund adviser has $150 million of private fund assets under management.

> *Investments in Other Funds*. Private fund advisers that invest in other private funds ("Underlying Funds") currently include the value of the Underlying Funds for purpose of determining whether the private fund adviser meets the Form PF reporting threshold, i.e., whether the private fund adviser has $150 million of private fund assets under management. Private fund advisers are, however, permitted to exclude investment in private funds for purposes of determining whether the private fund meets the other threshold (e.g., to be a large hedge fund) as well as reporting in other sections of the form as long as they do so consistently. Under the August Proposal, the calculation of the Form PF thresholds would remain the same, but private fund advisers would, in responding to some questions, be required to "look through" an Underlying Fund to identify the indirect holdings (i.e., equity, debt, or other securities) unless the fund is a "trading vehicle" (discussed below). If adopted, this change would require the private fund adviser to have access to position-level information about Underlying Funds managed by third-party advisers.

> *Trading Vehicles*. The August Proposal would require reporting of special purpose vehicles, alternative investment vehicles, blocker entities, or other holding entities of reporting funds ("Trading Vehicles"). If the reporting fund owns all the equity in the trading vehicle, private fund advisers would have the option of aggregating its assets with those of the reporting fund or reporting them as a separate fund. A Trading Vehicle owned or used by multiple reporting funds would have to be reported as a separate private fund and separately characterized as a hedge fund, private equity fund or liquidity fund depending upon its activities. This particular change could create significant additional reporting burdens for funds that employ SPVs as blockers or for other tax purposes.

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

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

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

> *Identifying Information*. The August Proposal would require private fund advisers to provide additional identifying information, including legal identifiers, about the private fund adviser, its related persons, as well as the private funds.

> *Assets under Management*. Question 3 of Form PF requires private fund advisers to report assets under management and net assets under management attributable to private funds. The August Proposal would require private fund advisers to exclude the value of its private funds' investments in any other private fund managed by the private fund adviser ("Internal Funds") to avoid double counting. The amended instruction reflects the common understanding that a private fund adviser to a master feeder structure should not count both the master and feeder fund in determining the private fund adviser's RAUM.

> *Withdrawal and Redemption Rights*. The August Proposal would require private fund advisers to each reporting fund (and not only private fund advisers to hedge funds) to disclose whether the fund provides investors with withdrawal or redemption rights "in the ordinary course." If the reporting fund does provide for redemptions or withdrawals, the frequency would have to be reported. The information would have to be reported notwithstanding any notice, gating, lockups or other restrictions. The SEC explains that, even though private equity and venture capital funds that would be covered if the amendments are adopted rarely provide investors with these rights, the information would give the FSOC a better "picture" of private funds.

> *Gross Asset Value and Net Asset Value*. The August Proposal would require private fund advisers filing quarterly updates to report gross asset value and net asset value as of the end of each month of the reporting period, rather than only reporting the information as of the end of the reporting period as Form PF currently requires. Also private fund advisers would be required to separately break out the value of unfunded commitments included in the gross and net asset values. This information will alert FSOC of funds in their early stages whose asset values consist primarily of unfunded commitments are not yet playing with real money.

> *Inflows and Outflows*. The August Proposal would add a new Question 14 asking about contributions to the reporting fund as well as withdrawals, redemptions and any distributions to investors. Private fund advisers would be required to report the amount of all new contributions from investors, but exclude contributions of committed capital that they have already included in gross asset value calculated in accordance with Form ADV instructions. Quarterly filers would provide this information for each month of the reporting period. The SEC explained that information about cash flows would give FSOC better information about stresses on funds.

> *Borrowings and Types of Creditors*. Question 18 of Form PF currently requires private fund advisers to report the value of the reporting fund's borrowings and the types of its creditors. (The question is a short-form version of the more detailed reporting requirements applicable to large hedge funds in Section 2 of Form PF and thus not applicable to them.) The August Proposal would codify SEC staff interpretations of Form PF (which currently refers only to secured and non-secured debt) in a new Question 18 to include "synthetic long positions," and provide a non-exhaustive list of other types of less exotic borrowings. In addition, private fund advisers would be required to report whether a creditor is based in the U.S. and, if it is, whether it is a U.S. depository institution (rather than a bank).

> *Fair Value Hierarchy*. Form PF requires private fund advisers to report assets and liabilities of reporting funds in categories based upon the fair value hierarchy of U.S. GAAP. The August Proposal would require private fund advisers to report the date of categorization, the

absolute value of liabilities, and an explanation of any negative valuations. Cash and cash equivalents would be separately reported but not based on the fair value hierarchy.

> *Beneficial Ownership*. Private fund advisers would be required to provide more granular information regarding beneficial owners of the reporting fund's equity. Question 16 currently requires private fund advisers to report a good faith estimate of the percentage of the reporting fund's equity that is beneficially owned by different groups (or types) of investors. The question would be revised (and re-designated as Question 22) to ask whether certain groups are or are not U.S. persons (broker-dealers, insurance companies nonprofits, pension plans, banking and thrift institutions), and whether beneficial owners that are themselves private funds are Internal Funds or are "external funds." Private fund advisers that report beneficial owners in the "other" category would have to explain (in Question 4) why the owners would not qualify for other groups and explain the selection of "other."

> *Fund Performance*. The August Proposal would change the way funds report performance information in a number of respects, including the circumstances when monthly and quarterly performance must be reported (when reported to investors, et al.) and the currency in which it is reported (the one used in reports to investors), and when dollar-weighted return should be reported ("IRR") instead of time-weighted return (i.e., when IRR is reported to investors, et al.). Use of local currency would remove currency fluctuations from the reported data, permitting the FSOC to convert using a standard methodology.

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

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

> *Fund Investment Strategies*. The August Proposal would expand and update the current reporting requirements of hedge fund strategies (including the percentage of fund assets represented by the strategy), including more granular types of equity strategies (factor driven, statistical arbitrage, emerging markets); and debt strategies (litigation finance, emerging markets, and asset backed/structured products). New categories would include real estate and digital assets. Private fund advisers that select the "other category" of strategies would be required to explain why none of the categories specifically listed work. The SEC explained that it is trying to reduce the number of "other responses" to improve the quality of the data it receives.

> *Counterparty Exposures*. The August Proposal would revise Form PF to require private fund advisers to report additional information about a hedge fund's borrowing and financing arrangements and its exposure to counterparties (its non-portfolios credit exposure). The new table would not apply to large hedge funds, which are required by proposed new Questions 41-43 of Section 2 to report the same exposures on a quarterly basis. Responses to new Questions 26 through 28 would be reported annually.
>
> Proposed new Question 26 would require private fund advisers to hedge funds (other than Qualifying Hedge Funds) to complete a new "consolidated counterparty exposure table" reporting the aggregate amount of exposures that the reporting fund has to creditors and

counterparties. The information in the new table would be broken down into the various types of exposures (e.g., secured and unsecured debt, margin, reverse repos, cleared and uncleared derivative positions, and short positions).

Proposed new Question 27 would require private fund advisers to hedge funds to identify significant fund counterparties. Question 22 currently requires private fund advisers to identify and provide information about the five creditors and counterparties to which the fund has the greatest mark-to-market exposure. Proposed new Question 27 would, instead, require private fund advisers to only identify counterparties to which the fund's total mark-to-market exposure (before posted collateral) is equal to or greater than, either (i) five percent of net asset value as of the data reporting date or (ii) $1 billion. If there are more than five such counterparties, the private fund adviser only would report the five counterparties to which the reporting fund owes the largest dollar amount. If there are fewer than five such counterparties, the private fund adviser would only report the counterparties meeting the threshold. Proposed new Question 28 would replace current Question 23 and provide information about counterparties' that have the greatest exposure to the fund using a similar test (except that posted collateral would not reduce the exposures).

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

Proposed Amendments for Hedge Fund Advisers: Section 2

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

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

> *Elimination of Section 2a*. The August Proposal would eliminate the three current questions (26, 27 and 28) comprising Section 2a which require reporting of aggregate information about hedge funds sub-asset class exposure, turnover and the geographical breakdown of their investments. Similar questions in the proposed new Section 2 (32, 34 and 35) would provide FSOC with similar information, although only from the larger qualified hedge funds.

> *Investment Exposure Reporting*. The August Proposal would replace the current table in Question 30 (re-designated as Question 32) with a series of "drop down" menu selections for each sub-asset class and the information required for each. The question would continue to require the aggregate dollar value of long and short position to various asset sub-classes for each Qualified Hedge Fund, but a significant amount of changes to data requirements would be made.

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

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

> *Currency Exposures*. Question 30 currently requires private fund advisers to report direct exposure to currency for sub-asset classes related to foreign-exchange derivatives and non-US currency holdings. The August Proposal would expand currency exposure by adding a new Question 33 that would also require reporting of significant indirect currency exposures, i.e., those exposures from a holding of a pooled investment vehicle the value of which is equal to or greater than either five percent of net asset value or $1 billion.

> *Country and Industry Exposures*. Currently, Question 28 of Form PF requires private fund advisers to report geographic exposures across eight regions and six countries, based on the percent of the reporting fund's net asset value. The August Proposal, if adopted, would replace Question 28 with a new Question 35 that requires reporting of the long and short value of a fund's exposure to various countries, and would also add a new Question 36 that would require reporting of a fund's industry exposure, each as of month-end. In responding to proposed Questions 35 and 36 private fund advisers would identify exposures, in either case, that are equal to or greater than, either (i) five percent of net asset value as of the data reporting date or (ii) $1 billion. Private fund advisers would be required to report, based on reasonably estimates, country and industry exposures that are direct or indirect (e.g., through an investment in other private funds, mutual funds, ETFs). Country exposures would be reported using International Organization for Standardization (ISO) codes, and industry exposures would be reported using the respective by North American Industry Classification System (NAICS) codes.

> *Turnover*. Currently, Question 27 requires private fund advisers to report a fund's portfolio turnover for each month, across ten categories of sub-asset classes (e.g., listed equities, corporate bonds, and sovereign and municipal bonds). If adopted, this question would be replaced with a similar new Question 34, which would be expanded to 26 categories (e.g., listed equity derivatives, foreign exchange derivatives, and derivative exposure to sovereign bonds).

> *Reporting Reference Assets*. One of the most significant changes in the August Proposal is related to reporting of granular information regarding "reference assets" (also commonly referred to as the underlying, in the case of a derivative or option contract). Currently, private

fund advisers provide summary information regarding the total number of their open positions, and report large positions that are greater than 5% of the reporting fund's net asset value. However, the SEC and FSOC have found it difficult to make meaningful comparisons among funds because private fund advisers use different methods for calculating their open positions. The August Proposal would redesign these questions to provide insights regarding concentrated positions held by funds.

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

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

> *Counterparty Exposures*. The August Proposal would include a new Question 41, which would create a consolidated counterparty exposure table similar to the new consolidated counterparty exposure table in proposed Question 26 in section 1c. This table would require reporting of the aggregate amount of exposures that a Qualified Hedge Fund has to creditors and counterparties, broken down into the various types of exposures (e.g., secured and unsecured debt, margin, reverse repos, cleared and uncleared derivative positions, and short positions). However, unlike the proposed table in section 1c, proposed Question 41 would require information to be reported monthly, rather than annually, and would expand the data collected (e.g., private fund advisers would report the expected impact to posted collateral in the event margin increased by one percent of the position size). Proposed Question 41 would replace current Questions 43, 44, 45 and 47, which would be deleted.
>
> Proposed new Questions 42 and 43 would require private fund advisers to Qualified Hedge Funds to identify significant fund counterparties, similar to proposed new Questions 27 and 28 in section 1c. Proposed new Question 42 would require private fund advisers to identify counterparties to which the fund's total mark-to-market exposure (before posted collateral) is equal to or greater than, either (i) five percent of net asset value as of the data reporting date or (ii) $1 billion. In Question 42(a), the private fund adviser would identify its top five counterparties, meeting this significance test, and on a counterparty-by-counterparty basis complete an "individual counterparty exposure table," broken down into the various types of exposures. Proposed Question 42(b), on the other hand, would require the private fund

adviser to identify all other significant counterparties, which also meet this same significance test, but would only require aggregate information about the total amount borrowed and the total collateral posted. Finally, proposed new Question 43 would require information about counterparties' that have the greatest exposure to the fund using a similar test (except that posted collateral would not reduce the exposures), and would have an analogous Question 43(a) with an individual counterparty exposure table for the fund's top five debtors and Question 43(b) would require aggregate information for all other significant debtors if the fund.

> *Market Factors*. The August Proposal, if adopted, would require private fund advisers to report data for all market factors that the fund's portfolio is directly exposed to, and providing such stress testing information will no longer be optional even if the private fund adviser does not regularly consider the factors in any formal testing. Private fund advisers would report data indicating how the reporting fund would be impacted, to both its long and short holdings, by certain increases or decreases in equity prices, interest rates, volatility, currency rates, commodity prices, among other market movements. The SEC believes this information would allow it to better track common market factor sensitivities, as well as correlations and trends in those market factor sensitivities, thereby giving it better insight to certain systemic risk.

> *Additional Data to be Reported*. The August Proposal also includes several other data changes and additions, which range from minor tweaks in the presentation of existing data—to new Questions seeking information that the private fund adviser are not required to report in the current version of Form PF.

Looking Ahead

The Form PF Proposed Amendments, if adopted, would significantly alter the reporting scheme for advisers to hedge funds, private equity funds and liquidity funds. Each of the proposed changes uniformly results in more granular information being reported by private fund advisers. Requiring private fund advisers to private fund to transition from reporting summary information to reporting detailed data for individual fund entities will have a compounding effect, especially when coupled with the multitude of new questions included in the Form PF Proposed Amendments, if aspects of both are adopted.

Modernization of Beneficial Ownership Reporting

On February 10, 2022, the SEC proposed amendments that would (i) accelerate the filing deadlines for beneficial ownership reports filed on Schedule 13D and Schedule 13G, (ii) deem certain holders of cash-settled derivative securities as beneficial owners of the underlying reference security, and (iii) expand the circumstances in which investors are a "group" and must aggregate holdings.

Proposed Shortening of Time Periods to File Schedules 13D/G

Currently, beneficial owners that are required to file an initial Schedule 13D must do so within 10 days, and any amendments thereto must be filed "promptly." Promptly has generally been understood to mean two business days in the most urgent circumstances (e.g., a proxy contest) but a longer period in less urgent circumstances. If adopted, the amendments would require an initial Schedule 13D to be filed within five days and any amendments to be made within one day. The table below summarizes the current and proposed filing deadlines for an Initial Schedule 13D.

Triggering Event	Current 13D Initial Filing Deadline	Proposed 13D Initial Filing Deadline
Acquiring 5% or more of registered voting equity securities, and not eligible to file Schedule 13G (*i.e.*, QII, Passive Investor or Exempt Investor (*as defined below*))	Within 10 days after acquiring beneficial ownership (trade date)	Within five days after acquiring beneficial ownership (trade date)
QII that ceases to be a QII and is not otherwise a Passive Investor	Within 10 days	Within five days
Passive Investors that come to own 20% or more of registered voting equity securities	Within 10 days	Within five days
Exempt Investors that acquire 2% or more of registered voting equity securities within a rolling 12-month period	Within 10 days	Within five days
Passive Investors or QIIs that cease to be passive (i.e., own with the purpose or effect of changing or influencing the control of the issuer)	Within 10 days	Within five days

There are three categories of beneficial owners that are eligible to file the short-form Schedule 13G in lieu of Schedule 13D. The three categories are known as Qualified Institutional Investors ("QIIs") (*13d-1(b) filer*), Passive Investors (*13d-1(c) filer*), and Exempt Investors (*13d-1(d) filer*), and each category has its own unique filing deadlines. The proposed amendments do not seek to modify eligibility requirements to file Schedule 13G, but rather focus on shortening the respective filing deadlines for each the three categories that are permitted to use the form. The table below summarizes the current and proposed filing deadlines for Schedule 13G.

Type of Filer	**Current 13G** **Initial Filing Deadline**	**Proposed 13G** **Initial Filing Deadline**	**Current 13G** **Amendment Deadline**	**Proposed 13G** **Amendment Deadline**
Qualified Institutional Investors (QIIs)	45 days after calendar year-end in which beneficial ownership exceeds 5%	Five business days after month-end in which beneficial ownership exceeds 5%	10 days after month-end in which beneficial ownership exceeded 10% or there was, as of the month-end, a 5% increase or decrease in beneficial ownership or 45 days after calendar year-end in which any change occurred	Five days after exceeding 10% beneficial ownership or a 5% increase or decrease in beneficial ownership or Five business days after month-end in which a material change occurred
Passive Investors	Within 10 days after acquiring beneficial ownership of more than 5%	Within five days after acquiring beneficial ownership of more than 5%	Promptly after exceeding 10% beneficial ownership or a 5% increase or decrease in beneficial ownership or 45 days after calendar year-end in which any change occurred	One business day after exceeding 10% beneficial ownership or a 5% increase or decrease in beneficial ownership or Five business days after month-end in which a material change occurred
Exempt Investors	45 days after calendar year-end in which	Five business days after month-end in which beneficial	45 days after calendar year-end in which any change occurred.	Five business days after month-end in which a

	beneficial ownership exceeds 5%	ownership exceeds 5%		material change occurred.

Proposed Expansion of Definitions of "Beneficial Ownership" and "Group" for 13D and 13G Reporting

The SEC's proposals would also require cash-settled derivatives (other than security-based swaps) to be included in calculating beneficial ownership for non-passive investors. Under current rules, market participants may acquire long positions using cash-settled derivatives — instead of physically-settled derivatives or purchasing the stock directly — to avoid crossing the 5% beneficial ownership threshold for 13D/G filings, or the 10% threshold for Section 16 reporting and liability. If adopted, the proposed rules would include such cash-settled derivatives (other than security-based swaps) to the beneficial ownership calculation. The SEC explained that it believes this proposed rule change will help provide market participants with greater transparency regarding those persons with significant interest in an issuer's equity securities.

The SEC has also proposed to expand the definition of a "group" whose members' holdings are required to be aggregated in determining whether the 5% or 10% beneficial ownership thresholds have been crossed. Among other things, the revised rule would reflect that a "group" may be formed without an agreement among the members of the group.

Notably, the SEC's proposed amendments would also impact any analysis to determine whether a person is a 10-percent holder for Section 16 purposes, as such determination requires the use of the Section 13 definition of beneficial ownership. The SEC has acknowledged that the proposed amendments would result in an approximate 10% increase to Section 16 filings, and requested comment on whether the proposed expansions to the Section 13 beneficial ownership determination should be excluded from the Section 16 determination.

Short Position and Short Activity Reporting by Institutional Investment Managers

On February 25, 2022, the SEC proposed Rule 13f-2 under the Exchange Act to require investment managers to report short sale information on a monthly basis, if such activity exceeds certain thresholds ("Proposed Rule"). The definition of "investment manager" in the Proposed Rule would be the same as that applied for purposes of reporting on Form 13F. The SEC stated that the short sale reporting proposal seeks to balance its goal to enhance regulatory surveillance and market transparency of short selling activity in light of the trading activity involving GameStop equity and other perceived market disruptions with the hope that additional transparency will discourage, rather than facilitate, manipulative market practices or "copy-cat" trading.

Filing Thresholds

Under the Proposed Rule, investment managers with discretion over accounts that exceed certain thresholds of short sale activity would confidentially file a proposed new Form SHO within fourteen days of any month-end in which a threshold has been exceeded. The filing thresholds are as follows:

- For any "equity security" of an issuer registered pursuant to Section 12 of the Exchange Act or required to file reports under section 15(d) of the Exchange Act, either:
    - a gross short position in the equity security with a U.S. dollar value of $10 million or more at the close of any settlement date, or

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

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

"Equity security" includes securities convertible into equity securities but would not include short positions established through derivatives, and "gross short position" is calculated without regard to any offsetting long position. The information reported would include whether the position is fully hedged, partially hedged, or unhedged, as well as daily activity as of each settlement date during the month.

Public Reporting of Aggregated Short Sale Data

While the proposed filings made by investment managers would not be publicly available, the Proposed Rules would make aggregated information about short positions publicly available by the end of the month following the reported month. Additionally, while information that is specific to any particular investment manager would not be publicly disclosed, it would be subject to a FOIA request. The Proposed Rules would make the following information publicly available:

> The issuer's name and other identifying information related to the issuer;

> The aggregated gross short position and corresponding dollar value across all reporting investment managers in the security at the close of the last settlement date of the relevant calendar month;

> The percentage of the reported aggregate gross short position that is reported as being fully hedged, partially hedged, or not hedged; and

> For each reported settlement date during the calendar month reporting period, the "net" activity aggregated across all reporting investment managers.

Cybersecurity Risk Management for Advisers

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

> advisers and funds to implement written cybersecurity policies and procedures reasonably designed to address cybersecurity risks, including risks of using interconnected systems and networks directly and through IT vendors;

> advisers and funds to memorialize and maintain various recordkeeping obligations surrounding cybersecurity programs and the occurrence of cybersecurity incidents;

> advisers to disclose cybersecurity risks and incidents to the adviser's clients and prospective clients; funds to provide prospective and current investors with cybersecurity-related

disclosures;

- advisers to report significant cybersecurity incidents to the SEC (including on behalf of a fund or private fund client); and
- Registered fund boards to undertake additional oversight of a cybersecurity risk management program.

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

Cybersecurity Policies and Procedures and Annual Review

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

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

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

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

Reporting Cybersecurity Incidents to the SEC

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

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

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

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

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

Annual Review

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

Registered Fund Board Oversight

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

Recordkeeping

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

Disclosure of Cybersecurity Risks and Incidents

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

Proposed Amendments to Registered Fund Registration Statements

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

Rule 10b5-1 and Insider Trading

Please see "Insider Trading Update" below for a discussion on developments relating to SEC Rules 10b-5 and 10b5-1(a).

Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer

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

Special Purpose Acquisition Companies, Shell Companies, and Projections

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

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

1. *Specialized SPAC Disclosure Requirements*

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

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

2. *Align De-SPAC Transactions with Traditional IPOs*

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

- *PSLRA Safe Harbor*. The definition of "blank check company" would be amended to make the safe harbor for forward-looking statements afforded by the Private Securities Litigation Reform Act of 1995 (the "PSLRA") unavailable during the de-SPAC process.
- *Underwriter Status and Liability*. Proposed rule 140a would deem any party that acted as an underwriter in a SPAC IPO and that facilitates or otherwise participates in the de-SPAC transaction, a statutory underwriter in the de-SPAC for Securities Act liability purposes.
- *Aligning Non-Financial Disclosures in de-SPAC Disclosures*. The SEC has also proposed rules that would require additional disclosures regarding the target company in filings related to de-SPAC transactions, including: description of the target's business, property and legal proceedings of the target; changes in and disagreements with accountants on accounting and financial disclosures; beneficial ownership disclosures and recent sales of unregistered securities. The foregoing would be subject to the liability regime of Sections 11 and 12(a) of the Securities Act in connection with the registration statement used for the de-SPAC transaction.
- *Minimum Dissemination Period*. The SEC proposes that a prospectus, proxy statement or

information statement filed in connection with a de-SPAC transaction be distributed to shareholders at least 20 calendar days in advance of a shareholder meeting or earliest date of an action by written consent. Currently, there is no federally-mandated minimum period of time, and it can be as short as 10 calendar days depending on the structure of the de-SPAC and the state of incorporation of the SPAC.

> *Target Company Becoming Co-Registrant on S-4/F-4*. The SEC has also proposed to amend Form S-4 and Form F-4 to require the target company to sign on as a co-registrant on these registration forms when filed by the SPAC pursuant to a de-SPAC transaction. The foregoing would make certain target company executives subject to liability for any material misstatements or omissions in the registration statement under Section 11 of the Securities Act.

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

3. *Business Combinations Involving Shell Companies*

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

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

4. *Enhanced Projections Disclosure*

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

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

> Proposed a new Item 1609 of Regulation S-K would require additional enhanced disclosures related to projections to allow investors to better asses the basis of such projections.

5. *Proposed Investment Company Act Safe Harbor*

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

6. Fairness of the de-SPAC Transaction

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

Item 1606 would further require SPACs to discuss in "reasonable detail" the material factors upon which their reasonable belief of fairness is based. As part of their proposal, the SEC suggested such factors to include, non-exhaustively: the valuation of the target; the consideration of financial projections; any fairness report or opinion issued by a third party and the dilutive effects of the de-SPAC on non-redeeming shareholders. We anticipate that this rule, if adopted, would drive more SPACs to request a fairness opinion from a financial advisor.

Proposed New Oversight Requirements for Advisers that Outsource Significant Functions to Service Providers

On October 26, 2022, the SEC proposed a new rule under the Advisers Act that would require advisers registered or required to be registered with the SEC to implement oversight programs for their outsourcing activities (the "Proposed Outsourcing Rule"). The Proposed Outsourcing Rule formulates a compliance regime based upon three main components, which are based on common industry practices: (i) due diligence, (ii) ongoing monitoring, and (iii) recordkeeping. The SEC's Proposed Outsourcing Rule is a deliberate move toward a formal oversight structure as replacement for the current paradigm where RIAs manage oversight of their service providers in accordance with their duty of care as a fiduciary.

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

"Covered Function"

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

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

The policy basis of the Proposed Outsourcing Rule, as discussed in the proposal, is the need to prevent fraudulent, deceptive or manipulative acts that may be caused by outsourcing of an RIA's key function(s).

Thus, the scope of the Proposed Outsourcing Rule is limited to advisory functions that could have a material negative impact on clients.

Due Diligence and Ongoing Monitoring

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

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

Further, after engaging a service provider, the Proposed Outsourcing Rule would mandate that RIAs conduct periodic oversight to monitor the relationship. The frequency and manner of oversight would depend on the facts and circumstances specific to the service provider and function being performed, with the same six elements used in the due diligence process being a component of an RIA's ongoing monitoring.

Recordkeeping

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

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

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

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

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

Review of Marketing Materials – Key SEC Considerations

November 4, 2022 marked the mandatory compliance date for compliance with amended Rule 206(4)-1 (the "Marketing Rule"), following an eighteen-month implementation period from its May 4, 2021 effective date. In February 2021, we issued an alert to provide a detailed introduction into the requirements of the new Marketing Rule, which included a consolidation of now-rescinded Rule 206(4)-3 (the "Cash Solicitation Rule"), related amendments to Form ADV, and updates to the Books and Records Rule. More recently, we held an in-depth discussion of the substantial changes brought about by these amendments in an installment of "The Bottom Line" webinar series. These amendments codify, in many respects, the large body of staff interpretations since the advertising rule's adoption in 1961 and the Cash Solicitation Rule's adoption in 1979, as well as make some significant changes to both rules.

> **Implementation**

The Marketing Rule applies to RIAs, and does not mandate compliance by advisers that are exempt from registration (e.g., ERAs) or otherwise not required to register with the SEC. The SEC also clarified in the Adopting Release that the Marketing Rule does not apply to offshore advisers, even if SEC-registered, when marketing offshore funds or otherwise marketing to offshore clients.[10] Nonetheless, the Marketing Rule can serve as a safe harbor for those exempt and offshore advisers that are seeking assurances that their practices are in compliance with the general antifraud provisions of the Advisers Act (i.e., Section 206 and Rule 206(4)-8), which apply to all advisers, registered and unregistered alike.

RIAs should consider conducting an in-depth assessment of their marketing policies and procedures as part of their Rule 206(4)-7 annual compliance review for 2022. This review, if conducted, would be best served by an evaluation of whether the adviser's policies and procedures adequately address: (i) the identification of content and other communications that fall within the definition of an "advertisement"; (ii) whether sufficient compliance controls have been implemented to ensure, prior to distribution, that marketing materials satisfy the rule's content standards and distinct requirements around the use of performance (i.e., actual, predecessor, hypothetical, and extracted), third-party rankings and ratings, and testimonials and endorsements; and finally (iii) appropriate employee training regarding the new Marketing Rule.

---

[10] For these purposes, "offshore advisers" means advisers having a principal office and place of business outside the U.S., "offshore fund" means a fund that is not domiciled in the U.S., and "offshore client" generally means an investor that is not a "U.S. person" under Regulation S. *See* Adopting Release at pp. 63-64 ("We have previously stated, and continue to take the position, that most of the substantive provisions of the Advisers Act do not apply with respect to the non-U.S. clients (including funds) of a registered offshore adviser....We believe it is appropriate to continue to apply this approach in this context.").

> **Definition of Advertisement**

The definition of "advertisement," subject to certain exceptions, contains two prongs:

- > Any direct or indirect communication to more than one person that offers advisory services to prospective clients or private fund investors (or to current clients or private fund investors); and
- > Testimonials and endorsements for which the adviser provides direct or indirect compensation. While capturing some traditional advertisements, this prong is designed primarily to include the activities of advisers' paid solicitors and private funds' placement agents.

> **Exclusions from the Definition of Advertisement**

The Marketing Rule excludes the following from the definition of advertisement:

- > One-on-one communications, unless (i) it is a compensated testimonial or endorsement, or (ii) contains hypothetical performance and is sent to a non-private fund investor on an unsolicited basis;
- > Extemporaneous, live, oral communications (other than compensated testimonial or endorsement); or
- > Information that is contained in a statutory or regulatory filing.

> **Content Standards - General Prohibitions**

The Marketing Rule imposes principle-based content standards for adviser advertisements, and in doing so employs six general prohibitions. In developing marketing rule policies and procedures, and through the course compliance reviews of marketing materials, advisers should consider the following:

- > ***Untrue Statements of a Material Fact***. The Marketing Rule codifies the standard under which the SEC has historically brought most of its enforcement actions for false or misleading advertisements. As such, advisers can look to past enforcement actions as a guidepost for compliance with the antifraud provisions of the Marketing Rule.
- > ***Unsubstantiated Material Statements of Fact***. This general prohibition sets a new mandate for advisers, requiring them to be able to demonstrate that they had a reasonable basis to believe each statement of material fact included in their advertisements. Thus, the rule creates an imperative for advisers to establish a process that evidences such reasonable basis. The most effective method, arguably, is to create a contemporaneous record of the backup support for material factual statements in the adviser's marketing materials. However, advisers may find this approach too burdensome to implement in every instance, and may instead (or in combination) incorporate objective compliance controls that test for adequate support for the factual statements used in advertisements, and maintain a record of such testing.
- > ***Untrue or Misleading Implications or Inferences***. This prohibition is generally consistent with the pre-amendment best practices, and similar to the above note, advisers can look to past enforcement actions as a guidepost for compliance.
- > ***Failure to Provide Fair and Balanced Treatment of Material Risks or Other Limitations***. This general prohibition also creates a new imperative, which calls for the implementation of a "fair and balanced" standard that has yet to be refined by the SEC. Depending on how this standard is eventually applied in practice, this provision could potentially require the addition of risk disclosures to advertising materials that do not already contain them. Given the

complete lack of SEC guidance to-date beyond the Adopting Release (which does not shed much light on this issue), it is unclear how far the SEC would expect this to go. It would likely be acceptable in most cases to limit such disclosure to a summary of risks relevant to the contents of that specific document, but simply linking or cross-referring to the full private placement memorandum or another document would not be sufficient.

> ***References to Specific Past Investment Advice in a Manner That Is Not Fair and Balanced***. The Marketing Rule replaces the longstanding prohibition against past specific recommendations with a new standard that generally permits past specific recommendations, so long as they are presented in a manner that is "fair and balanced." As noted above, this new "fair and balanced" standard has yet to be interpreted and applied in practice. Generally, when showing the performance of a specific investment, through a case study or otherwise, advisers should be mindful not to create marketing that appears, on its face, to be slanted (i.e., in practice, only resulting in high-performing investments, even though the selection criteria was nominally not performance-based). Further, in addition to providing, or offering to provide, the full track record for the portfolio from which the select investment was made, advisers should consider implementing consistently-applied objective non-performance-based criteria for its individual investment selection process.

> ***Showing Performance Information in a Manner That Is Not Fair and Balanced***. This general prohibition is also largely consistent with pre-amendment best practices, and although it imposes the new "fair and balanced" standard, in effect, the rule encompasses the longstanding anti-cherry picking principles of the pre-amendment rule.

> **Performance Information**

The Marketing Rule prohibits performance results in any advertisement, unless the information complies with the following:

> ***Net Returns***: Net performance must accompany any gross performance information.

> ***Standard Performance Periods***: Non-private fund performance information must include one-, five-, and ten-year periods.

> ***Statement of SEC Approval***: Advisers may not make any statement indicating SEC review or approval of performance information.

> ***Related Performance***: Where an advertisement includes the performance of any portfolio other than the one being advertised, the performance results for all other portfolios with substantially similar investment policies, objectives, and strategies must also be shown (with narrow exceptions).

> ***Extracted Performance***: Where the performance of a subset of investments extracted from a portfolio is shown, then the advertisement must provide, or offer to provide promptly, the performance results of the total portfolio.

> ***Hypothetical Performance***: Where showing hypothetical performance (i.e., investment performance not achieved by any portfolio), the adviser must adopt certain related policies and procedures, and any such performance must be accompanied by appropriate disclosures.

> ***Predecessor Performance***: Where showing investment performance generated at a prior investment advisory firm, the relevant investment personnel must have been primarily responsible for having generated that performance at the prior firm (per the SEC's historical

guidance on this topic, as codified by the amendments). The SEC clarified in the Adopting Release that under Rule 204-2 investment advisers are required to maintain books and records that substantiate any predecessor performance, which is consistent with the staff's pre-amendment guidance.[11] Thus, where an investment adviser uses predecessor performance, it should expect the SEC to focus on compliance with the corresponding books and records requirements, and relatedly, the new prohibition against unsubstantiated statements of material fact, discussed above.

> **Third-Party Rankings**

Advertisements may include third-party rankings or ratings, so long as the adviser reasonably believes the rating is derived from a survey or other inputs that make it equally easy for a participant to provide favorable and unfavorable responses and is not designed or prepared to produce any predetermined result, and discloses:

- The date on which the rating was given and the period of time upon which the rating was based;
- The identity of the third-party that created the rating; and
- If applicable, that compensation has been provided directly or indirectly by the adviser in connection with obtaining or using the third-party rating.

> **Testimonials, Endorsements and Application to Solicitors and Placement Agents**

The amended Marketing Rule ends the longstanding prohibition against testimonials, and establishes certain conditions for the use of compensated endorsements and testimonials, including in the context of placement agents and solicitors, which are drawn from the rescinded Cash Solicitation Rule.

- ***All Testimonials and Endorsements***: Advertisements containing testimonials or endorsements must clearly and prominently: (i) disclose whether it is given by a current client or investor (testimonial) or by someone other than a current client or investor (endorsement); and (ii) include a brief description of any material conflicts of interest resulting from the adviser's relationship with the person giving the testimonial or endorsement.
- ***Compensated Testimonials and Endorsements (Including Placement Agents and Solicitors)***: In addition to the above, compensated testimonials and endorsements must: (i) disclose the fact that the testimonial or endorsement was compensated and disclose the details of the compensation arrangement; (ii) not be made by any party (e.g., placement agent, solicitor or other person) that is subject to disqualification; and (iii) be subject to a written agreement and with the relationship being subject to compliance oversight by the adviser.
- ***SEC Registered Broker-Dealers and Regulation D Private Placements***: A testimonial or endorsement given by an SEC-registered broker-dealer disclosing the fact that compensation is being paid and a brief description of any materials conflicts of interest is sufficient to satisfy the rule's disclosure requirements, and the above more detailed disclosures are not required (including amount/terms of compensation). In addition, the anti-disqualification provisions of the Marketing Rule do not need to be satisfied where a placement agent and its applicable

[11] *See* Adopting Release at n. 764 (Rule 204-2 requires advisers to have "access to the books and records underlying the [predecessor] performance"). *See also* Great Lakes Advisors, Inc., SEC Staff No-Action Letter (Apr. 3, 1992) at n.3. (now-rescinded staff guidance regarding the portability of predecessor performance requiring, among other things, sufficient records to substantiate performance calculations).

personnel are able to satisfy the anti-disqualification provisions under Rule 506(d).

> **Form ADV Part 1A**

Related amendments to Form ADV Part 1A require RIAs to complete new Item 5.L, checking boxes to indicate which of the following items are included in the adviser's advertising materials: (i) performance results, (ii) individual investment results, (iii) testimonials, (iv) third-party ratings, (v) endorsements, (vi) hypothetical performance, and (vii) predecessor performance. In practice, many advisers seem likely to select most boxes unless an item is unlikely to ever apply. RIAs are only obligated to amend Item 5.L as part of their annual amendment. Accordingly, advisers generally would not be obligated to amend their Form ADV to include this information until the next annual amendment following November 4, 2022 (i.e., by March 31, 2023, for an adviser with a December 31 fiscal year-end).

> **Targeted Marketing Rule Examinations**

- The SEC's September 2022 Risk Alert announced the Exams Division's intent to conduct targeted reviews of RIAs regarding compliance with the Marketing Rule. Reviews will be conducted both as part of specific national initiatives (sometimes referred to as "sweep" exams, which often focus on one or several related topics) as well as through the normal course of its routine compliance examinations of RIAs.
- The SEC's announcement came as somewhat of a surprise in that it is unusual for the Exams Division to so prominently highlight a special examination focus area in advance, outside of the annual announcement of their examination priorities.[12] The effect is therefore to provide greater emphasis on what seems likely to be a deep and prolonged focus by the SEC on RIA marketing practices. And in adopting such a strong examination focus on these issues while significant interpretive questions remain unanswered,[13] the likelihood increases that the staff of the Exams Division – or its individual members – will begin to interpret and apply the amended Rule during the examination process in unanticipated ways.
- Given the extensive and nuanced changes under the amendments, all advisers, to the extent they have not already done so, should survey their marketing materials and practices, and their policies and procedures, in order to determine what changes will be necessary or advisable. In many respects, these changes will likely be substantial.

CFTC / NFA Updates

In 2022, neither the CFTC nor the National Futures Association (the "NFA") proposed or adopted new rules with material and notable effects on private funds or advisers, with the exception of a few actions taken by the CFTC with respect to derivatives. Please see "Derivatives" below for a discussion of certain recent actions taken by the CFTC in connection with position limits, no-action relief, swap clearances and cryptocurrencies.

[12] The Exams Division's 2022 Examination Priorities contained very little emphasis on this topic at all, aside from one reference to "marketing practices" within the entire 32-page document. Please see Proskauer's April 2022 Alert for additional background on this annual announcement.

[13] Despite previously acknowledging that these amendments were likely to result in "practice changes" for advisers, replacing a regime "on which advisers have relied for decades," and despite encouraging advisers to "actively engage with Commission staff as questions arise in planning for implementation," the SEC and its staff have yet to publish any formal guidance clarifying any aspect of the amended Rule's application in specific scenarios beyond those contained in the 2020 Adopting Release.

Derivatives

New rulemaking related to derivatives has been relatively quiet in 2022, especially in comparison to the slew of regulations over the past decade in connection with the enactment of the Dodd-Frank Act. While the majority of the CFTC's regulations applicable to swaps have been effective for some time, the SEC's regulations applicable to security-based swaps became effective at the end of 2021. The SEC has proposed a number of rules aimed at further increasing transparency in the derivatives and securities markets. In 2022 we have seen the CFTC actively using its statutory authority under the Commodity Exchange Act (the "CEA") against those unlawfully offering or engaging in derivatives in the digital asset space. The CFTC has issued a number of warnings advising customers to only trade on registered exchanges. In connection with the Polymarket order and settlement (discussed below), CFTC Acting Director of Enforcement Vincent McGonagle said "all derivatives markets must operate within the bounds of the law regardless of the technology used."

> CFTC

CFTC position limits currently apply to 25 commodity futures and options contracts ("Referenced Contracts"). Swaps that are economically equivalent to these Referenced Contracts will become subject to position limits on January 1, 2023. Certain swaps may be economically equivalent to a Referenced Contract for purposes of position limits even if the notional amount, delivery date or day count convention differ from those in the Referenced Contract if the other material contractual terms are identical to those in the Referenced Contract.

The CFTC has previously provided temporary relief for certain entities that hold or control the trading of multiple accounts with substantially similar trading strategies from the requirement to aggregate their positions for purposes of the position limits. On August 10, 2022, the CFTC issued a no-action letter (the "No-Action Letter") extending the relief from compliance with certain notice filings that are required to make use of these exemptions. The No-Action Letter extends the exemption from filing notice until August 12, 2025 or the date a relevant rulemaking is effective (if earlier).

On August 24, 2022, the CFTC issued final regulations relating to the transition away from the London Interbank Offered Rate and the mandatory clearing of certain swaps referencing Interbank Offered Rates. The regulation, which went into effect on October 31, 2022, requires that swaps referencing certain risk-free rates, including the Secured Overnight Financing Rate, be cleared through a registered derivatives clearing organization.

> Crypto

On January 3, 2022, the CFTC entered an order charging Blockratize, Inc. (d/b/a Polymarket.com) ("Polymarket") with offering off-exchange binary options contracts and failing to register with the CFTC as a designated contract market or swap execution facility as required under the CEA. Polymarket's markets featured a range of binary options, including cryptocurrency/digital assets, current events, and financial conditions. Each event-based market consisted of a pair of binary options contracts related to the occurrence or non-occurrence of some event, the majority of which resolved to a definitive "yes"/"no" answer. The CFTC ordered Polymarket to cease and desist all such unregistered market-making activities and issued a $1.4 million fine.

On May 5, 2022, the U.S. District Court for the Southern District of New York entered consent orders against three co-founders of the BitMEX cryptocurrency trading platform stemming from a complaint filed by the CFTC in October 2020. BitMEX solicited orders for futures, options and swaps, offered leveraged trading and accepted money, securities or other property to margin the resulting trades without properly registering as a designated contract market, swap execution facility or futures commission merchant. The three co-founders were found civilly liable of the same as control persons of BitMEX and previously pled guilty to one of the criminal indictments against them. Gretchen Lowe, the acting Director of the Enforcement Division, commented in a CFTC release, "Individuals who control cryptocurrency derivatives trading platforms conducting business in the U.S. must ensure that their platform complies with applicable federal commodities laws, including CFTC registration and regulatory requirements such as Know-Your-Client and Anti-Money Laundering regulations."

On September 22, 2022, the CFTC announced an order simultaneously filing and settling charges against bZeroX and its creators for illegally offering leveraged and margined retail commodity transactions in digital assets, operating as an unregistered futures commission merchant and failing to conduct Know-Your-Client on its customers. Simultaneously, the CFTC filed an enforcement action against Ooki DAO (successor to bZeroX) for violating those same regulations. The CFTC stated that bZeroX and its creators engaged in this unlawful activity in connection with their decentralized blockchain-based software protocol that functioned in a manner similar to a trading platform. The transactions executed by bZeroX, and subsequently on Ooki DAO, were required to take place on a registered designated contract market. Additionally, bZeroX and Ooki DAO were operating as unregistered futures commission merchants by soliciting and accepting orders from customers, accepting money or property as margin and extending credit. The enforcement action against Ookie DAO is notable in that the CFTC has taken the view that anyone who voted in the governance of Ookie DAO is liable for its activities.

> FINRA

On January 6, 2022, the SEC entered an order approving changes to the rules of FINRA to address security-based swaps. Prior to January 2022, security-based swaps were largely exempted from FINRA rules while the SEC regulations applicable to security-based swaps were not yet effective. When the SEC regulations became effective at the end of 2021, FINRA proposed, and the SEC consented, to amend certain FINRA rules to also be applicable to security-based swaps. In particular, FINRA Rule 4240 requires FINRA members that are not Security-Based Swap Dealers to post and collect margin in line with the requirements of Exchange Act Rule 18a-3, which is applicable to Security-Based Swap Dealers.

> SEC

On December 8, 2021, the SEC proposed a new regulation requiring reporting of securities' lending transactions. The regulation would require any person who lends securities on their own behalf or for others to report certain information to a registered national securities association within 15 minutes of the loan. The information to be reported includes information about the individual securities' lending transaction, information on the collateral used to secure the loan as well as information about securities on loan and securities available to lend. Note that the names of the parties to the securities' lending transaction will not be made public. The proposed regulation provides that, to the extent a lender to a securities' lending transaction uses a lending agent, the lending agent will be required to report the transaction. The regulation also allows market participants to enter into an agreement with a broker-dealer to act as reporting agent for all of their securities' lending transactions.

On December 15, 2021, the SEC proposed new Rule 10B-1 requiring large positions in security-based swaps and related securities to be reported to the SEC and publicly disseminated. Rule 10B-1 would require any person or affiliate of such person or group of persons who would directly or indirectly be the owner or seller of a security-based swap to report such security-based swap position on EDGAR, subject to certain thresholds. The thresholds vary based on the type of swap and, in certain circumstances, will include the value of any underlying securities owned by the holder of the reportable security-based swap position in determining whether the threshold has been met. The information on security-based swaps positions is required to be filed on EDGAR within one business day of execution of the relevant position and will be publicly disseminated.

At the same time, the SEC also re-proposed regulations prohibiting fraudulent, deceptive and manipulative conduct in connection with security-based swaps. The new re-proposed rule prohibits fraudulent, deceptive and manipulative conduct in connection with security-based swaps and also includes anti-manipulation rules similar to those promulgated by the CFTC. The rule prohibits persons in possession of MNPI from using swaps to gain exposure to securities and avoid the liability that would otherwise arise from directly purchasing the relevant securities while in possession of MNPI.

Please see "SEC Policy and Rulemaking Updates" for a description of the SEC proposals of new Rule 13f-2 and to amend Rule 13d-3 governing beneficial ownership reporting.

Alternative Data

Alternative data, or data garnered from non-traditional sources, is increasingly being used by private funds advisers and registered investment companies as part of their business and investment decision-making processes.

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

> SEC Focus

Over the last few years, the SEC has honed in on the acquisition and use of alternative data in response to its increased popularity with advisers. The Exams Division of completed its "alt data" sweep of several large multi-strategy hedge funds in 2021 and announced in its 2022 Examination Priorities that it will scrutinize whether firms are implementing appropriate controls and compliance around the creation, receipt, and use of potentially MNPI obtained through alternative data sources.

At several hedge fund industry events during 2022, including one at Proskauer, a senior Exams Division staff member shared perspectives on how the Exams Division views the creation, acquisition, use and on-going surveillance of alternative data vendors and their data sets by advisers. Our takeaways are as follows:

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

- The Exams Division may inquire whether advisers are conducting simple Google searches of alternative data vendors to see whether there were any issues regarding vendors that were easily identifiable.
- The Exams Division may expect to see more disclosure around alternative data in an adviser's Form ADV Part 2.

On April 26, 2022, the Exams Division released a risk alert regarding notable deficiencies that the staff has found with respect to alternative data. The risk alert states that advisers did not adequately implement reasonable policies and procedures to mitigate the risk of receipt and use of MNPI obtained through alternative data sources. For example: (i) advisers inconsistently memorialized or failed to followed its own diligence processes; (ii) advisers did not have policies to assess the terms, conditions, or legal obligations related to the collection or provision of the data, including when red flags are identified about the sources of such data and (iii) advisers did not have policies to adequately or consistently diligence service providers of alternative data, especially for when due diligence should be re-performed based on passage of time or changes in data collection practices.

> FTC Focus

General. The Federal Trade Commission ("FTC") has turned its attention to the collection of mobile location data and the subsequent sharing and sale of information to data aggregators and brokers that then sell data access or data analysis products to marketers, researchers, or other businesses interested in gaining insights from alternative data sources. On July 11, 2022, the FTC published on its Business Blog that the misuse of mobile location and health information, including reproductive health data, "exposes consumers to significant harm." As such, the FTC announced that it will "vigorously enforce the law if we uncover illegal conduct that exploits Americans' location, health, or other sensitive data."

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

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

In the complaint, the FTC alleges that Kochava, in its role as a data broker, collects a wealth of information about consumers and their mobile devices by, among other means, purchasing data from outside entities to sell to its own customers. The FTC also alleges that the location data provided by Kochava to its customers was not anonymized and that it was possible, using third party services, to identify a mobile device user or owner. The FTC asserts that the data may be used to track consumers to sensitive locations and poses an unwarranted privacy risk likely to cause substantial injury to consumers, thus constituting an unfair business practice.

This case signals that there will be more FTC scrutiny of the collection and use of location data in general, beyond reproductive health privacy concerns. With the FTC sharpening its focus regarding practices related to the collection, use and sale of mobile location data, it's possible that additional enforcement actions will follow in the coming year. Until a comprehensive federal data privacy law is passed the federal lead in regulation over data privacy will sit with the FTC under its existing authority. Moreover, for companies that acquire geolocation data or related data analytics, due diligence about how and where the data was collected remains vital to ensure that the information being offered by outside data analytics firms complies with applicable laws and regulations.

Advanced Notice of Proposed Rulemaking. On August 11, 2022, the FTC issued an Advance Notice of Proposed Rulemaking ("ANPR") and announced the commencement of its rulemaking process to "crack down on harmful commercial surveillance" and lax data security. The agency defines commercial surveillance as "the collection, aggregation, analysis, retention, transfer, or monetization of consumer data and the direct derivatives of that information."

The FTC has not released any proposed rules but is seeking public comment on the harms of commercial surveillance and whether new rules are needed to protect consumer data privacy. In the ANPR, the FTC discusses potential harms to consumers stemming from the subsequent sharing and sale of information to data aggregators and brokers that then sell data access or data analysis products to marketers, researchers, or other businesses interested in gaining insights from alternative data sources. The hypothetical new trade regulations or regulatory alternatives would cover the ways companies (i) collect, aggregate, protect, use, analyze, and retain consumer data, as well as (ii) transfer, share, sell, or otherwise monetize that data in ways that are unfair or deceptive. Of the myriad of questions posited within the ANPR, the most noteworthy asked by the FTC are: "Which kinds of data should be subject to a potential privacy rule?" and "To what extent, if at all, should a new regulation impose limitations on companies' collection, use, and retention of consumer data?"

This ANPR is the culmination of heightened interest within the FTC and Congress about the need for stronger data privacy regulation that would limit certain data tracking practices, particularly for sensitive data, that are widespread (and poorly understood) in an era of an increasingly digitized economy. It remains to be seen whether the FTC will see through to the end what would be a multi-year rulemaking process.

> FCC Focus

The Federal Communications Commission ("FCC") announced its probe of the top 15 mobile providers on July 19, 2022. The letters of inquiry by Chair Jessica Rosenworcel asked for the carriers' policies around geolocation data, such as how long geolocation data is retained and why and what the current safeguards are to protect this sensitive information. The letters also asked about the carriers' process for sharing geolocation data and whether and how consumers are notified when their geolocation data is shared with third parties.

On August 25, 2022, FCC Chair Rosenworcel publicly released the responses from the top 15 mobile carriers following a request for information about their data retention and data privacy policies and practices. In addition, Chair Rosenworcel announced she has "asked the Enforcement Bureau to launch a new investigation into mobile carriers' compliance with FCC rules that require carriers to fully disclose to consumers how they are using and sharing geolocation data."

The latest FCC probe is consistent with the agency's previous actions to protect consumers' location-based data.

> Data Privacy Legislation

Public awareness and general scrutiny over the collection, selling and packaging of geolocation data has heightened in recent years, earning the attention of both federal and state regulators and legislatures. Two bills have been introduced, one in the House of Representatives and one in the Senate, addressing the use of personal locational data. These are not the first bills introduced in Congress in recent years that have attempted to generally limit the sale and use of locational data.

Senator Warren Introduces Bill to Ban the Sale of Location and Health Data

On June 15, 2022, Senator Elizabeth Warren introduced a bill, the "Health and Location Data Protection Act of 2022," which, subject to a few exceptions, would, among other things, prohibit the selling, sharing or transferring of location data and health data. The bill gives the FTC rulemaking and enforcement authority for violations of the law and also grants state attorneys general the right to bring actions; notably, the law would also give a private right of action to persons adversely affected by a violation of the proposed law. The bill has been referred to committee, but has not advanced any further.

Representative Pallone Introduces Bipartisan General Privacy Bill

On June 21, 2022, Representative Frank Pallone introduced a bipartisan data privacy bill, the "American Data Privacy and Protection Act," which generally requires most companies to limit the collection, processing, and transfer of personal data to that which is reasonably necessary to provide a requested product or service and to other specified circumstances. The bill also generally prohibits companies from transferring individuals' personal data without their affirmative express consent. Congress continues to debate the bill and an amended draft passed the House Commerce Committee in July 2022.

> Litigation Relating to Alternative Data

LinkedIn-HiQ Scraping: Ninth Circuit Holds Scraping of Publicly Available Website Data Falls Outside of CFAA

On remand from the Supreme Court, the Ninth Circuit affirmed on April 18, 2022, the lower court's order preliminarily enjoining LinkedIn Corp.'s ("LinkedIn") from blocking data analytics company hiQ Labs, Inc.'s ("hiQ") access to publicly available LinkedIn member profiles in *hiQ Labs, Inc. v. LinkedIn Corp* 31 F. 4th 1180 (9th Cir. 2022)) ("hiQ II"). The Ninth Circuit found that hiQ raised serious questions about whether LinkedIn may invoke the Computer Fraud and Abuse Act ("CFAA") to preempt hiQ's claims or block access and, on a whole, whether hiQ's activities are lawful under the CFAA. [*Note*: Subsequently, a California district court dissolved the preliminary injunction, finding that hiQ could no longer sufficiently show the original irreparable harm supporting the original injunction, as the company has since ceased operations. (*hiQ Labs, Inc. v. LinkedIn Corp.*, No. 17-03301(N.D. Cal. Aug. 1, 2022)].

HiQ used automated bots to capture information from public profiles on LinkedIn in order to generate "people analytics," which it sold to its clients. In response, LinkedIn took steps to prohibit such behavior, including signaling to automated bots that they are prohibited from accessing LinkedIn servers, blocking automated attempts to scrape data and sending hiQ a cease-and-desist letter. LinkedIn asserted in a claim against hiQ that hiQ violated the CFAA, which prohibits "accessing a computer without authorization or exceeding authorized access." When the case reached the Ninth Circuit, the court ruled against LinkedIn and held "it is likely that when a computer network generally permits public access to its data, a user's accessing that publicly available data will not constitute access without authorization under the CFAA."

Supreme Court Ruling in June 2021

On June 14, 2021, the Supreme Court vacated and remanded the Ninth Circuit's 2019 ruling in *LinkedIn Corp. v. hiQ Labs, Inc.*, which held that hiQ did not violate the Computer Fraud and Abuse Act ("CFAA") by data scraping public profiles on LinkedIn's website. The case was sent back to the Ninth Circuit for further consideration in light of the Supreme Court's holding in *Van Buren v. United States*, which narrowed the interpretation of "exceeds unauthorized access" under the CFAA.

In *Van Buren v. United States* a former police sergeant was charged with violating the CFAA for using his computer to access a government database and retrieve information about a particular license plate. The Supreme Court held that this behavior did not violate the CFAA because "exceed[ing] authorized access" under the CFAA only prohibits unauthorized access, not unauthorized uses." In its decision the Supreme Court adopted a "gates up or down" approach to interpreting the CFAA, meaning one either can or cannot access a computer system or certain areas within such computer system. Importantly, the Supreme Court declined to decide in *Van Buren* whether authorized access turns on only code-based restrictions (such as a password to access a computer).

hiQ II (9th Cir. 2022)

In what might be considered an emphatic, pro-scraping decision (even more so than its first, now-vacated 2019 decision), the appeals court found that hiQ "raised at least serious questions" that its scraping of public LinkedIn member profile data, even after having had its access revoked and blocked by LinkedIn, is lawful under the CFAA. The panel concluded that the reasoning of the Supreme Court's *Van Buren* decision, which narrowly interpreted the "exceeds authorized access" provision of the CFAA, reinforced the Ninth Circuit's interpretation that the concept of "without authorization" under the CFAA does not apply to public websites. Thus, while the law relating to screen scraping remains unclear in many respects – particularly as scraping technology and the applied uses of public website data continue to evolve – this important decision carries the reasoning forward from *Van Buren* and limits the applicability of the CFAA as a tool against the scraping of publicly available website data.

In the scraping context, as seen by this highly-contested dispute, CFAA's "without authorization" liability presents nuanced issues. In this case, the court looked to whether hiQ's further scraping and use of LinkedIn's data after having its access revoked was likely "without authorization" within the meaning of the CFAA and thus a violation of the statute. If so, hiQ would have no legal right of access to LinkedIn's data and LinkedIn could invoke the CFAA to preempt hiQ's tortious interference claim. Here, the Ninth Circuit concluded that hiQ raised a serious question as to applicability of the CFAA's concept under the circumstances: "[W]here access is open to the general public, the CFAA 'without authorization' concept is inapplicable."

As stated in our 2017 Client Alert about the lower court's *hiQ* decision, entities engaged in scraping should still tread carefully, even if the CFAA's "authorization" issue regarding public websites has been resolved within the Ninth Circuit. Indeed, the Ninth Circuit itself says in *hiQ II*: "Entities that view themselves as victims of data scraping are not without resort, even if the CFAA does not apply." Moreover, a future case could involve non-user data on a different type of website, database or mobile app and governed by different levels of access controls, or technical measures. And, it is always the case that computers and servers hosting public websites may contain web pages or portals that require authorization to access, such that the authorization gate could be considered "down" at least with respect to that specific data. Thus, even though the path for data scraping involving public websites may have cleared considerably with respect to the CFAA, it is by no means an open road, and still involves certain risks that require diligence and calculated legal and business decisions.

> Settlement in Plaid Fintech Data Case

On August 5, 2021, a proposed class action settlement was reached in the suit against a startup financial technology ("fintech") services company Plaid Inc. ("Plaid"). Plaid provides account linking and verification services for fintech apps that consumers use to send and receive money from their bank accounts.

In a civil class action law suit filed against Plaid, the plaintiffs argued that Plaid violated their privacy by obtaining their financial account information without their consent. Fintech apps typically verify a user's bank account by redirecting the user to the bank's platform where they are prompted to log in. The bank in turn allows the app to access the necessary information without giving it access to the user's login information. Plaid, however, designed its login screens to mimic the look and feel of the login screens of individual financial institutions. Plaintiffs allege that users were not informed that they were not logging into their bank's own platform, and that they unwittingly gave Plaid their login credentials. They claim that Plaid retained access to their credentials and used them to mine, aggregate and sell users' financial transaction data to third parties. At no time, according to the plaintiffs, were users given conspicuous notice or meaningfully prompted to read through the privacy policy indicating that Plaid was taking such actions.

In the proposed settlement, Plaid has agreed to change some of its privacy and data collection practices, delete certain data it collected, and provide a $58 million fund for the settlement class of consumers. This action is one of the increasing number of actions being filed concerning mobile data collection practices, as the collection and use of consumer data have become more highly scrutinized in recent years.

> Mobile Platforms Block Data Broker from Collecting User Location Data

In December 2020, the Wall Street Journal reported that Apple and Google told app developers to remove the X-Mode Social Inc. ("X-Mode") social tracking software development kit ("SDK") from their apps or face being removed from the platforms' app stores. The decision by Apple and Google was announced following reports that X-Mode was selling location data to government entities and defense contractors. X-Mode pays developers to include its SDK in their apps in exchange for providing users' location data. Google has since also requested that developers remove code from another location data broker, Predicio, which has been connected to a government contractor that has sold location data to government agencies.

The sale of location data has come under greater scrutiny as privacy laws become more stringent and public awareness of locational data sharing grows. In the past year a group of Senators, including Senator Ron Wyden of Oregon, have solicited government inquiries into the sale of location data to government agencies and contractors. Senator Wyden argues that commercial data brokers' sale of location data to government entities is unlawful without a warrant, citing Supreme Court decision *Carpenter v. United States*, which held that the acquisition of cell-site location information constitutes a Fourth Amendment search.

The question arises of whether Apple and Google's actions signal the beginning of the end of widespread location sharing on mobile phones, or of the sharing of locational data with government entities. Given the heightened scrutiny of the sharing of user data, recipients of aggregated user data should take care to perform due diligence and understand how the data was collected and whether such collection comports with contractual and mobile platform requirements.

> SEC Brings First Enforcement Action Against Alternative Data Provider

On September 14th, 2021, the SEC filed a settled securities fraud action against App Annie Inc. ("App Annie"), a leading alternative data provider with respect to mobile app performance data. The settlement is the first enforcement action brought by the SEC against an alternative data provider.

App Annie offered a free app analytics product called “Connect,” which enabled companies to visualize and track how their apps are performing. App Annie misrepresented in communications with Connect users and through its terms of service that there would be limitations on the ways that App Annie could use Connect users’ data. For example, App Annie representatives were trained to respond to inquiries from Connect users that Connect data would be “aggregated” and “anonymized” before being entered into a “statistical model” that generated “estimates.”

App Annie’s business model relied on selling estimates of how apps belonging to certain companies were performing. App Annie sold these estimates through a paid subscription product called “Intelligence,” which included estimates of app revenue, app downloads and app usage. App Annie assured paying subscribers, including many hedge funds, that it had processes and internal controls in place to ensure that it was not selling MNPI through Intelligence. Specifically, App Annie represented that public company Connect data was not used to generate Intelligence estimates.

However, during most of the relevant period, App Annie did not have effective internal controls, and, contrary to representations and other assurances made by App Annie, certain public companies’ Connect data had been used to generate Intelligence estimates.

The SEC charged App Annie and its CEO with violations of the antifraud provisions of the Exchange Act. The action highlights that the SEC is focused on alternative data providers, and that it is more than willing to bring enforcement actions based upon fraud in the alternative data space.

Digital Assets

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

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

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

Now more than a decade from the release of the Bitcoin whitepaper by the pseudonymous Satoshi Nakamoto about a new peer-to-peer electronic cash system using distributed ledger technology, digital currency and related assets are no longer in their infancy. Instead, they are constantly evolving, creating both challenges and opportunities. One important aspect of capitalizing on such opportunities is, among other things, understanding and recalibrating, if necessary, in response to new legal developments. Indeed, a new type of diligence is required to mitigate risk and succeed in the digital asset space and lawyers and financial advisors can add a tremendous amount of value when it comes to designing a platform, say, or setting up the governance structure and legal wrapper of a DAO.

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

> **Regulatory Uncertainty**

In recent years, federal regulators have struggled with questions over which agency has jurisdiction over the emerging, and rapidly growing, cryptocurrency market. At the same time, the crypto industry has called for greater guidance regarding digital tokens from the SEC and the CFTC. SEC Chair Gensler has made some comments indicating he wants the SEC to engage in rulemaking to regulate crypto, though to date, the SEC's jurisdiction has been slowly based on one-off enforcement actions. Regulatory agencies would strongly prefer that their jurisdiction over this industry be made explicit via direct congressional action instead of through rulemaking. On that front, Congress has held multiple hearings on digital asset regulation and has introduced a handful of bills, with the leading proposal being the bipartisan Lummis-Gillibrand Responsible Financial Innovation Act (S.4356), which would create a complete regulatory framework for digital assets and create standards for determining which digital assets are commodities and what types are securities. Despite some support from both sides of the aisle, it appears unlikely that this bill will become law in 2022.

In the short term, in the absence of Congressional action or SEC rulemaking, existing financial laws are the main source of law governing crypto, as federal agencies defend their turf and jurisdiction over these emerging markets. This has been echoed by SEC Chair Gensler on September 8, 2022 at the SEC Speaks conference. Even as many in the crypto industry have called for new rules tailored to DeFi, Chair Gensler stated that, while he has asked staff to consider using "our regulatory toolkit to possibly fine-tune compliance for crypto security tokens and intermediaries," existing laws and regulations are designed to apply to a wide variety of situations, and that "the core principles from these statutes apply to all corners of the securities markets." Chair Gensler also reiterated his view that: "Most crypto tokens are investment contracts under the *Howey* Test." Chair Gensler called on cryptocurrency platforms to register each function they perform with the SEC – for example, requiring crypto dealers, brokers, and lenders to separately register those functions with the SEC. Such a move could result in a dramatic shakeup in the crypto market, where there are currently several cryptocurrency platforms that perform all of these functions. This is in stark contrast to the traditional securities markets, in which such services are separated from each other.

Chair Gensler's comments, and the SEC's corresponding actions, come on the heels of other developments that have affected the industry, particularly in the stablecoin sector. The latter part of 2022 has also seen a marked drop in crypto values (the so-called "crypto winter"), spooking some consumers. Perhaps most notably, in July, crypto lender Voyager Digital filed for bankruptcy, once again shaking confidence in the cryptocurrency market. Moreover, certain DeFi platforms have suffered serious cyberattacks, resulting in the exfiltration of cryptoassets. Overall, prices of digital assets can be highly volatile, as the recent global market capitalization of cryptocurrencies is approximately one-third of its

November 2021 peak. Even with Chair Gensler's comments, and the SEC's proposed rulemaking, the regulatory outlook for cryptocurrency remains unclear. The aforementioned Lummis-Gillibrand bill, which would place most crypto under the CFTC's jurisdiction, appears unlikely to proceed in the near term. The SEC has brought a number of enforcement actions (detailed below), in what some in the industry have termed "regulation by enforcement." Yet, the crypto market is such a recent phenomenon that there is, naturally, limited precedent to guide how existing statutes and regulations apply to it. While new rules could bring more stringent oversight to this space, it is also likely that individual enforcement actions and settlements could continue to build a body of precedent that clarifies the SEC's role in regulating the emerging market.

To bolster its enforcement efforts, in May 2022, the SEC announced that it would hire twenty additional positions to the Crypto Assets and Cyber Unit (formerly known as the Cyber Unit) within the Enforcement Division, increasing the number of dedicated positions to fifty. The "Crypto Unit" is tasked with protecting investors in crypto markets and from cyber-related threats. With more personnel and resources available, the SEC believes the unit will be "better equipped to police wrongdoing in the crypto markets" while still staying involved in disclosure and controls issues with respect to cybersecurity.

> Selected Enforcement Actions Involving Digital Assets

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

Some noteworthy enforcement actions in the digital assets industry include:

> The SEC brought insider trading charges against a former manager at Coinbase, the largest cryptoasset trading platform in the United States (*SEC v. Wahi*). The SEC alleged that the former manager improperly provided, or "tipped," material nonpublic information about the timing and content of Coinbase's "listing announcements" to his brother and a close friend. These individuals then allegedly used the information to trade ahead of multiple listing announcements and earn at least $1.1 million. According to the SEC, the insider trading scheme involved at least 25 different types of cryptoassets. But, because insider trading charges under Section 10(b) and Rule 10b-5 can only be brought "in connection with the purchase or sale of securities," the SEC specifically alleged that nine of the cryptoassets traded were securities. The SEC's decision to file this complaint brings with it uncertainty to Coinbase and other cryptoasset trading platforms. Although the complaint indicates that the SEC views some, but not all, cryptoassets to be securities, the SEC has not laid out a clear regulatory framework aside from its application of the Howey test. In response to the *Wahi* charges, Coinbase published a blog post arguing that none of the assets on its platform are securities, and that it "filed a petition for rule making with the SEC calling for actual rule making so the crypto securities market has a chance to develop." It should be noted that in the U.S. Department of Justice ("DOJ") parallel criminal action against the same three individuals, it brought wire fraud, but not securities fraud, charges – perhaps sidestepping any legal question of whether the assets are securities. In September 2022, the Coinbase employee's brother pled guilty to wire-fraud conspiracy. The Assistant U.S. Attorney handling the case noted during the brother's allocution that the wire-fraud charge did not involve questions about whether the cryptocurrencies at issue were securities. Even absent further guidance, however, the SEC's efforts to regulate certain cryptoassets as

securities is likely to embolden private plaintiffs. According to a **recent report**, the number of cryptocurrency-related securities class action filings in 2022 so far are on pace to exceed the 2021 totals.

- The SEC settled charges with BlockFi Lending LLC over its purported failure to register the offers and sales of its retail crypto lending product. (*In re BlockFi Lending LLC*). BlockFi agreed to pay a $50 million penalty, cease its unregistered offers and sales of the lending product, BlockFi Interest Accounts, among other things. BlockFi's parent company also announced that it intends to register under the Securities Act of 1933 the offer and sale of a new lending product. In parallel actions, BlockFi agreed to pay an additional $50 million in fines to 32 states to settle similar charges.
- As discussed above under "Derivatives – Crypto" the CFTC entered an order charging Blockratize, Inc. (d/b/a Polymarket.com) with offering off-exchange binary options contracts and failing to register with the CFTC as a designated contract market or swap execution facility as required under the CEA. (*In re Blockratize, Inc. d/b/a Polymarket.com*). The CFTC ordered Polymarket to cease and desist all such unregistered market making activities and issued a $1.4 million fine (which the order noted was reduced in light of Polymarket's "substantial cooperation" with the investigation).
- The SEC charged two companies and their founder for violations of antifraud and registration provisions of the federal securities laws in connection with an ICO. The SEC announced charges against Australian citizen Craig Sproule and two companies he founded, Crowd Machine, Inc. and Metavine, Inc., for making materially false and misleading statements in connection with an unregistered offer and sale of digital asset securities in an ICO. (*SEC v. Crowd Machine, Inc.*).
- The SEC settled charges and issued an order that imposed fines against blockchain-based trading platform tZERO ATS, LLC, an alternative trading systems ("ATS"), for alleged violations of Regulation ATS, which requires certain disclosures to the Commission. (*In re tZERO ATS, LLC*). While other SEC enforcement actions against blockchain-based platforms and entities involved allegations of fraud, the tZERO Order focused on apparent failures in required disclosures and filings. The tZERO Order does not delve into substantive issues about the agency's stance on "digitally enhanced securities" or how they could be regulated differently in the future.

> New York Financial Regulator Publishes Stablecoin Guidance

The New York Department of Financial Services (NYDFS) released its "Guidance on the Issuance of U.S. Dollar-Backed Stablecoins" which is meant to set foundational criteria for USD-backed stablecoins issued by NYDFS-regulated entities on the issues of redeemability, assets reserves and attestations about such reserves. The NYDFS is the first state regulator to release such guidance. With the fate of Congressional action on stablecoins this year uncertain (and equally uncertain whether federal agencies or banking regulators will step in to offer certain guardrails), it will likely be left to the states (and the industry itself) to establish certain baselines that offer consumer protection and stability without harming innovation. Given NYDFS's experience in the virtual currency space and its prominence, its latest guidance may be influential to other regulators around the country.

NYDFS is no stranger to regulating the virtual currency industry. In 2015, it released its final "BitLicense" rules, becoming the first state to promulgate a comprehensive framework for regulating virtual currency-related businesses. Since 2018, NYDFS has also imposed requirements and controls on the stablecoins issued by its regulated entities. As noted in the guidance, the agency carefully reviews a company's product offerings (including any stablecoin-related products) when evaluating a BitLicense application, and going forward, BitLicensees and New York State limited purpose trust companies that engage in virtual currency business activity must obtain NYDFS's written approval before introducing a materially new product, service, or activity (including issuance of stablecoins).

> Financial Stability Oversight Council Statements about Digital Assets

At the close of 2021, FSOC released its 2021 Annual Report (the "Report"). In the Report, the FSOC offered wide-ranging insight into what it perceived to be various vulnerabilities in the financial system and related regulatory concerns on topics ranging from climate-related financial risks, the real estate market, certain financial structures, data challenges, and cybersecurity. Notably, the FSOC additionally dedicated a section of the Report on the specific risks digital assets pose to the financial system, specifically, those involving stablecoins.

The Report sees digital assets like stablecoins as presenting great payment innovations and efficiencies if reasonably regulated. Proponents note that a well-designed stablecoin may certainly be leveraged to enable faster and more efficient payment options, reaching a wider customer base. At the same time, the FSOC sees potential systemic risk due to stablecoins' lack of consistent risk-management standards and their operational complexity, all of which the FSOC advocates should be addressed by Congress and the appropriate financial regulators. One of the FSOC's concerns is that the reserve assets supporting a particular stablecoin may not be subject to rigorous audits. Thus, the reserves may not live up to the issuer's claims related to the quantity or quality of the coin's collateral. If investors begin to doubt the credibility of the issuer's claim that the stablecoins will maintain a stable store of value, then the stablecoin may be subject to widespread redemptions and asset liquidations. The Report points to other operational risks as well, including a failure to institute appropriate protections to stem illegal activity and maintain appropriate safeguards around reserve assets. According to the FSOC, these issues, and related cybersecurity concerns surrounding the collecting and storing of data, could undermine consumer confidence in stablecoins as a reliable source of value.

On October 3, 2022, in response to President Biden's executive order on digital assets, FSOC released its Report on Digital Asset Financial Stability Risks and Regulation. The report reviews financial stability risks and regulatory gaps posed by various types of digital assets and provides recommendations to address such risks. According to the Report, some characteristics of cryptoasset activities have acutely amplified instability within the cryptoasset ecosystem, including the fact that: many cryptoasset activities lack basic risk controls to protect against run risk or to help ensure that leverage is not excessive, many digital asset prices are driven by speculation as opposed to fundamental economic use cases, and many cryptoasset firms or activities have sizable interconnections with cryptoasset entities that have risky business profiles and opaque capital and liquidity positions.

Insider Trading Update

> Insider-Trading Developments

Perhaps the most attention-grabbing development in insider trading in the past 12 months has been the progress of the SEC's "shadow trading" enforcement action, which survived a motion to dismiss a claim based on the defendant's trading the shares of a company that was not the direct subject of allegedly MNPI. Other noteworthy events included (i) an SEC enforcement action based on an alleged lack of internal controls over insider trading, (ii) the SEC's defeat in an insider trading trial that had depended largely on statistical analysis of the defendant's trading, (iii) an SEC Risk Alert on advisers' compliance with matters relating to insider trading, (iv) governmental insider trading actions relating to crypto assets,

(v) the SEC's proposed amendments to Rule 10b5-1, which governs trading plans, and (vi) the CFTC's continued interest in insider trading.

SEC's "Shadow-Trading" Claim Survives Motion to Dismiss

The SEC prevailed on a motion to dismiss in a closely watched lawsuit alleging that a corporate employee had engaged in insider trading based on news about a not-yet-public corporate acquisition when he purchased securities of a company not involved in that transaction. The decision in *SEC v. Panuwat*, 2022 WL 633306 (N.D. Cal. Jan. 14, 2022), marks the first time a court considered the theory of "shadow trading," which involves trading the securities of a public company that is not the direct subject of the material, nonpublic information ("MNPI") at issue.

The *Panuwat* decision does not appear to break new ground under the misappropriation theory of insider trading in light of the particular facts alleged. But the "shadow trading" theory warrants attention because, depending on the underlying factual allegations, its broad view of materiality could have wide-ranging ramifications for traders, advisers and funds.

The SEC brought an enforcement action against Matthew Panuwat, the then-head of business development at a pharmaceutical company called Medivation. The SEC alleged that Panuwat had learned that Medivation was on the verge of being acquired by a large pharmaceutical firm and that, before the acquisition was announced, he had purchased call options on securities issued by one of Medivation's competitors, Incyte.

The SEC's theory was that several potential acquirers had been interested in buying Medivation, that Incyte was one of a "limited number of mid-cap" companies in Medivation's area of business, that Incyte would become more attractive to potential acquirers once the Medivation deal was announced, and that Incyte's stock price would increase as a result. The facts allegedly supported the SEC's theory: when the Medivation deal was announced, Incyte's stock price rose, and Panuwat made $107,066 on his call options.

Panuwat moved to dismiss the SEC's complaint on two grounds. First, he argued that the SEC's complaint had failed to satisfy three elements of the misappropriation theory of insider trading: materiality, breach of duty, and scienter. Second, he asserted that the SEC's allegations violated his due-process rights because the shadow-trading theory inappropriately expanded insider trading law beyond its generally understood parameters and thereby failed to provide adequate notice of what the law prohibits. The court disagreed and denied Panuwat's motion to dismiss.

Court's Decision

The court began by addressing the parties' materiality contentions, which constituted the "bulk of the parties' arguments." It first evaluated the parties' competing readings of whether information about Incyte – which was not the direct subject of the MNPI about the Medivation acquisition – could be material under § 10(b) of the Exchange Act ("§ 10(b)") and SEC Rules 10b-5 and 10b5-1(a). Panuwat argued that Rule 10b5-1(a) required the SEC to prove he had traded Incyte securities on the basis of MNPI about Incyte itself. The SEC responded that Rule 10b5-1(a) is not exhaustive and that trading in connection with "any security" could violate § 10(b).

The court agreed with the SEC's interpretation. It held that § 10(b) and Rule 10b-5 "cast a wide net" to prohibit insider trading of "*any* security" and that neither of those provisions nor Rule 10b5-1(a) requires the information to have come from or to be about the issuer itself (*i.e.*, Incyte). The court read the

Supreme Court's decision in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) as focusing on whether the information is significant to the security issuer without "foreclos[ing] the possibility that information may be significant to an issuer even if it comes from outside the company."

Applying the SEC's reading, the court found it reasonable to infer at the pleading stage that Panuwat's MNPI about the Medivation acquisition would be significant to Incyte in light of "the limited number of mid-cap, oncology-focused biopharmaceutical companies with commercial-stage drugs in 2016" and the number of other companies that had been interested in buying Medivation. The rise in Incyte's stock price after the Medivation acquisition was announced confirmed the court's materiality analysis. In addition, the court's summary of the factual allegations noted that Panuwat had reviewed Medivation's investment bankers' presentations, which had "discussed Medivation's peer companies in the biopharmaceutical industry, including Incyte," and that Panuwat himself had "noted to the investment bankers that they might want to consider Incyte a comparable company to Medivation."

The court next held that the SEC had sufficiently alleged a breach of Panuwat's fiduciary duties to Medivation under the misappropriation theory of liability: he had used MNPI obtained from his employer for his personal benefit in violation of an agreement not to do so. Panuwat had signed Medivation's insider-trading policy, which stated that signatories "may be in a position to profit financially by buying or selling or in some other way dealing in the Company's securities . . . *or the securities of another publicly traded company*, including all significant collaborators, customers, partners, suppliers, or competitors of the Company…For anyone to use such information to gain personal benefit…is illegal." (*Emphasis added*.)

In light of this broad prohibition, the court held that "the plain language of the policy covers 'the securities of another publicly traded company, *including*' the enumerated categories…The word ['including'] does not cabin the policy's applicability to only the types of companies listed…Because Incyte is a publicly traded company, it is covered by Medivation's trading policy."

In evaluating whether the SEC had adequately pled Panuwat's scienter, the court noted disagreement among District Courts in the Ninth Circuit regarding whether a defendant must actually *use* the MNPI in carrying out a trade or whether he or she need only be *aware* of it. The court held that the Ninth Circuit's decision in *United States v. Smith*, 155 F.3d 1051 (9th Cir. 1998), which had required actual use, did not resolve the issue, because *Smith* was a criminal case, it had expressly left open the question whether the use standard was required in civil proceedings such as this one, and it had been decided before the SEC's promulgation of Rule 10b5-1, which requires only an awareness, not actual use, of MNPI.

Nevertheless, the court held that the SEC's allegations satisfied even the stricter actual-use standard. The SEC had pled several examples of circumstantial evidence showing actual use, including that Panuwat had bought Incyte options "within minutes" after learning that the Medivation deal was imminent and that he had never previously traded Incyte stock. The awareness standard was also satisfied, as the complaint included detailed allegations that Panuwat had been aware of the impending acquisition before he bought the Incyte options.

The court also rejected Panuwat's due-process argument and, in so doing, signaled its acceptance of "shadow trading" as encompassed within the misappropriation theory of insider trading. Panuwat had argued that his due-process rights had been violated because the SEC's novel theory of "shadow trading" stretched the misappropriation theory beyond its previously recognized boundaries. The court conceded that "there appear to be no other cases where the [MNPI] at issue involved a third party." But, in the court's view, the "shadow trading" theory still fell within the framework of the misappropriation theory, which, by its own terms, reaches trading by corporate outsiders and can involve information that is material to more than one company. The theory also fit within what the court called § 10(b)'s "expansive" language. The court concluded that "scienter and materiality provide sufficient guardrails to insider trading liability" even where the particular theory of liability has not previously been adjudicated.

Implications

The court's decision appears to validate the SEC's reliance on a "shadow trading" theory where a trader breaches his or her duty by using MNPI about one company to trade another company's securities. But the decision was based on the pleadings and depended on the specific factual allegations at issue, including that (i) the third-party issuer (Incyte) was one of only "a limited number" of companies in the acquisition target's business and financial space, (ii) the MNPI had specifically identified the third-party issuer as a comparable company, (iii) the trader had signed a confidentiality agreement that expressly prohibited trading the securities of any public company based on MNPI learned from his employer, and (iv) the trader had been directly involved in the underlying corporate discussions and presentations concerning the employer's acquisition. Changing these variables could conceivably produce different results. And the fact-intensive nature of these allegations increased the difficulty of obtaining a dismissal at the pleading stage.

For example, at what point does "a limited number" of comparable companies become too big a universe for information about Company A to be material to Company B (or C, D, or E)? How comparable do Companies A and B need to be? Would the court have reached a different conclusion if the Medivation investment bankers' presentations had *not* mentioned Incyte as a comparable company, or if Panuwat had *not* seen those materials? What if the insider-trading policy had not *expressly* covered "the securities of another publicly traded company"? Would the absence of such language have proven fatal to the SEC's claims? Or could the SEC have invoked general corporate fiduciary-duty principles prohibiting an insider from using corporate MNPI for his or her personal benefit? These and other issues might arise in future cases.

Companies and traders, including advisers and private funds, should consider whether insider-trading policies and procedures, as well as any relevant nondisclosure agreements, cover securities of third-party companies – and, if so, whether they want their policies and procedures to extend so far. The language and breadth of those policies could be determinative – and could influence any trading restrictions or "walls" that companies implement.

As we noted in our 2021 annual update, "shadow-trading" claims can raise issues for private fund advisers in terms of enforcing policies and procedures to prevent insider trading. For firms that allow employees "over the wall" to analyze potential transactions on a regular basis, determining which companies should be placed on the firm's restricted list might be more difficult where the information available to the "over the wall" employee does not relate to a specifically identifiable company (such as a party to the transaction at issue) or even to only a small number of identifiable companies. Typically, if MNPI relates to a particular company, a person cannot use that information to trade in major suppliers or customers of that company. (That limitation was the apparent focus of Medivation's insider-trading policy.) But, taken to its logical conclusion, the SEC's shadow-trading theory could potentially implicate trading in an entire industry based on MNPI relating to only one company, especially in light of SEC Rule 10b5-1's warning that mere awareness of MNPI can constitute trading "on the basis of" MNPI.

For example, confidential information about one company might bolster an analyst's confidence about a broader industry, but is the trader then "aware" of MNPI about the whole industry? The answer might depend on the size and depth of the industry. If the industry involves many similarly situated companies, the nonpublic information might not be considered too material. But if, as here, the industry allegedly consists of only a handful of similarly situated companies (Incyte supposedly was one of the few oncology-focused mid-cap biopharmaceutical companies remaining as a potential acquisition target), the nonpublic information might be more likely to be material.

Legal and compliance professionals also should evaluate how far to extend trading restrictions when signing a nondisclosure agreement (an "NDA") with a particular company. They should be aware that the restrictions might go beyond the companies at issue and their major suppliers and customers; they might cover a wider swath – such as "the securities of another publicly traded company," as in the *Panuwat* case. In those situations, investment professionals might need to keep an eye out for other companies mentioned in materials contained in a data room, or companies – or perhaps even competitors – that one would reasonably believe might be affected by the particular transaction.

Legal and compliance professionals often hope to avoid having to make trading decisions based solely on assessments of materiality, because those assessments are highly fact-specific and therefore unpredictable from a legal point of view. But at the end of the day, if confidential information about a particular company has potentially broader impact on another company or an entire industry, trading decisions might require assessing the risk that particular information could be deemed material – especially in hindsight, after the market has reacted to disclosure of that information.

SEC Enforcement Action Based on Lack of Internal Controls Over Insider Trading

An SEC enforcement action based on a corporation's alleged lack of internal controls over insider trading survived a motion to dismiss in *SEC v. Cavco Industries Inc.*, 2022 WL 1491279 (D. Ariz. Jan. 25, 2022).

The *Cavco* case involved alleged insider trading by Cavco's CEO (who settled with the SEC) for Cavco's own benefit. The CEO had used Cavco's surplus cash to buy securities of competitors with which Cavco had been discussing potential acquisitions and about which it had received MNPI pursuant to NDAs.

Cavco's investment policy had required the CEO to obtain pre-approval from the company's CFO and board for those types of investments. And Cavco's insider trading policy had prohibited employees from using MNPI in the purchase or sale of securities, including "public securities of other companies where the person learns of the information through his connection with Cavco." But the CEO had not obtained the requisite Board approvals before making the transactions at issue, and the CFO allegedly had devised a process that did not include any role for him to review or approve the trades.

The court denied Cavco's motion to dismiss, holding that "the SEC's detailed allegations regarding the CEO's serial use of his authority for insider trading raises a reasonable inference that Cavco violated § 10(b)."

The court also upheld the SEC's claim for accounting-controls violations under § 13(b)(2)(B) of the Exchange Act, which requires security issuers to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that (i) transactions are executed in accordance with management's general or specific authorization; . . . [and] (iii) access to assets is permitted only in accordance with management's general or specific authorization." The court concluded that the SEC had adequately alleged "specific shortcomings in Cavco's controls – that there were insufficient checks for how investments outside [Cavco's policies] would be identified and reported and for how improper investments would be prevented." The court added that, "although the Investment and Insider Trading policies constitute internal accounting controls which [the CEO and CFO] circumvented, the SEC also alleges that such controls alone could not provide the reasonable assurances required under Section 13(b)(2)(B)."

In addition, the court denied the CFO's motion to dismiss the aiding-and-abetting claims against him. The court ruled that the SEC had adequately pled that the CFO had "at least recklessly disregarded his substantial role in furthering Cavco's primary violation" and had "affirmatively abandoned his duty to review Cavco's trading, most notably when he allegedly created a system through which [the CEO] could place trades for Cavco with 'no procedures at all to review' the trades."

On September 23, 2022, Cavco entered into a consent agreement with the SEC providing for injunctive relief and a payment of $1,500,000.

SEC Does Not Always Win Insider Trading Cases – But Don't Try This at Home

In what some have viewed as a surprising decision, a federal court in Virginia dismissed an SEC enforcement action during trial after the SEC had put on its case in chief and before any presentation from the defense. The court ruled from the bench that the SEC had not established insider trading based merely on a statistical analysis of the defendant's allegedly suspicious trades and a relationship between the defendant and a corporate insider who had MNPI. *SEC v. Clark*, 2021 WL 69326889 (E.D. Va. Dec. 13, 2021), *appeal filed*, No. 22-1157 (4th Cir. Feb. 16, 2022).

The defendant in the *Clark* case allegedly had traded on MNPI from his brother-in-law about a merger involving the company at which the brother-in-law worked. The SEC relied on what it deemed suspicious trading: the defendant had bought speculative out-of-the-money call options on the issuer's stock; the transactions were unusual for the defendant; he had borrowed money to pay for some of his trades; and he allegedly had told his son to buy some of the same options. The SEC also introduced evidence that the defendant had spent allegedly substantial amounts of time with his brother-in-law. The brother-in-law settled with the SEC and paid $240,000, but the defendant proceeded to trial.

The court dismissed the action after the close of the SEC's case, finding no testimony, documents, or other evidence showing that, despite the defendant's seemingly anomalous trading pattern, the defendant actually had received MNPI from his brother-in-law. The court concluded that "[t]here's just simply no circumstantial evidence here that gives rise to an inference that [the defendant] received the insider information." The SEC has appealed.

The court might have taken an unusually hard line on the need for direct or even "circumstantial" evidence in light of the showing of unusual and potentially suspicious trading, the borrowing of money, and the fairly close relationship between the defendant and the alleged tipper. Stay tuned for the Fourth Circuit's decision.

The *Clark* court's apparent distaste for enforcement actions based largely on statistical evidence might be viewed as inconsistent with decisions of other courts, including the Fifth Circuit's recent decision in *SEC v. World Tree Financial, L.L.C.*, 43 F.4th 448 (5th Cir. 2022). *World Tree* was not an insider-trading case; it involved allegations of "cherry-picking" against an adviser, who allegedly had traded for clients in a block trade or omnibus account and then allocated the transactions to favored clients (or themselves) depending on the end-of-day results. The SEC's case was based on statistical evidence: the SEC's expert testified that the adviser had transmitted most trades to the broker during the trading day, but, 90% of the time, had waited until after the markets had closed to allocate the trades. The expert's account of the trades and allocations showed a "'once in one million chance that these patterns [of allocations] could have occurred if allocations were being made without regard to first-day returns.'" The court held a bench trial and ruled in favor of the SEC. The Fifth Circuit affirmed and rejected the defendants' argument that the SEC was required to introduce direct evidence of cherry-picking instead of relying on statistical evidence.

Securities-Fraud Liability Without Personal Benefits and Fiduciary Breaches

Our annual updates over the past several years have discussed the "personal benefit" requirement for insider-trading liability under § 10(b) and prosecutors' efforts to avoid having to meet that requirement by bringing criminal proceedings under 18 U.S.C. § 1348. As we previously explained, § 10(b) liability arises only if securities were bought or sold on the basis of MNPI used or obtained in breach of a fiduciary duty or a duty of trust or confidence owed to the shareholders of the issuer or to the source of the information. That breach of duty depends on whether the tipper received a personal benefit in exchange for providing the information. 18 U.S.C. § 1348, in contrast, does not facially require consideration of either fiduciary breaches or personal benefits. Section 1348 imposes criminal liability on anyone who "knowingly executes, or attempts to execute, a scheme or artifice" either (1) "to defraud any person in connection with" any commodity or any security of a registered issuer or (2) "to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of" any such commodity or security.

Accordingly, prosecutors sometimes use § 1348 in criminal insider-trading cases to avoid having to prove a breach of duty or receipt of a personal benefit, and courts have upheld that construction of the statute. Last year's update discussed several of those cases, including *United States v. Ramsey*, 2021 WL 4554631 (E.D. Pa. Oct. 4, 2021), which held that § 10(b)'s personal-benefit requirement is not an element of a claim for criminal liability under § 1348.

The *Ramsey* case later went to trial, and Ramsey was convicted of insider trading under § 1348. The court denied his motion for judgment of acquittal and rejected his efforts to narrow the scope of § 1348. *United States v. Ramsey*, 2022 WL 596378 (E.D. Pa. Feb. 28, 2022). The court ruled that § 1348 did not require proof that the insider-trading scheme was designed to deprive an "identifiable victim" of money or property. Accordingly, Ramsey's claim that the trading scheme had sought only to deceive Ramsey's employer (by using the employer's confidential information) and "to make money in the securities market at large" did not preclude liability under § 1348.

The court also held that stock options constitute "securities" under § 1348 and that the prosecution need not prove who issued the options if they relate to stock of an issuer governed by the securities laws.

SEC Risk Alert on MNPI Compliance

On April 26, 2022, the Exams Division issued a Risk Alert on Investment Adviser MNPI Compliance Issues. The Risk Alert stated that the staff of the Exams Division found "notable deficiencies" relating to compliance with § 204A of the Code of Ethics Rule.

Section 204A requires all investment advisers, whether registered or unregistered, to establish, maintain, and enforce written policies and procedures to prevent the misuse of MNPI by the adviser or any associated person. The Code of Ethics Rule requires registered (or required-to-be-registered) advisers to adopt a code of ethics prescribing the standards of business conduct expected from the adviser's supervised persons and the duties of certain supervised persons (called "access persons") to report their personal securities transactions to the adviser's Chief Compliance Officer or other designated person.

The Risk Alert cited a number of "deficiencies and weaknesses" that Exams Division staff had observed in connection with § 204(A) compliance, including:

> ***"Alternative data"*** (defined to include information from satellite and drone imagery, crop yields, parking lots, credit-card transactions, social-media and internet searches, geolocation data, etc.): nonexistent, inadequate, or inadequately enforced policies and procedures to address the potential receipt and use of MNPI. (For more detail, see the "Alternative Data" section in the Annual Review);

> ***"Value-add investors"*** (e.g., clients or fund investors who are corporate executives or financial professionals who might have MNPI): nonexistent, inadequate, or inadequately enforced policies and procedures to address the risks posed by value-add investors' potential possession of MNPI; and

> ***Expert networks***: nonexistent, inadequate, or inadequately enforced policies and procedures regarding dealings with expert-network consultants who might have MNPI about publicly traded companies. The deficient policies included those relating to:

  - "Tracking and logging calls with expert network consultants";
  - "Reviewing detailed notes from expert network calls"; and
  - "Reviewing relevant trading activity of supervised persons in the securities of publicly traded companies that are *in similar industries as those discussed during the calls.*" (Emphasis added.)

The italicized language in the preceding bullet shows the extent to which the SEC remains interested in the shadow-trading issues being litigated in the *Panuwat* case (discussed above).

The Risk Alert also cited a number of deficiencies that Exams Division staff had observed in connection with the Code of Ethics Rule, including:

> ***Identification of access persons***: Advisers did not sufficiently identify and supervise access persons.

> ***Lack of pre-approval for investments***: Access persons purchased beneficial ownership in IPOs and limited offerings without requisite pre-approval.

> ***Personal securities transactions***: Deficiencies existed in the required reporting of access persons' personal securities transactions and holdings.

> ***Written acknowledgments***: Some supervised persons were not provided with the applicable code of ethics or did not provide written acknowledgment of receipt.

The Risk Alert concluded with several recommendations from Exams Division staff concerning advisers' codes of ethics:

> ***Trading investments on restricted list***: Advisers should consider having their codes include restricted lists of issuers about which the adviser has MNPI and prohibit any trading in those issuers' securities.

> ***Allocation of investment opportunities***: Advisers should consider having their codes incorporate procedures to ensure that investment opportunities are offered first to clients before the adviser or its employees may act on them.

Government Interest in Block Trading

The DOJ and SEC recently have shown some interest in potential insider trading arising from tips about "block trades": large blocks of securities involving either more than 10,000 shares or shares worth at least $200,000 (as defined in 17 C.F.R. § 242.600(b)(12) and NYSE Information Memorandum No. 14-06 (Feb. 25, 2014)). The government is investigating whether financial institutions have tipped certain clients about block trades that the institutions are handling for other clients. The DOJ and SEC reportedly have subpoenaed various financial institutions in the past several years for records relating to block sales.

Any insider trading charges arising from tips about block trades would presumably rely on the misappropriation theory: the financial institutions allegedly breach a duty to the clients that own the blocks of stock if the institutions provide those clients' nonpublic trading information to the institutions' other clients and if the institutions receive some sort of benefit from the tippee-clients. Alternatively, in a criminal case, the government might choose to plead a violation of 18 U.S.C. § 1348, which (as discussed above) does not require the government to prove a breach of duty or a receipt of a personal benefit.

As discussed below, the CFTC has also been looking at tips about block trading.

SEC/DOJ Insider Trading Actions Relating to Crypto Assets

Please see "Digital Assets" for a discussion on an insider trading charge brought by the SEC and DOJ against a crypto asset trading platform.

SEC Proposal to Tighten Requirements for 10b5-1 Trading Plans

On December 15, 2021, the SEC proposed amendments to Exchange Act Rule 10b5-1, which (among other things) governs trading plans that, in some circumstances, can provide a defense to charges of insider trading. The current version of Rule 10b5-1(c)(1) establishes an affirmative defense to a claim of trading "on the basis of" MNPI if the trader can demonstrate that, "before becoming aware of the information," he, she, or it had "adopted a written plan for trading securities" and that the trades at issue were made pursuant to that plan.

The proposed amendment to Rule 10b5-1 would place some new limitations on the availability of that defense:

- A 120-day waiting period for directors and officers, and a 30-day waiting period for issuers, between the adoption or modification of a trading plan and the first purchase or sale made under that plan;
- A requirement that directors and officers provide the issuer, when adopting or modifying a trading plan, with a certification that they are not aware of MNPI about the issuer and are adopting the plan in good faith;
- A prohibition on multiple, overlapping trading plans; and
- A limitation to only one trading plan in any 12-month period for trading plans covering only a single trade.

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

- Issuer disclosure in Form 10-Q or 10-K as to whether, during the last fiscal quarter, any issuer, director, or Section 16 officer had adopted, modified, or terminated any trading arrangement;

- Issuer disclosure about the adoption of any insider-trading policies and procedures;
- Mandatory "checkbox" disclosures in Forms 4 and 5 requiring filers to note whether a reported transaction was made pursuant to a trading plan; and
- Required disclosure on Form 4 of any bona fide gifts of equity securities by Section 16 insiders.

CFTC's Continued Interest in Insider Trading

The CFTC pursued an enforcement action against EOX Holdings (an inter-dealer broker) and one of its brokers relating to block trading. But although the CFTC's claims survived certain pretrial motions, a jury concluded in August 2022 that the defendants had not engaged in insider trading.

The CFTC's complaint alleged that the broker had breached a duty of trust and confidence to EOX's customers by tipping one customer (who was also a friend) about other EOX customers' confidential block-trading orders and information and by using that confidential information to trade the customer-friend's discretionary account against the other customers without their prior consent. The claim was based on § 6(c)(1) of the CEA and on CFTC Rule 180.1(a), which prohibit the use of manipulation, deception, or misrepresentations in connection with the trading of any commodity or future.

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

The court denied defendants' motion to dismiss in 2019, *see CFTC v. EOX Holdings L.L.C.*, 405 F. Supp. 3d 697 (S.D. Tex. 2019), and the case proceeded to summary judgment. In 2021, the court mostly denied both sides' cross-motions for summary judgment. *CFTC v. EOX Holdings L.L.C.*, 2021 WL 4482145, at *19 (S.D. Tex. Sept. 30, 2021).

The court observed that neither it nor the parties had found any case holding a broker liable for misappropriating MNPI in violation of CFTC § 6(c)(1) and Rule 180.1(a). However, the court recognized that those provisions are modeled on § 10(b) and SEC Rule 10b-5 and that "misappropriation of material, non-public information in breach of a pre-existing duty violates § 10(b) and Rule 10b-5." *Id.* at *19. The court therefore applied the familiar Exchange Act standards to the CEA: the CFTC must prove that the defendants "(1) misappropriated confidential information in breach of a pre-existing duty of trust and confidence to the source of the information; (2) intentionally or recklessly, *i.e.*, with scienter; (3) in connection with a contract for sale or purchase of a commodity in interstate commerce; (4) for personal benefit." *Id.* at *22.

The court held that 17 C.F.R. § 155.4(b) and ICE Futures U.S. rules impose duties on brokers not to disclose or use customers' confidential information for the brokers' personal benefit. *Id.* at *24-25. However, the court found factual questions about the extent to which EOX's individual contracts with the various trading customers did or did not allow the use of those customers' information for purposes other than executing the customers' orders. *Id.* at *28.

In so ruling, the court seems to have revived a distinction between *disclosure* and *use* of MNPI – an issue that arose some years ago in the SEC's high-profile enforcement action against Mark Cuban. In that case, a Texas District Court had held that an alleged agreement not to *disclose* MNPI did not necessarily include an agreement not to *use* the MNPI for trading purposes. The Fifth Circuit vacated the District Court's pleadings-stage ruling based on the specific allegations of the SEC's complaint. *SEC v. Cuban*, 634 F. Supp. 2d 713 (N.D. Tex. 2009), *vacated*, 620 F.3d 551 (5th Cir. 2010). But the *EOX* decision cites the District Court's ruling in *Cuban* for the proposition that, for contracts "to constitute agreements sufficient to support liability for misappropriation, they must reflect agreements *both* not to disclose *and* not to use the customer's confidential information." 2021 WL 4482145, at *28. (Emphasis added.)

The court also held that factual questions precluded summary judgment for the CFTC on the failure-to-supervise claims against the EOX broker's employer. Under 17 C.F.R. § 166.3, registrants like EOX must develop procedures to detect and deter possible wrongdoing by their agents. Evaluation of a claim for failure to supervise requires courts "first to determine whether there was a program of supervision designed to detect violations; and secondly, whether the relevant policies and procedures were followed." *EOX*, 2021 WL 4482145, at *43. The court found factual questions about the nature and extent of EOX's supervision program and its enforcement of that program.

The case was tried before a jury in the summer of 2022 – perhaps the first time a CFTC insider-trading case has ever gone to trial. On August 9, 2022, the jury found in favor of the CFTC on three of the four counts, but it found in favor of the defendants on the count alleging insider trading.

The jury concluded that the broker had traded against customer orders without the customers' consent on numerous occasions and had disclosed customers' nonpublic information at least five times. The jury also found that the company had failed to keep adequate records and to implement procedures that supposedly would have caught the broker's alleged misconduct.

But the jury rejected the claim that the broker had committed "fraud by misappropriation" by trading against customers' orders through the account he had managed for his customer-friend. The jury might have concluded that the broker had not owed a duty of trust and confidence to customers concerning block-trade information and/or that the broker had not misappropriated MNPI.

Defendants had argued that, in a block trade, a broker acts as agent to both sides of a transaction, because he or she must connect the interested counterparties to effect the transaction. The broker thus is on both sides of the deal and must share one counterparty's information with the other. Defendants also had contended that, because they must share counterparty-customers' order information, the information is not truly confidential, so the broker therefore had not provided confidential information to his allegedly favored customer-friend.

Post-trial motions for judgment as a matter of law are pending, and appeals could follow.

Legislation on Insider Trading: Again, Not Much Progress

As we previously reported, several bills were introduced in Congress in recent years to address insider trading. None of them became law, usually because of lack of progress in the Senate. The same has been true of the past 12 months. At this point in the legislative cycle, further action seems unlikely.

The House's "Insider Trading Prohibition Act"

We reported last year on H.R. 2655, the "Insider Trading Prohibition Act," which the House passed on May 18, 2021. The bill would prohibit the purchase or sale of securities while the trader is "aware of [MNPI] relating to such security," or "any nonpublic information, from whatever source, that has, or would reasonably be expected to have, a material effect on the market price of any such security," if the trader "knows, or recklessly disregards, that such information has been obtained wrongfully, or that such purchase or sale would constitute a wrongful use of such information." The bill also prohibits any such person from "wrongfully" communicating MNPI if (*i*) the person who receives the communication purchases or sells the security at issue or communicates the MNPI to someone else who does so *and* (*ii*) "such a purchase or sale . . . while aware of such information is reasonably foreseeable."

Trading while aware of MNPI, or communicating MNPI, would be "wrongful" "only if the information has been obtained by, or its communication or use would constitute, directly or indirectly,"

- "Theft, bribery, misrepresentation, or espionage (through electronic or other means),"
- "A violation of any Federal law protecting computer data or the intellectual property or privacy of computer users,"
- "Conversion, misappropriation, or other unauthorized and deceptive taking of such information," or
- A breach of any fiduciary duty, confidentiality agreement, contract, code of conduct or ethics policy, or "any other personal or other relationship of trust and confidence for a direct or indirect personal benefit (including pecuniary gain, reputational benefit, or a gift of confidential information to a trading relative or friend)."

The person trading while aware of MNPI, or communicating MNPI, need not know "the specific means by which the information was obtained or communicated, or whether any personal benefit was paid or promised by or to any person in the chain of communication, so long as the person trading while aware of such information or making the communication . . . was aware, consciously avoided being aware, or recklessly disregarded that such information was wrongfully obtained, improperly used, or wrongfully communicated."

The bill thus would appear to codify aspects of insider-trading law as we know it, including the relatively expansive definition of "personal benefit" and the SEC's position in Rule 10b5-1 that a person trades "on the basis of" MNPI if he or she was "aware of" it. However, unlike current insider-trading law, the bill does *not* appear to require that the person trading on or disclosing MNPI have known whether a personal benefit had been paid or promised. To the contrary, the bill says that the knowledge component does *not* require the trader to know "the specific means by which the information was obtained or communicated, or whether any personal benefit was paid or promised by or to any person in the chain of communication, so long as the person trading while aware of such information . . . was aware, consciously avoided being aware, or recklessly disregarded that such information was wrongfully obtained, improperly used, or wrongfully communicated."

The bill further states that, except as provided in Exchange Act § 20(a), a controlling person shall not be liable "solely by reason of the fact that such person controls or employs a person who has violated this section, if such controlling person or employer did not participate in, or directly or indirectly induce the acts constituting a violation of this section." This provision could provide protection to a fund whose employee has gone rogue, as long as the fund itself did not profit from or directly or indirectly induce the alleged misconduct.

The bill also carves out transactions made pursuant to trading plans under SEC Rule 10b5-1. In addition, the bill directs the SEC to review Rule 10b5-1 and make any necessary modifications. (As discussed above, the SEC recently proposed amendments to Rule 10b5-1.)

The Senate still has not acted on the bill.

Senate Bills

On April 4, 2022, S. 3990 – the "Insider Trading Prohibition Act" – was introduced in the Senate. This bill is generally similar to H.R. 2655, the House's Insider Trading Prohibition Act, discussed above.

We reported last year on S. 2360, the "8-K Trading Gap Act of 2021," which was introduced in July 2021. This bill would require the SEC, within one year after the proposed legislation's enactment, to issue rules requiring issuers to establish policies, controls, and procedures to prevent executive officers and directors from trading the issuers' securities between (i) either the date a reportable event occurs (for Form 8-K §§ 1-6) or the date the issuer determines to report that event (for Form 8-K §§ 7-8) and (ii) the date the issuer files a Form 8-K or furnishes it to the SEC. The SEC may exempt "automatic" transactions, such as those made pursuant to advance election or trading plans, but not if the trading plans were adopted during the pre-8-K periods described in the preceding sentence. The Senate still has not acted on this bill.

Private Fund Litigation

The litigation risks for advisers and private funds are greater than at any time since the financial crisis of 2008. Advisers and private funds are now an integral part of the global economy and, as a consequence, are affected by it. There are massive structural changes occurring simultaneously across industries and the economy as a whole. Meanwhile, the macro economy is undergoing a sea change. These changes are happening as we continue through the third year of a pandemic that has disrupted every part of society, not just supply chains. None of that is to signal concern for the private funds industry. It will continue to flourish. But the benign market and relatively benign regulatory environment of the last decade are unlikely to persist. Accelerated change and volatility are coming, and together they are likely to result in more disputes affecting the private fund industry. With that backdrop, below are a few recent notable cases and developments affecting the private fund space.

> MAE/MAC

In the wake of the Covid-19 pandemic, "material adverse effect" (MAE) clauses in purchase and sale agreements have been tested by the courts amid a flurry of recent MAE litigation. *AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC* (Del. Dec. 8, 2021); *Snow Phipps Grp., LLC v. KCake Acq. Inc.* (Del. Ch. Apr. 30, 2021). Delaware courts continue to be skeptical of MAE clause litigation, maintaining a very high bar for triggering an MAE out for buyers, whose assertion of MAE the courts continue to view as buyer's remorse for unprotected reasons (cyclical trends, industry-wide effects, etc.). The *Snow Phipps* case, in which the private equity firm owner of a cake-decorating supply and equipment company sued for specific performance of a buyer of the company, is illustrative. Despite an upwards of 50% year-over-year decline in sales in the five weeks post-deal signing in March 2020, as a result of the onset of the pandemic, the Court declined to find a MAE under the Stock Purchase Agreement. Delaware's MAE jurisprudence was poised to be tested again on the world stage with the high profile *Twitter v. Musk* trial. In the run-up to the trial, the conventional wisdom was that Musk faced an uphill climb. Musk's agreement to honor his original offer on the eve of trial and close on his purchase of Twitter suggests that he came to the same conclusion.

> Sandbagging

Sandbagging refers to the situation where a buyer knows pre-closing that a seller's representation or warranty is false, nevertheless proceeds to closing, and then sues the seller for that breach. While a buyer deliberately setting up a seller for a lawsuit may seem untoward, a recent decision from the Delaware Court of Chancery clarified that Delaware "is, or should be, a pro-sandbagging jurisdiction" – that is, a buyer that sandbags is still entitled to indemnification from the seller under Delaware Law. In *Arwood v. AW Site Services*, LLC (Del. Ch. Mar. 9, 2022), the seller of a waste removal business had been defrauding customers by overbilling them for services, rendering the seller's representation that it was in compliance with all laws false. In opposing buyer's claim for indemnification, seller argued that it should not be liable because buyer – a private equity firm affiliate – actually knew, pre-closing, that the seller's representations were false. Vice Chancellor Slights rejected that argument, clarifying that under Delaware law a buyer is entitled to rely on the truth of a seller's representation *regardless* of whether the buyer knew of its falsity pre-closing. In so holding, the Vice Chancellor reinforced Delaware's "profoundly contractarian predisposition," and provided valuable guidance for buyers and sellers when considering whether, and if so how, to address sandbagging in their acquisition agreements.

> Fund Indemnification

Private fund advisers, including private equity sponsors, have historically counted on receiving indemnification from the private funds they manage for the vast majority of lawsuits or other claims that might be asserted against them. The broad indemnification provided by the private funds has traditionally meant that the adviser was unlikely to have its own assets exposed to claims in most circumstances, even when the adviser did not have insurance or had inadequate insurance. Earlier this year, however, the SEC proposed a number of new rules governing private fund advisers. One of the proposed rules would prohibit advisers from seeking indemnification from funds or investors for some of the more common claims for which advisers currently receive indemnification and would thus significantly restrict the fund-indemnification upon which advisers have historically relied. Another proposed rule would prohibit advisers from charging to private funds "the cost of any ensuing government or regulatory examinations or investigations." If adopted, these rules have the potential to dramatically alter the litigation and regulatory exposure of advisers by making it more likely that, absent robust insurance, an adviser would need to utilize its own assets to pay the costs of defending, settling, or paying a judgment for what were previously indemnifiable claims. Please see "SEC Policy and Rulemaking Updates" for a discussion on the proposed rules for private fund advisers.

FINRA / Broker-Dealer Updates

> SEC Proposes Rules Expanding Interpretation of "Dealers" Subject to Registration

On March 28, 2022, the SEC proposed new rules that would require hedge funds and other proprietary (principal) trading firms that act as "liquidity providers" in securities markets (including the government securities market) to register as "dealers" with the Commission under Section 15 of the Exchange Act,[14] become members of a self-regulatory organization ("SRO"), in most cases FINRA, and comply with

[14] Liquidity providers in government securities would register as government securities dealers under Section 15C of the Exchange Act.

federal securities laws and SRO obligations.[15]

A "dealer" is defined as a person that is "engaged in the business of buying and selling securities…for its own account." The Exchange Act excludes from the definition of dealer, among others, any person that trades for their own account "but not as a part of a regular business." This is known as the "trader" exception. In determining whether trading is part of a regular business, the SEC has historically looked at more than just the frequency of a trading and also considered whether a person is (i) acting as a market maker or a specialist in an organized market; (ii) acting as a de facto market maker or liquidity provider; (iii) holding oneself out as buying or selling securities; or (iv) regularly buying and selling securities at a regular place of business. Moreover, the SEC has focused on whether such trading activity is secondary to the person's investment activities. With regards to "government securities dealers," the definition is largely the same as a dealer except that trading activities are limited to government securities, and furthermore the same trader exception is also available in the government securities dealer context.

The Commission is proposing new Rules 3a5-4 and 3a44-2 under the Exchange Act ("Proposed Trader Rules") that would further define what it means to buy and sell for one's own account "as part of a regular business" in the definitions of "dealer" and "government securities dealer" in Sections 3(a)(5) and 3(a)(44) of the Exchange Act.[16] The Proposed Trader Rules, if adopted, would make the "trader" exception to the definition of dealer unavailable for certain market participants that engage in trading activity that has traditionally been performed by regulated dealers. In its proposal, the SEC attributed the rise in such activity by non-dealer market participants to the evolution of the securities markets, from a forum of manual trading to a system predominately comprised of electronic trading venues. Under the Proposed Trader Rules, private funds and investment advisers that meet the new definition of a dealer — or said differently, are no longer able to rely on the trader exception — would need to register with the SEC as a dealer and comply with the numerous regulatory obligations of such entities (i.e., net capital requirements, limits on participating in new issues (initial public offerings), and various other compliance requirements).

Qualitative Factors: Proposed Trader Rules 3a5-4 and 3a44-2

Under Proposed Trader Rules, persons that previously relied on the trader exception would no longer be able to do so, where they "engag[e] in a routine pattern of buying and selling securities (or government securities) that has the effect of providing liquidity to other market participants." Such conduct would be considered "part of a regular business" and therefore outside the trader exception. The Proposed Trader Rules establish three qualitative standards that would determine whether a routine pattern of trading has the effect of providing market liquidity; they are:

- making roughly comparable purchases and sales of the same or substantially similar securities in one day;
- expressing trading interests that are at or near the best available prices on both sides of the market; or

[15] In a related initiative, on July 29, 2022, the SEC proposed amendments to Rule 15b9-1 under the Exchange Act to narrow an exemption from the requirement to become a FINRA member firm.

[16] Section 3(a)(5) of the Exchange Act generally defines the term "dealer" to mean "any person engaged in the business of buying and selling securities . . . for such person's own account through a broker or otherwise" but excludes "a person that buys or sells securities . . . not as a part of a regular business." This exclusion is typically referred to as the "trader exception." Section 3(a)(44)(A) has a similar construct for the definition of government securities dealer. The proposal defines the term "own account" and other terms to deal with various ownership structures and to prevent evasion. The proposal does not affect the definitions of "municipal securities dealer" or "security-based swap dealer" under Section 3(a)(30) or Section 3(a)(71) of the Exchange Act.

> earning revenue primarily from capturing bid-ask spreads or from capturing any incentives offered by trading venues for providing liquidity.

Quantitative Factors: Proposed Trader Rule 3a44-2

Proposed Trader Rule 3a44-2, which applies only to government securities dealers, would establish a quantitative test that would result in certain trading activity in government securities to be deemed "as a part of a regular business" and therefore also outside of the trader exception. This rule would mandate that where a person "[i]n each of four out of the last six calendar months, engage[s] in buying and selling more than $25 billion of trading volume in government securities," such person would be a government securities dealer and required to register with the SEC as such.

Exempt Persons and Scope of "Own Account"

The Proposed Trader Rules would not apply to:

> Any person that has or controls assets less than $50 million;

> Investment companies registered under the Investment Company Act; and

> Any person that relies on an existing statutory exemption (i.e., certain banks and foreign broker-dealers).

Private funds and advisers were not excluded from the Proposed Trader Rules, unlike registered investment companies. Nonetheless, to be a dealer under the Exchange Act, trading must be conducted for one's "own account." The Proposed Trader Rules adopt a broad interpretation of "own account," including accounts that are "controlled" by the person conducting the subject trading. The definition of "control" under the Proposed Trader Rules also incorporates the definition from Rule 13h-l. Thus, private funds are likely to be deemed an adviser or general partner's "own account" under the Proposed Trader Rules. Additionally, the proposal is clear that an adviser's proprietary accounts (25% or greater ownership) would be their "own account."

The Commission is concerned that certain "proprietary trading firms" that currently rely on the trader exception have evolved to take on critical roles as liquidity providers without being subject to the same regulations as traditional securities dealers. Hedge funds and other market participants that frequently buy and sell the same securities would have to consider whether those activities could make them dealers or government securities dealers under the rules.[17] Registered brokers and dealers are subject to extensive legal and regulatory requirements under the Exchange Act, SEC and SRO rules (including net capital, financial reporting, recordkeeping and trade reporting requirements), and SEC and SRO examinations. (See here for client advisory on broker-dealer registration and FINRA membership: https://www.proskauer.com/uploads/broker-dealer-registration.) Objections to the proposal have emphasized the fact that hedge funds and other private investment funds potentially affected are already subject to regulation as investment advisers and that the additional regulation as broker-dealers would be unduly burdensome. Some commenters expressed concern about the possibility that as dealers they would be expected to provide liquidity in times of market imbalance counter to their constituents' interests.

[17] Under the proposal, an investment adviser, including a fund manager, would be subject to the rules to the extent it trades for its own proprietary account or any account that the adviser controls. Discretion alone would not constitute control for purposes of aggregating a client's account.

> **SEC Sanctions Firms for Employee Use of Personal Devices and External Communications Platforms**

Please see "SEC Enforcement" for a discussion on enforcement pertaining to electronic recordkeeping.

Section 17(a) and Rules 17a-3 and 17a-4 of the Exchange Act require broker-dealers to maintain and preserve a host of business records, including incoming and outgoing, written and electronic communications. The rules specify the length of time and the manner in which the records must be stored and maintained. FINRA rules also impose recordkeeping requirements on member broker-dealers. Section 204(a) and Rule 204-2 of the Advisers Act contain similar requirements for investment advisers. See here for our summary of broker-dealer recordkeeping requirements: https://www.proskauer.com/uploads/broker-dealer-record-retention-chart.

> **SEC Staff Lets MiFID II No-Action Relief for Research Payments Expire**

On July 26, 2022, William Birdthistle, Director of the SEC's Division of Investment Management, announced that the Division would let expire on July 3, 2023, the no-action relief issued on October 26, 2017, that allows broker-dealers to accept "hard dollar" payments for research from advisers subject to the EU Markets in Financial Instruments Directive II ("MiFID II") without having to comply with the Advisers Act. The development raised the prospect that broker-dealers accepting such payments after the expiration will have to register as advisers with the SEC or the states to continue to distribute research for hard dollars.

Director Birdthistle noted "developments in the marketplace for research services" in explaining why the staff decided not to renew the relief, referring specifically to efforts by broker-dealers to register as advisers with respect to research or to deliver their hard dollar research through affiliated advisers. The timing of the announcement was intended to allow market participants time to address any issues they face as producers and consumers of hard dollar research.

As we noted in our client advisory analyzing the SEC's MiFID II no-action relief in January 2018, broker-dealers distributing research for hard dollars or specified charges under a soft dollar payment regime should consider registering as advisers with respect to the research. Advisers that consume research for client commissions or hard dollars may be obliged to ensure that it is produced by an appropriate adviser.

Our original client advisory can be found here.

You can see our videos discussing the Advisers Act implications for broker-dealers that distribute research for hard dollars or specified soft dollar payments here and here.

Foreign Corrupt Practices Act

Last year, the Biden administration established the fight against corruption as a core national security interest, and in 2022 the Biden administration continued to signal its focus on anti-corruption.

On April 24, 2022, the Financial Crimes Enforcement Network ("FinCen") released an Advisory on Kleptocracy and Foreign Public Corruption (the "FinCen Advisory") urging financial institutions to focus their efforts on detecting the proceeds of foreign public corruption. The FinCen Advisory provides typologies and potential indicators of what it calls "kleptocracy," and other forms of foreign public corruption, namely bribery, embezzlement, extortion, and the misappropriation of public assets. In addition, reminders concerning funds appear in the FinCen Advisory, including:

- FinCEN's Customer Due Diligence Rule requires banks, brokers or dealers in securities, mutual funds, and futures commission merchants and introducing brokers in commodities ("FCM/IBs") to identify and verify the identity of beneficial owners of legal entity customers, subject to certain exclusions and exemptions.
- Banks, brokers or dealers in securities, mutual funds, and FCM/IBs also are reminded to comply with their general due diligence obligations for correspondent accounts under 31 CFR § 1010.610(a), in addition to their general obligations with respect to sanctions screening and anti-money laundering/countering the financing of terrorism under 31 U.S.C. § 5318(h) and its implementing regulations (which apply to all U.S. financial institutions).
- In other developments, Stericycle, Inc. ("Stericycle"), a medical waste services company based in Illinois, entered into settlements with the SEC and the DOJ to resolve civil and criminal charges brought by authorities in the US and in Brazil relating to alleged bribery of officials in the US and Latin America. Among other enforcement measures, Stericycle paid approximately $80 million in fines and agreed to retain an "independent compliance monitor" for at least two years. The use of an independent compliance monitor represents a reversal of Trump-era guidance which discouraged its use.
- On July 13, 2022, the First Circuit ruled that the FCPA was not covered under the SOX whistleblower protection provisions, and reversed a denial of summary judgment, finding plaintiff could not show he engaged in protected activity under SOX. The decision affirms that protected activity under SOX is limited to reporting violations of "any rule or regulation" of the SEC, which does not include federal statutes like the Foreign FCPA. The First Circuit's narrow reading of what constitutes an SEC "rule or regulation" will make it more challenging for plaintiffs to show they engaged in protected activity under SOX. See our blog entry.

These developments demonstrate that the need for continued monitoring and a rigorous response plan for potential FCPA red flags remains strong.

Antitrust/HSR

In an environment where the bounds of antitrust enforcement are being tested and expanded, knowing precisely where you stand is key for advisers and private funds. The FTC and DOJ, under direction of an unprecedented Executive Order on antitrust enforcement, are on a "whole-of-government" antitrust effort that has led to roadblocks for investors across all industries. Among a rush of antitrust initiatives and priorities, private fund related enforcement has become a prime focus. The antitrust agencies' recent attention to private fund activities has transitioned from rumblings to concrete action, manifested in noteworthy enforcement actions.

The Hart-Scott-Rodino Antitrust Improvements Act of 1976 ("HSR" or "HSR Act") imposes filing and waiting period requirements for transactions that meet certain annually adjusted thresholds (currently $101 million). HSR enables antitrust regulators to review transactions and investments, investigate and address potential competitive concerns prior to completion, and carries monetary penalties for failure to comply — also adjusted for 2022, to $46,517 per day. Advisers should consider HSR filing obligations in all types of transactions, including smaller transactions, minority investments, exercises of warrants or options, and follow-on investments. Also consider the current market value of previously acquired positions to plan for potential HSR filing and waiting period requirements when participating in follow-on offerings and investments. Review minority holdings that may have appreciated above the HSR threshold, and plan for incremental purchases that may trip the initial or subsequent notification thresholds. Subsequent notification thresholds for 2022 are: $202.0 million, $1.0098 billion, 25% if valued at greater than $2.0196 billion, and 50%.

The basic HSR reporting threshold increased to $101 million, and suspension of the HSR early termination program continues, indefinitely – meaning that most HSR filings are subject to the full 30-day waiting period. Legislation is pending that would increase HSR filing fees for transactions in excess of $5 billion to $2.25 million – up from the current $280,000. If passed, the new fee for mergers between $1 billion and $2 billion, would be $400,000; for mergers between $2 billion and $5 billion the fee would be $800,000; and mergers above $5 billion would face the top tier fee of $2.25 million.

Private fund HSR enforcement remains active. Fund operator Biglari Holdings Inc. agreed to a $1.4 million civil penalty in settlement of claims that acquiring shares in Cracker Barrel Old Country Store, Inc. without filing and observing the HSR waiting period violated the HSR Act. According to the FTC, the share acquisitions, together with the firm's prior holdings in Cracker Barrel, triggered HSR reporting requirements as a result of acquiring shares beyond the 5-year period allowable under the firm's earlier HSR filing. Where HSR filings are submitted, approval of the transaction allows certain subsequent acquisitions of shares of the same issuer to take place over the following 5 years without additional HSR filing requirements.

According to the complaint in the matter, FTC's Premerger Notification Office contacted the firm and inquired as to why no filing had been made with respect to certain share acquisitions, likely indicating monitoring by the agency of certain share acquisitions. While the penalties imposed in the matter do not represent the maximum available, they attest to the potential risk of failures to file under the HSR Act. The enforcement action is a reminder not only that the HSR Act is strictly enforced, with dozens of enforcement actions under the FTC's belt, but that the application of the HSR rules is not always intuitive or clear-cut - and that routine private fund activities often can unexpectedly trigger HSR reporting requirements.

In merger settlements, the FTC's new Consent Decree policy requiring a 10-year period of prior approval of the parties' future acquisitions has also been extended to divestiture buyers. The provisions have been included in several recent consent decrees settling proposed transactions, including EnCap Energy Capital Fund XI, L.P.'s acquisition of EP Energy Corp.'s crude oil production operations in Utah's Uinta Basin and Buckeye Partners, L.P.'s acquisition of light petroleum product terminals from Magellan Midstream Partners, L.P. Private funds that acquire control positions and engage in roll-up strategies will be most directly impacted by the new more onerous approach to agency merger settlements.

The DOJ's Antitrust Division is similarly wary of merger activity and merger settlements, having gone a step further, saying "the simplest remedy [rather than settle] is to just stop an anticompetitive transaction from occurring." Antitrust Division Chief Kanter recently warned "[c]ompanies considering mergers that may harm competition should know that the Antitrust Division will not back down from a fight so long as that threat remains."

While today's antitrust enforcers are generally suspicious of M&A, they are more suspicious of serial acquisitions or roll-ups by advisers and private funds, highlighted in a June 2022 statement on the consent order settling JAB's acquisition of SAGE Veterinary Partners. The FTC has promised stepped up efforts to address such "stealth roll-ups" by private equity firms, charging that investment firms' business models may "distort incentives in ways that strip productive capacity, degrade the quality of goods and services, and hinder competition." According to the June 2022 statement, "[p]rivate equity firms playbook for purchasing or investing in companies can include tactics such as leveraged buyouts, which saddle businesses with debt and shift the burden of financial risk in ways that can undermine long-term health and competitive viability, [and] incentivize unfair or deceptive practices and the hollowing out of productive capacity." The apparent concern is that serial acquisitions are being used by investment firms to consolidate fragmented sectors, "enabling them to accrue market power and reduce incentives to compete, potentially leading to increased prices…" According to the FTC, transactions involving such strategies of multiple smaller acquisitions often are not subject to HSR reporting and can allow investment firms to "quietly increase market power and reduce competition."

The agency is particularly concerned about non-HSR reportable roll-ups in the health care sector, where "[p]rivate equity roll-ups occupy a growing proportion of this activity." Private equity acquisitions of physician practices (including specialties like anesthesiology and emergency medicine), the opioid treatment sector, in hospice care and in air ambulances have been identified as areas of significant recent consolidation. As part of its focus on private fund investment activity, the FTC Chair has promised closer scrutiny of HSR filings by private equity firms "to gain insight on their future acquisitions that may be non-reportable" and is pursuing potential changes to the HSR Act or its implementing regulations "that would help the agency detect harmful roll-up activity." Still, agencies are not the final word, and recent losses at both the FTC and DOJ, including with respect to sponsor backed businesses, demonstrate a judiciary that is cautious of overreach and respectful of the limits of antitrust law and agency enforcement.

The DOJ has doubled down on its enforcement efforts relating to Clayton Act Section 8 and its prohibition on director overlaps between competitors. Section 8 has particular import for advisers and private funds taking minority positions in competing companies and seeking board representation. The DOJ has begun issuing letters and opening investigations triggered by information disclosed in HSR flings, and sometimes public SEC filing. The letters warn that enforcement may be initiated with respect to alleged Section 8 violations.

Under the statute, no person, or representative of the same person or entity, may serve simultaneously as a director or officer of competing companies, but there are carve-outs and exceptions. The prohibitions of Section 8 are limited to cases in which each of the companies has, under the revised thresholds for 2022, capital, surplus, and undivided profits of more than $41,034,000. Even where the threshold is met, the restrictions do not apply where the competitive sales of either company represent less than 2 percent of its total sales, or are less than $4,103,400; or where the competitive sales of each company represent less than 4 percent of its total sales. Importantly, the statute also permits directors and officers whose appointments were not prohibited at the time of appointment to continue to serve for up to a year after the Section 8 thresholds are exceeded, thus the revised Clayton Act Section 8 thresholds can potentially eliminate an existing violation, which is not the case with the HSR threshold adjustments.

Committee on Foreign Investment in the United States

The Committee on Foreign Investment in the U.S. ("CFIUS") now plays a prominent part in private fund transactions in a number of ways. First, private funds that are managed or operated outside the U.S. regularly need to review investment activities and the extent to which CFIUS filing requirements or risk assessment issues are implicated. This is especially so with respect to transactions implicating critical technology. The top acquirers of U.S. critical technology include firms in Germany, United Kingdom ("UK"), Japan, South Korea, Cayman Islands, Canada and China.

For U.S. private fund advisers, the recurring question is how to take on non-U.S. investors while managing CFIUS compliance and not implicating potential foreign control of the private fund. The framework and rules for such evaluations have now been in place for several years following the historic enactment of the CFIUS update legislation, FIRRMA, in 2018. What continues to change – tighten – is the CFIUS enforcement posture leading to more reviews of notified transactions and more *sua sponte* investigations of transactions that were not subject to notification and filing requirements. There were 135 transactions identified through the non-notified/non-declared process in the most recent reporting year that were put forward to CFIUS for consideration. From the transactions identified, eight transactions resulted in a request for filing.

President Biden issued a sweeping Executive Order on CFIUS enforcement and priorities in 2022 – the first such EO since CFIUS was established in 1975. The EO expands the list of factors CFIUS considers when reviewing transactions for national security risks. While the EO did not change CFIUS jurisdiction or filing requirements, it is a manifestation of the policy changes we've seen with respect to how foreign investment in the U.S. is reviewed and scrutinized in the current regulatory and political landscape. Broadly, the following five factors are identified by the EO as key to CFIUS review of national security risk with respect to foreign investment in the U.S.: (1) the effect on the resilience of critical U.S. supply chains; (2) the effect on U.S. technological leadership; (3) industry investment trends; (4) cybersecurity risks that threaten to impair national security; and (5) risks to U.S. persons' sensitive data.

China is not specifically identified in the EO, and the Biden administration has said publicly that: while "issues of geography, jurisdiction, [and] makeup of the investors would certainly go into . . . risk analysis, there's nothing that's . . . China-specific about this order or CFIUS" Still, the EO recognizes that "some countries use foreign investment to obtain access to sensitive data and technologies for purposes that are detrimental to U.S. national security," and the sentiment among practitioners and investors is that the issues identified in the order skew towards Chinese investors. Biotech has been identified as a focus with respect to CFIUS reviews and enforcement, and, in addition to applying additional scrutiny with respect to cybersecurity and sensitive data sharing, the EO specifically calls out certain industries that are "fundamental to national security." These include: microelectronics, artificial intelligence, biotechnology and biomanufacturing, quantum computing, advanced clean energy (such as battery storage and hydrogen), climate adaptation technologies, critical materials (such as lithium and rare earth elements), and elements of the agriculture industrial base that have implications for food security. According to Treasury Secretary Yellen, who serves as chair of CFIUS, "Strengthening our supply chains and protecting against foreign threats enhances our national security, and this Executive Order highlights CFIUS's important role in that work. It also reaffirms CFIUS's mission to protect America's technological leadership and the security of our citizens' sensitive data from emerging threats." The EO also identifies aggregate industry investment trends as a factor for the Committee to consider when reviewing transactions – akin to the scrutiny of roll-ups we are seeing with respect to enforcement under other regulatory regimes, namely antitrust.

Other expansions aimed at maintaining U.S. technological leadership include proposed legislation aimed at monitoring *outbound* investment -- so-called "reverse CFIUS." The most recent versions of the reverse CFIUS (or outbound CFIUS) bills did not make it into legislation; lawmakers aimed to attach it to the CHIPS Act. Thus, reverse CFIUS is not yet law, though expectations are that there will be continued bipartisan support for such measures, and the Biden administration has signaled its willingness to sign. Expect some form of reverse CFIUS requiring notification and review with respect to outbound investment that enhances capabilities with respect to a "National Critical Capability" in China and certain other countries. "National Critical Capabilities" would likely implicate industries relating to semiconductors, large-capacity batteries, pharmaceuticals, AI, and quantum computing.

The CFIUS annual report for 2021 issued in 2022 reveals a number of noteworthy trends with respect to CFIUS flings and enforcement. Parties now have the option in all transactions to comply with CFIUS by short-form Declaration or full long-form Joint Notice. Under FIRRMA, CFIUS is authorized to take the following actions after its assessment of submitted short-form Declarations:

- Request that the parties file a long-form submission;
- Initiate a unilateral review; or
- Notify the parties that the Committee has concluded all action.

According to the report, there were 164 such Declaration filings for the most recent reporting year. Of those, 47 were subject to mandatory filing requirements, and 30 resulted in requests for long-form filings. Most Declaration filings (2/3) are from allied countries, including: Canada, Japan, United Kingdom, Germany, South Korea, Singapore, France, Cayman Islands, Guernsey, and Sweden. The implication is that parties are more willing to take the risk of a short-form filing where the risk profile of the buyer is lower.

China remains the single largest source of long form-filings, as Chinese investors and buyers viewed as presenting heightened CFIUS risk are less likely to initiate review by short-form Declaration filing. There were no Presidential decisions issued (i.e. transactions blocked) in 2021, versus 5 in prior 5 years. There were 272 long-form filings, 130 of which were subject to subsequent investigations, including 26 that were ultimately subject to mitigation measures (approximately 10 percent). According to the report, mitigation measures and conditions typically included elements of the following in the most recent reporting year for CFIUS:

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

> exclusion of certain sensitive U.S. assets from the transaction;

> ensuring that only authorized vendors supply certain products or services;

> prior notification to and approval by relevant U.S. Government parties in connection with any increase in ownership or rights by the foreign acquirer; and

> divestiture by the foreign acquirer of all or part of the U.S. business.

Key takeaways are that CFIUS enforcement continues on the upswing trajectory, and should remain on the short list of regulatory and compliance items to address early and proactively in every transaction that may involve non-U.S. funding.

Anti-Money Laundering and Sanctions Enforcement Updates

> Russia Sanctions

In response to Russian President Vladimir Putin's decision to invade Ukraine in February 2022, the U.S. government imposed sweeping sanctions against Russia, including on major Russian financial-institutions, Russian oligarchs, and members of Russian President Vladimir Putin's inner circle, and even Putin himself. The U.S. Department of Treasury's Office of Foreign Assets Control ("OFAC") has implemented these sanctions by rolling out a series of new directives, general licenses, and guidance pursuant to various executive orders. Below is a summary of the most notable sanctions.

Sanctions on DNR and LNR Regions

On February 21, 2022, President Biden issued Executive Order 14065 ("EO 14065") sanctioning Russia for its recognition of the so-called Donetsk People's Republic (DNR) and Luhansk People's Republic (LNR) regions of Ukraine. The Order broadly prohibits:

- New U.S. investment in the so-called DNR or LNR regions of Ukraine;
- Imports from those regions;
- Exports, sales, or supply from or by the U.S. to those regions; and
- U.S. approval, financing, facilitation, or guarantee of transactions by a foreign person engaged in the above prohibited categories.

EO14065 also blocks and prohibits the transfer, payment, export, and withdrawal of all property and interests in property in the U.S. of anyone determined to be operating in the DNR or LNR regions.

Following EO 14065, OFAC issued General Licenses authorizing certain transactions such as those involving agriculture and medicine, telecommunications and mail, personal remittances, and wind-down transactions.

Russian Sovereign Debt

On February 22, 2022, OFAC issued Directive 1A, concerning trading in Russian sovereign debt. Directive 1A expands previously issued Directive 1 under Executive Order 14024 ("EO 14024"), which was issued on April 15, 2021 in response to Russia's attempts to undermine the 2020 presidential election and its facilitation of cyber-attacks and other national security threats.

Directive 1A prohibits U.S. financial institutions from participating in the primary market for ruble or non-ruble bonds issued by or lent to the Central Bank of the Russian Federation, the National Wealth Fund of the Russian Federation, or the Ministry of Finance of the Russian Federation, and from participating in the secondary market for ruble or non-ruble bonds issued by the same entities. "U.S. financial institutions" is defined broadly, and includes "any U.S. entity (including its foreign branches) that is engaged in the business of accepting deposits, making, granting, transferring, holding, or brokering loans or credits, or purchasing or selling foreign exchange, securities, futures or options, or procuring purchasers and sellers thereof, as principal or agent."

Sanctions on Russian Banks and State-Owned Entities

The U.S. imposed unprecedented sanctions that directly target Russian financial institutions — including the two largest banks, Sberbank and VTB. The U.S. also designated many other major banks and state-owned entities as Specially Designated Nationals ("SDNs").

The U.S. with the UK and EU have removed a number of Russian banks, including Sberbank and VTB, from the Society for Worldwide Interbank Financial Telecommunication ("SWIFT"), which is the dominant messaging network used by over 11,000 entities worldwide to quickly and securely send and receive cross-border money transfers. This is arguably one of the harshest measures as it effectively cuts off Russian financial institutions and banks from financial markets across the world.

OFAC also imposed full blocking sanctions on VTB Bank, freezing all assets in U.S. financial institutions, as well as broadly prohibiting U.S. persons from transactions and other dealings with VTB. OFAC imposed similar blocking sanctions against a number of other major Russian financial institutions.

As for Sberbank, OFAC issued Directive 2 which prohibits U.S. financial institutions from opening or maintaining correspondent accounts or payable-through accounts, or processing any financial transaction for Sberbank and a number of its affiliates and subsidiaries.

In addition, Directive 3 under EO 14024, prohibits all U.S. persons, not just U.S. financial institutions, from conducting transactions for new debt of longer than 14 days maturity and new equity of certain Russian state-owned enterprises and entities that operate in the financial services sector of the Russian Federation economy.

In conjunction with these sanctions, OFAC issued General Licenses authorizing limited exceptions for certain transactions involving international organizations and entities, agriculture and medicine, overflight and emergency landings, energy, certain dealings in debt and equity, derivative contracts, wind-down of transactions with blocked persons, and rejection of blocked transactions.

New Investment

In March and April 2022, the Biden Administration issued three new executive orders, which prohibit U.S. persons from making "new investments" in (1) the Russian Federation's energy sector (2) any sector of the Russian Federation economy as determined by Treasury and (3) the Russian Federation. OFAC defined "investment" as "the commitment of capital or other assets for the purpose of generating returns or appreciation." Investments are considered "new" if the transaction occurs after the effective date of the relevant executive order. Executive Order 14071 also prohibits U.S. persons from providing accounting, trust and corporate formation, and management consulting services to any person located in Russia.

In June 2022, OFAC issued guidance, in the form of Frequently Asked Questions (FAQs), that broadly interpret the meaning of "new investment." The FAQs clarify that U.S. persons are prohibited from purchasing both new and existing debt and equity securities issued by any entity in Russia. In some circumstances, the sanctions also ban U.S. persons from lending funds to, or purchasing an equity interest in, entities located outside of Russia. Investments outside of the Russian Federation could still potentially violate the current sanctions where they are (1) specifically intended for new projects or operations in the Russian Federation; and (2) the target entity's revenues are "predominantly derived from its investments in the Russian Federation." (OFAC FAQ 1055).

Sectoral Sanctions

The U.S. continues to maintain certain sanctions targeting specific sectors of the Russian economy. Pursuant to Executive Order 13662, OFAC issued directives implementing sectoral sanctions against entities identified on the Sectoral Sanctions Identification List (SSI List) operating in certain sectors of the Russian economy such as financial services, energy, metals and mining, engineering and defense and related material.

Designation of Russian Leaders and Oligarchs

OFAC directly sanctioned Vladmir Putin himself and Russian Minister of Foreign Affairs Sergei Victorovich Lavrov, as well as other Russian Security Council members and enablers of Putin. In addition, OFAC designated a number of Russian elites, including families and other kleptocrats associated with Putin. With these sanctions, all property and interests in property of the designated individuals that are in the United States or in the possession or control of U.S. persons are blocked and must be reported to OFAC. OFAC's 50% rule also applies, which means that any entities that are owned, directly or indirectly, 50 percent or more by one or more blocked persons, individually or in the aggregate, are also blocked.

KleptoCapture

Alongside sanctions, the DOJ created a new task force, "KleptoCapture," focused on seizing assets belonging to sanctioned persons and criminal actors, and specifically targeting the crimes of Russian oligarchs and those who aid or conceal their unlawful conduct.

SEC Guidance for Companies Affected by Russia Sanctions

The ever-changing regulatory and enforcement environment created by the Russian invasion of Ukraine poses unique risks for companies seeking to navigate the global landscape, both in terms of their actions and their public-facing statements. In May 2022, the SEC issued guidance on how affected companies should disclose the affect the conflict is having on their operations, including the impact of evolving sanctions. The guidance, posted by the Division of Corporation Finance on May 2, 2022, advises impacted companies to consider disclosure about a variety of topics, including, if material, whether they have direct or indirect operations, investments, or employees in Russia, Ukraine, or Belarus that may be affected by the war; whether they have material direct or indirect reliance on goods in Ukraine, Russia, or countries supportive of Russia; whether the war is having or is expected to have material impacts on a company's supply chain; or whether the company has material business relationships, assets, or other connections to Russia, Ukraine, or Belarus.

> Digital Currency Regulation

This year Treasury continued to focus its efforts on the digital assets space, which if left unchecked could harm the efficacy of OFAC sanctions and anti-money laundering laws and regulations.

In 2021, OFAC entered into settlement agreements with two cryptocurrency payment processing platforms, for allowing persons in sanctioned jurisdictions to engage in digital currency-related transactions with the companies' merchant customers in violation of multiple sanctions.

In 2022, Treasury pursued virtual currency "mixing services," which blend funds from separate blockchain transactions together to make their sources difficult to trace. FinCEN brought enforcement actions against two virtual currency mixers and OFAC sanctioned two others. One of these mixers is Tornado Cash, a smart contract that allowed users to anonymize the senders and recipients of virtual currency over the Ethereum blockchain. Despite knowing that users could conduct transactions anonymously, Tornado Cash continued to operate and did not take any of the steps to screen users for sanctions compliance. Accordingly, OFAC designated Tornado Cash for facilitating the laundering of billions of dollars, including those committed by a hacking organization sponsored by the North Korean government. In October 2022, OFAC and FinCEN announced a global settlement with a cryptocurrency exchange and hosted wallet provider, Bittrex Inc., for sanctions and AML violations. The Bittrex settlement represents the largest penalty ever against a cryptocurrency company for sanctions violations, exceeding $29 million.

Just like other cryptocurrency platforms, NFT platforms have also caught Treasury's attention. The emergence of the digital art market, where digital art with no physically tangible presence is traded, has provided fertile ground for illicit actors looking to launder money. In a report published in February 2022, Treasury proposed that platforms offering NFTs may be considered virtual asset service providers under FinCEN regulations, depending on the nature and characteristics of NFTs offered. Sanctions are also a potential area of regulation and enforcement for transactions involving NFTs. If engaging in transactions with parties subject to sanctions, NFTs could be blocked property like anything else.

Treasury's actions reflect a trend of holding digital currency companies accountable for failing to prevent sanctions or AML violations by third-party users.

Enforcement of sanctions in the digital assets space is also crucial to efforts to combat the growing threat that ransomware poses to the public and economy. OFAC sanctions have increasingly targeted individuals and entities that have used virtual currency in connection with malign activity. For example, in September 2021, OFAC designated a Russian-based virtual currency exchange (SUEX) for facilitating financial transactions for ransomware actors. In November 2021, OFAC sanctioned another virtual currency exchange, Chatex for its facilitation of ransomware payments.

In October 2021, OFAC released detailed guidance to help companies in the digital currency industry protect themselves from sanctions violations and the intentional misuse of digital currencies and platforms by actors attempting to evade sanctions and undermine U.S. foreign policy and national security interests. This guidance follows OFAC's issuance of an updated ransomware advisory on sanctions risks for making or facilitating ransomware payments, which discourages all private companies and citizens from paying ransom or extortion demands.

> Strict Liability and Framework for Compliance

OFAC sanctions apply with strict liability, meaning that a U.S. person can violate U.S. sanctions without having knowledge or reason to know it was engaging in a transaction that was prohibited under sanctions laws and regulations administered by OFAC. However, OFAC takes into consideration the totality of facts and circumstances surrounding an apparent violation to determine the appropriate response and where applicable, the appropriate amount of a civil monetary penalty. For example, where ransomware attacks are concerned, Treasury announced in 2020 that any payment made to a sanctioned entity on OFAC's list is a violation of federal sanctions regulations and the paying entity is strictly liable. However, when determining an appropriate enforcement response, Treasury will consider the following mitigating factors (i) the strengthening of defensive and resilience measures to prevent and protect against ransomware attacks, (ii) the reporting of ransomware attacks to appropriate U.S. government agencies, and (iii) a company's implementation of a risk-based OFAC compliance program, which is outlined in A Framework for OFAC Compliance Commitments, published by Treasury in May 2019.

In its Framework, OFAC suggested for the first time that companies have an affirmative obligation to maintain an effective sanctions compliance program, which signaled that firms must now comply with OFAC's expectations by taking affirmative steps to understand and effectively address their sanctions risks.[18] Advisers to private funds should note this development, as all U.S. persons are required to comply with OFAC sanctions.

While failing to implement a sanctions compliance program is not itself a violation of OFAC's regulations, maintaining a sanctions compliance program has always been a mitigating factor in the assessment of monetary penalties in OFAC enforcement actions. A compliance program that falls short of the basic requirements outlined in OFAC's Framework may be viewed as a separate aggravating factor leading to increased monetary penalties in the event of a violation.

It is clear from the Framework that OFAC expects to see firms maintain more than just a check-the-box program. The guidance acknowledges that a firm's risk-based compliance program will depend on several factors, including the size and sophistication of firm, the products and services it offers, the nature of its customers and counterparties, and the geographic locations in which the firm operates. At the same time, OFAC identifies five essential components that every compliance program should incorporate: (1) support from senior management; (2) periodic risk assessments; (3) internal controls, including policies and procedures designed to identify, interdict, escalate, report, and maintain records related to activity that is prohibited by OFAC administered sanctions programs; (4) periodic testing and auditing; and (5) periodic training for all appropriate employees. In evaluating these criteria, OFAC appears focused on practical indicia that firms are committed to sanctions compliance, including how resources are allocated and the quality and experience of relevant personnel. Recent enforcement actions in the months following the guidance underscore OFAC's new emphasis on the importance of compliance programs.

In light of OFAC's Framework and recent guidance, advisers to private funds should take a hard look at their current sanctions compliance programs and consider implementing or enhancing existing procedures to attempt to ensure they do not engage in unauthorized transactions or with sanctioned persons or jurisdictions. In issuing penalties in recent years, OFAC continued to recognize the presence of an OFAC compliance program in its settlements.

> SEC Examinations for Funds with an Affiliated Broker-Dealer or Investment Company

AML issues should also be top of mind for advisers to private funds that have an affiliated broker-dealer or investment company. In March 2022, the Exams Division announced its 2022 examination priorities. Just as it did in past years, the Exams Division stated it intends to "continue to prioritize examinations of broker-dealers and registered investment companies for compliance with their AML obligations." In particular, the Exams Division intends to focus on whether such firms are filing suspicious activity reports with FinCEN, as appropriate, and whether they have established appropriate customer identification programs and are conducting due diligence on customers. During examinations, the Exams Division also intends to focus on whether firms are complying with beneficial ownership requirements, which as described below have changed, and conducting independent tests of their AML program on a timely basis. According to the Exams Division, "[t]he goal of these examinations is to evaluate whether broker-dealers and registered investment companies have adequate policies and procedures in place that are reasonably designed to identify suspicious activity and illegal money-laundering activities." The SEC's continued focus on AML affects even those private funds that are not subject to a mandatory AML program rule, due to enhanced scrutiny facing private fund affiliates, counterparties, and institutions that custody funds.

Potential areas for examination could include compliance with new beneficial ownership requirements,

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

books and records requirements, and suspicious activity reporting. For example, in *SEC v. Alpine Securities Corp.*, the Southern District of New York suggested that the SEC's books-and-records authority under Exchange Act rule 17a-8, allows the SEC to bring enforcement actions based on the reporting of potentially suspicious transactions under the Bank Secrecy Act, expanding the SEC's jurisdiction over AML cases.

Over the last several years, the total amount of AML penalties imposed globally has been steadily rising, to more than $10.4 billion in 2020. Financial institutions in the United States took the brunt of the penalties in 2020, at $7.5 billion, led by a large investment bank, which was hit with nearly $7 billion in global fines in connection with three bond offerings the firm had structured and arranged for Malaysia's state development fund 1MDB. There has also been an increased focus on individual penalties of late – in 2020 over 200 individuals were fined nearly $90 million for related breaches.

> The Financial Crimes Enforcement Network Updates Regulations Concerning the Bank Secrecy Act

The past few years have been transformative for AML laws and regulations. In January 2021, Congress enacted the Anti-Money Laundering Act of 2020 (the AMLA), which made sweeping reforms to the Bank Secrecy Act. Part of the AMLA is the Corporate Transparency Act (the CTA) which, requires reporting companies to file a report with FinCEN that identifies the companies' beneficial owners and applicants. The purpose of the CTA is to "better enable critical national security, intelligence, and law enforcement efforts to counter money laundering, the financing of terrorism, and other illicit activity."

In September 2022, pursuant to the CTA, FinCEN issued a final rule establishing a beneficial ownership information reporting requirement, which requires most corporations and companies in the United States to report information about their beneficial owners – the persons who ultimately own or control the company – to FinCEN. The reporting requirement, which is intended to increases transparency of the US financial system, will not take effect until January 1, 2024, and reporting companies registered before the rule takes effect will have one year to file their reports. The new rule is designed in part to discourage the use of shell companies by money launderers or illicit actors.

Last year, FinCEN published a list of enforcement priorities to assist covered institutions to meet their obligations to combat money laundering and counter-terrorism financing. In order, the new priorities are: (1) corruption; (2) cybercrime, including relevant cybersecurity and virtual currency considerations; (3) foreign and domestic terrorist financing; (4) fraud; (5) transnational criminal organization activity; (6) drug trafficking organization activity; (7) human trafficking and human smuggling; and (8) proliferation financing.

The AMLA also enhanced DOJ and Treasury subpoena authority for non-U.S. bank records, so long as those banks hold correspondent accounts with U.S. financial institutions. Both DOJ and Treasury are now able to demand information about any account from the foreign bank, including records maintained outside the United States.

As discussed above, Crypto-currencies and NFTs will continue to be of interest to FinCEN in 2023, as the AMLA broadened various definitions throughout the BSA to include virtual currency, codifying previously issued guidance by the regulatory agency. And finally, the AMLA substantially increased penalties for BSA violations.

On the rulemaking front, on June 23, 2022, FinCEN issued a press release informing financial institutions of updates to the Financial Action Task Force's ("FATF") list of jurisdictions with strategic deficiencies in their regimes regarding anti-money laundering, combating the financing of terrorism and counter-proliferation financing. Financial institutions should review FATF statements regarding their obligations and risk-based policies, procedures, and practices while dealing with relevant jurisdictions.

On October 15 and November 8, 2021, FinCEN published financial trend analysis focusing on ransomware patterns and trend information identified in Bank Secrecy data between January 2021 and June 2021. To date, the analysis has not been updated, but it continues to demonstrate that ransomware is an increasing threat to the U.S. financial sector, businesses, and the public. The total number of SARs from January 1, 2021 to June 30, 2021 was 30% higher than the total for the entire 2020 calendar year. The total value of suspicious activity reported in ransomware-related SARs during the first six months of 2021 was $590 million, exceeding the value reported for all of 2020 ($416 million). Accordingly, FinCEN recommended that financial institutions: (1) incorporate Initial Operating Capabilities ("IOCs") from threat data sources into intrusion detection systems and security alert systems to block or report suspected malicious activity; (2) contact law enforcement immediately regarding any ransomware activity, and contact the Office of Foreign Assets Control if there is any reason to suspect the cyber actor demanding ransomware payment may be sanctioned or have a sanctions nexus; (3) report suspicious activity to FinCEN; and (4) review FinCEN's October 1, 2020 advisory on financial red flag indicators of ransomware mentioned above.

U.S. Tax

> Inflation Reduction Act Signed into Law

On August 16, 2022, President Biden signed the legislation, named the Inflation Reduction Act of 2022 (the "IRA"), into law. Enactment of any significant tax legislation appeared unlikely after Senator Joe Manchin had previously retracted support for the Biden administration's ambitious "Build Back Better" plan in December of 2021. However, in late July, Senators Joe Manchin and Chuck Schumer announced they had reached an agreement on legislation that amounted to a scaled back and heavily revised version of Build Back Better. For a discussion of the proposed tax reform provisions in Build Back Better, please see our December 19, 2021 blog post.

The IRA contains certain tax provisions designed to raise revenue, including a 15% corporate alternative minimum tax, a 1% excise tax on stock buybacks and a two-year extension of the excess business loss limitation rules. The IRA also contains a number of energy tax provisions.

Main Tax Provisions

15% corporate alternative minimum tax

The IRA imposes a 15% corporate alternative minimum tax on corporations which meet a three-year taxable year average annual adjusted financial statement income in excess of $1 billion. In general, the test is met with respect to a particular tax year only if the average annual adjusted financial statement income for the three-taxable-year period ending with such tax year exceeds $1 billion. The corporate alternative minimum tax is effective for tax years beginning after December 31, 2022.

The average annual adjusted financial statement income of a corporation includes any other entities that are treated as a single employer with the corporation under section 52 to determine whether the corporation satisfies the $1 billion threshold. This may cause corporations with less than $1 billion of adjusted financial statement income to be subject to the tax. Although prior proposals would have amended section 52 essentially to provide that portfolio companies of an investment fund generally would be aggregated with other portfolio companies for purposes of the $1 billion threshold, this amendment *did not* make it into the IRA.

The 15% corporate alternative minimum tax is equal to the difference between a corporation's "adjusted financial statement income" for the taxable year and the corporation's "alternative minimum tax foreign tax credit" for the taxable year. A corporation's tax liability is the greater of its regular tax liability and the 15% alternative minimum tax.

A corporation's annual adjusted financial statement income is based on its book income, with certain adjustments, such as to account for a corporation's activities undertaken indirectly through a consolidated group, a partnership, or a disregarded entity. The adjusted financial statement income is also adjusted for certain taxes, such as federal income and excess profits taxes, and accelerated depreciation.

For corporations in existence for less than three years, the three-year income test is applied over the period during which the corporation was in existence. The adjusted financial statement income of a corporation with a taxable year shorter than 12 months is applied on an annualized basis.

The corporate alternative minimum tax applies to a foreign-parented corporation (i.e., a U.S. subsidiary of a foreign parent) if its three-year taxable year average annual adjusted financial statement income exceeds $100 million and that of the foreign-parented multinational group exceeds $1 billion. It is not clear whether the $100 million threshold is tested on a separate basis or on aggregate basis so that, for example, the adjusted financial statement income of two domestic subsidiaries of a common foreign parent (neither of which would separately meet the $100 million threshold) would be aggregated. The Secretary has the authority to issue regulations on the threshold tests.

Excise tax on corporate stock buybacks

The IRA imposes a nondeductible 1% excise tax on stock repurchases by *publicly traded* domestic corporations (including certain publicly traded inverted foreign corporations treated as "surrogate foreign corporations") and domestic subsidiaries of publicly traded foreign corporations. The tax applies to repurchases of stock after December 31, 2022.

The tax is imposed on the fair market value of the stock "repurchased" by the corporation during the tax year, reduced by value of stock issued by the corporation during the tax year (including those issued to the employees).

The term "repurchase" is defined broadly as a redemption within the meaning of section 317(b), which is a transaction in which a corporation acquires its stock from a shareholder (and is not a dividend for federal income tax purposes). The statute's broad applicability apparently would include repurchases of non-traded stock acquired in privately negotiated transactions and stock that is redeemable (such as redeemable preferred stock), even if such stock was issued prior to enactment.

Prior to enactment of the IRA, stock buybacks allowed some shareholders to defer tax until they sold their stock—which may result in permanent avoidance in some cases (e.g., by holding until death when the basis of the stock is stepped-up or in the case of foreign shareholders—who generally don't general pay US tax on capital gains).

Repurchases that are (i) dividends for federal income tax purposes, (ii) part of tax-free reorganizations, (iii) made to contribute stock to an employee pension plan or ESOP, (iv) made by a dealer in securities in the ordinary course of business, or (v) made by a RIC or a REIT is not be subject to the excise tax. Repurchases that are less than $1 million in a year are also excluded.

The IRS has the authority to issue regulations to prevent abuse through the above exclusions and apply the rules to other classes of stock and surrogate foreign corporations. It is not clear how broad that authority is intended to be and whether the Secretary will issue guidance on certain common transactions, such as redemptions of preferred stock or of a non-publicly traded subsidiary's debt that is exchangeable for its publicly-traded parent's stock.

Extension of excess business loss limitation rules

Under pre-IRA law, for taxable years that begin before January 1, 2027, non-corporate taxpayers may not deduct excess business loss (generally, net business deductions over business income) if the loss is in excess of $250,000 ($500,000 in the case of a joint return), indexed for inflation. The excess loss becomes a net operating loss in subsequent years and is available to offset 80% of taxable income each year.

The IRA extends the excess business loss limitation rules to taxable years that begin before January 1, 2029.

The IRA's amendments apply to taxable years beginning after December 31, 2026.

The IRA also includes a number of energy tax provisions, which are summarized in our August 8, 2022 blog post.

Provisions Excluded from the IRA

Notably, the IRA did not include any changes to the carried interest rules. The proposed version of the IRA released on July 27, 2022 included provisions changing the taxation of carried interest that were ultimately removed from the version that was passed.

Under current law, a "carried" or "profits" interest in a partnership received in exchange for services is generally not taxable when received and the recipient is taxed on their share of partnership income based on the character of the income at the partnership level. Section 1061 requires certain carried interest holders to satisfy a three-year holding period – rather than the normal one-year holding period – to be eligible for the long-term capital gain rate.

Prior proposals would have amended section 1061 to extend the holding period for long-term capital gain treatment on all income (including dividends) from three years to five years (or longer) (the "holding period exception"). Under the July version of the IRA, for example, the holding period exception for long-term capital gain treatment would have applied to amounts realized after the date that is five years after the latest of (i) the date on which the taxpayer acquired substantially all of the carried interest with respect to which the amount is realized; (ii) the date on which the partnership in which the carried interest is held acquired substantially all of its assets; or (iii) if the partnership owns, directly or indirectly, interests in one or more other partnerships, the dates determined by applying rules similar to the rules in (i) and (ii) in the case of each other partnership.

In the proposed legislation, the term "substantially all" was not defined and it was unclear how these rules would have applied. Many private funds, for example, acquire their investments over a number of years (some of which are held in partnerships which themselves may make further investments). Consequently, the five-year holding period could easily be much longer in practice.

Taxpayers (other than trusts and estates) with adjusted gross income of less than $400,000 per taxable year or with income from a real property trade or business would have remained subject to the current holding period of three years.

For further discussion of the previously proposed changes to carried interest taxation, please see our May 23, 2022 blog post.

> Summary of the Biden Administration's Fiscal Year 2023 Green Book Tax Proposals

On March 28, 2022, the Biden Administration released the Fiscal Year 2023 Budget, and the "General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals," which is commonly referred to as the "Green Book." The Green Book summarizes the Administration's tax proposals contained in the Budget. The Green Book is not a proposed legislation and each of the proposals will have to be introduced and passed by Congress. Note many of these proposals were not included in the IRA, but may remain salient as part of the Biden Administration's policy objectives.

The Green Book Proposes Significant Changes to Certain Tax Provisions

Business taxation

- Increase the corporate income tax rate from 21% to 28%

Individual taxation

- Impose a 20% minimum tax on individuals who have more than $100 million in assets
- Treat death as a realization event

International taxation

- Enact a 15% minimum "undertaxed profits rule" (a "UTPR") to replace the "Base Erosion Anti-Abuse Tax" ("BEAT"), and a 15% "qualified domestic minimum top-up tax" (a "QDMTT"). These proposals are intended to comply with "Pillar Two" – the "Global Anti-Base Erosion" ("GloBE") rules – of the "Inclusive Framework on Base Erosion and Profit Shifting" ("BEPS"), agreed to by the OECD/G20 member states on October 8, 2021
- Increase the "Global Intangible Low-Taxed Income" ("GILTI") rate from 10.5% to 20%
- Provide a 10% tax credit for expenses incurred in "onshoring" and deny deductions for "offshoring" a U.S. trade or business
- Authorize the IRS to issue regulations to allow taxpayers to make retroactive "qualified electing fund" ("QEF") elections for their "passive foreign investment companies" ("PFICs") without requesting IRS consent

Cryptocurrency taxation

- Apply securities loan rules to digital assets

- Apply the mark-to-market rules to digital asset dealers and traders
- Require information reporting for digital asset transactions

Taxation of investments in real property

- Restrict deferral of gain for like-kind exchanges under section 1031
- Treat 100% of depreciation recapture on the sale of section 1250 property as ordinary income

Partnership taxation

- Tax carried interests as ordinary income
- Prevent basis shifting by related partners
- Include the 3.8% Medicare tax and self-employment taxes in the centralized partnership audit regime

Private Foundation Taxation

- Limit use of donor advised funds ("DAFs") to avoid private foundation payout requirement

Please see our July 21, 2022 blog post for a discussion of each of these proposed changes.

- **Proposed Regulations Regarding the Aggregate Treatment for Pass-Through Owners of PFIC Stock**

On January 25, 2022, the IRS and the Department of the Treasury ("Treasury") released regulations (the "Final Regulations") finalizing provisions in prior proposed regulations which generally would treat domestic partnerships as *aggregates* of their partners (rather than as entities) for purposes of determining income inclusions under the Subpart F provisions applicable to certain shareholders of controlled foreign corporations. Under the aggregate approach, a partner in a domestic partnership would have a Subpart F inclusion from an underlying CFC only if the partner itself is a US shareholder of the CFC.

The IRS and Treasury also released new proposed regulations (the "Proposed Regulations") which would broaden the aggregation approach to domestic partnerships and S corporations that own stock of PFICs. Under the Proposed Regulations, this aggregation treatment would apply for purposes of making the QEF election or the PFIC mark-to-market ("MTM") election, recognizing QEF inclusions or MTM amounts, making PFIC purging elections, the CFC overlap rule, and filing Forms 8621. Thus, for example, a domestic partner, rather than the domestic partnership, would make a QEF election (and file Form 8621) in respect of PFIC stock held by the partnership.

The Proposed Regulations would require each electing partner (or S corporation shareholder) to notify the partnership (or S corporation), respectively, of its election in order to assist the partnership (or S corporation) with information reporting and tracking basis in the QEF stock. In addition, each partner (and S corporation shareholder) would include its pro rata share of ordinary earnings and net capital gain attributable to the QEF stock as if such person owned its share of the QEF stock directly, and not as a share of the pass-through entity's income.

Responding to questions regarding whether the aggregate approach was administrable, the Treasury Department and the IRS request comments on whether the final regulations should permit a domestic partnership-level (or S corporation-level) QEF election on behalf of its partners (or shareholders). With respect to preexisting QEF elections made by a domestic partnership (or an S corporation), the Proposed Regulations would effectively treat the preexisting QEF election as if it were made by each partner or S corporation shareholder owning an interest in the preexisting QEF.

The Final Regulations apply to tax years of a foreign corporation beginning on or after the date that the regulations are filed with the Federal Register. Domestic partnerships may, however, apply the regulations to tax years of a foreign corporation beginning after 2017, subject to consistency requirements. The Proposed Regulations would apply to tax years beginning on or after the date adopted as final regulations.

> Additional Reporting Requirements for Certain Taxpayers: Schedules K-2 and K-3

Starting from taxable year 2021, certain taxpayers are required to prepare Schedules K-2 and K-3 with Forms 1065, 1102-S and 8865. The two new schedules provides standardized reporting for items of international tax relevance. Schedule K-2 summarizes all partners' share of such items and will be filed with Schedule K. Schedule K-3 informs each partner of its share of the partnership's items of international tax relevance.

For tax year 2021, the IRS provided certain penalty relief for the transition period in Notice 2021-39. For taxable years that began in 2021, a partnership required to file Form 8865 will not be subject to the relevant penalties for any incorrect or incomplete reporting on the Schedule K-2 and K-3 if it establishes to the satisfaction of the IRS Commissioner that it has made a good faith effort to comply with filing requirements (and Schedule K-3 furnishing requirements) per the instructions.

> Secondary Withholding Liability Under Section 1446(f) Set to go into Effect

Enacted as part of the "Tax Cuts and Jobs Act," Section 1446(f) generally requires a transferee, in connection with the disposition of a partnership interest by a non-U.S. person, to withhold and remit ten percent of the "amount realized" by the transferor, if any portion of any gain realized by the transferor on the disposition would be treated under Section 864(c)(8) as effectively connected with the conduct of a trade or business in the United States ("Section 1446(f) Withholding"). Section 1446(f)(4) requires the partnership in which an interest was transferred to withhold from any distributions with respect to the transferred interest if a transferee of the partnership interest fails to withhold any amount required to be withheld under Section 1446(f). A partnership that must pay the withholding tax but fails to do so may be liable for the payment of the tax and any penalties and interest. An IRS notice issued on August 24, 2021 suspended the obligation for partnerships to withhold.

The secondary withholding obligation is set to go into effect for transfers occurring on or after January 1, 2023.

For further discussion of Section 1446(f) Withholding, please see our October 15, 2020 blog post.

> Annual U.S. Tax Elections and Filings

This section briefly summarizes certain U.S. tax filings and elections (and related deadlines) relevant to private funds, their investors, and related persons.

Form 8832 Filings. If an entity filed an IRS Form 8832 (an entity classification election) with respect to 2022, that entity must attach a copy of the Form 8832 with its U.S. federal income tax return. If that entity is not required to file a U.S. return, all direct or indirect owners of that entity generally must attach a copy with their U.S. federal income tax returns if they are otherwise required to file U.S. returns. The deadline will be the due date (including any applicable extensions) of the filer's 2022 U.S. federal income tax return.

Form 1065. All U.S. partnerships must file a Form 1065, including limited liability companies (LLCs) classified as a partnership. The deadline is typically March 15.

QEF Election. If a private fund has invested in a non-U.S. portfolio company that is (or may be) a PFIC, the first U.S. person in the PFIC's ownership chain (e.g., the fund itself if a U.S. fund, or each U.S. investor if a non-U.S. fund) may wish to file a QEF election with respect to that PFIC. The QEF election must be filed with that U.S. person's U.S. federal income tax return for the first year in which the fund invested in the PFIC. The deadline for PFICs acquired in 2022 will be the due date (including any applicable extensions) of that U.S. person's 2022 U.S. federal income tax return. Please see "Proposed PFIC Regulations" above for discussion of proposed changes to making a QEF election.

"Electing Investment Partnership" (EIP) Election. Private funds that satisfy certain requirements may opt out of otherwise mandatory tax basis adjustments (including those that may result from transfers of interests in a fund) by filing an EIP election. The EIP election must be filed with the private fund's U.S. federal income tax return for the first year in which the election is intended to apply. For funds wishing to be treated as EIPs with respect to 2022 (and subsequent years), the deadline will be the due date (including any applicable extensions) of the private fund's 2022 U.S. federal income tax return.

CbCR Reporting. A U.S. tax resident parent entity of a multinational enterprise (MNE) group that has revenues of $850 million or more during the taxable year must file IRS Form 8975 by the due date (including any applicable extensions) of its 2022 U.S. federal income tax return.

Certain U.S. Tax Filings with respect to Non-U.S. Entities. U.S. private funds and their U.S. investors may be required to make certain filings with respect to non-U.S. entities owned by the private fund. These filings may include, without limitation:

> IRS Form 5471 (with respect to certain non-U.S. corporations, including "controlled foreign corporations," owned by the private fund);

> IRS Form 926 (with respect to certain contributions of property to a non-U.S. corporation);

> IRS Form 8621 (with respect to certain non-U.S. corporations that are PFICs; however, such reporting generally is not required of U.S. tax-exempt investors);

> IRS Form 8865 (with respect to certain non-U.S. partnerships); IRS Form 8858 (with respect to certain non-U.S. disregarded entities);

> IRS Form 8938 (with respect to certain non-U.S. financial assets); and

> IRS Form 8992 (with respect to certain U.S. shareholders of controlled foreign corporations to calculate their share of "global intangible low-taxed income" (GILTI)). Generally, the deadline will be the due date (including any applicable extensions) of the U.S. person's 2022 U.S. federal income tax return.

ERISA

> DOL Proposes Significant Changes to the QPAM Exemption

On July 27, 2022, the U.S. Department of Labor (the "DOL") issued notice of a proposed amendment (the "Proposed Amendment") to Prohibited Transaction Class Exemption 84-14 (which is commonly referred to as the "QPAM Exemption") that would (as described in more detail below) significantly amend certain of the exemption's conditions, including:

> increasing the equity/net worth and assets under management thresholds to qualify as a "qualified professional asset manager" ("QPAM");

- adding a new requirement for a QPAM to notify the DOL if it will be relying on the exemption;
- specifically incorporating foreign criminal convictions into the list of criminal convictions that would make an asset manager ineligible to rely on the exemption;
- adding new types of prohibited misconduct that would make an asset manager ineligible to rely on the exemption;
- requiring upfront terms in the QPAM's written management agreement that would apply in the event the QPAM became ineligible to rely on the exemption as a result of a specified criminal conviction or participation in prohibited misconduct (including indemnification for certain resulting losses/costs);
- providing for a one-year winding-down period to minimize the impact of a QPAM losing the ability to rely on the exemption as a result of a specified criminal conviction or participation in prohibited misconduct;
- clarifying the requirement that the terms of the applicable transaction and related negotiations be the sole responsibility of the QPAM; and
- adding a recordkeeping requirement.

If finalized, the Proposed Amendment would have far-reaching effects on employee benefit plans subject to Title I of ERISA and individual retirement accounts ("IRAs") subject to Section 4975 of the Code (collectively, "Plans"), and private funds and separate accounts holding "plan assets" of one or more such Plans ("Plan Asset Entities"). The Proposed Amendment would affect advisers managing Plan Asset Entities (including eliminating the ability of certain advisers to qualify as a QPAM), employers/plan sponsors of Plans, IRA owners and other fiduciaries responsible for engaging or monitoring advisers, as well as counterparties to Plan Asset Entities seeking to rely on the QPAM Exemption.

Background

The prohibited transaction rules under Section 406(a)(1)(A)-(D) of ERISA prohibit, among other things, sales, leases, loans and the provision of services between Plans and certain parties related to those Plans referred to as "parties in interest."[19] In light of how broadly the term "party in interest" is defined, some Plans could have hundreds or thousands of "parties in interest," which often results in the practical assumption that every counterparty is a prohibited "party in interest" and every transaction requires an exemption from the prohibited transaction rules. The alternative would require potentially extremely costly and burdensome (as well as potentially inaccurate) "party in interest" diligence for every transaction involving a Plan (which would be even more difficult for a Plan Asset Entity holding "plan assets" of many Plans).

Thankfully, the QPAM Exemption provides broad exemptive relief from those prohibited transaction restrictions for transactions between a "party in interest" with respect to a Plan and a Plan Asset Entity holding "plan assets" of such a Plan, where the Plan Asset Entity is managed by a QPAM and the other Plan protective conditions of the QPAM Exemption are met. If the QPAM Exemption is available, it minimizes the need to perform any such "party in interest" diligence and often provides comfort to the parties to the transaction that a non-exempt "party in interest" prohibited transaction will not occur. Accordingly, it is quite common for Plan fiduciaries, advisers and counterparties to seek or require

[19] Similar rules exist under Code Section 4975(c)(1)(A)-(D) with respect to "disqualified persons." For purposes of this discussion, any references to the prohibited transaction rules under Section 406 of ERISA and "parties in interest" apply equally to the prohibited transaction rules under Section 4975 of the Code and "disqualified persons."

compliance with the QPAM Exemption whenever available (even where it might not be necessary because, for example, another exemption is available or an exemption might not be required because the transaction is not likely to otherwise be prohibited).

In order to qualify as a QPAM with respect to a Plan, the relevant entity must be either a bank, a savings and loan association, an insurance company, or an RIA that meets certain financial requirements and acknowledges in writing that it is a fiduciary to the Plan. However, one of the Plan protective conditions of the exemption (which is particularly relevant to the Proposed Amendment) provides that a QPAM would become ineligible to rely on the exemption for a period of 10 years if the QPAM, or various affiliates or five percent or more owners of the QPAM, are convicted of certain crimes.

The Proposed Amendment

In light of significant changes in the financial services industry since the exemption was originally drafted in 1984, the DOL is now seeking (in its view) to modernize the QPAM Exemption accordingly. Below is a high-level summary of certain material aspects of the DOL's proposed changes. For more information regarding the Proposed Amendment, please see here.

Increase of equity/net worth and assets under management thresholds to qualify as a QPAM

The Proposed Amendment would increase the financial thresholds necessary for an entity to qualify as a QPAM, to reflect prior inflation (and provides that the DOL would also publish future annual inflation adjustments) as follows:

> The equity capital or net worth threshold (as applicable) for a bank, a savings and loan association and an insurance company would increase from $1,000,000 to $2,720,000;

> The current assets under management threshold for a registered investment adviser would increase from $85,000,000 to $135,870,000; and

> The shareholders' or partners' equity threshold for an RIA would increase from $1,000,000 to $2,040,000.

Requirement for a QPAM to notify the DOL if it will be relying on the exemption

The Proposed Amendment would add a new requirement that a QPAM must notify the DOL by email that it is relying on the QPAM Exemption. The DOL will publish on its website a list of QPAMs who have provided such notification to the DOL.

Specific inclusion of foreign criminal convictions in the list of criminal convictions that would make a QPAM ineligible to rely on the exemption

As noted above, a QPAM would become ineligible to rely on the QPAM Exemption for a period of 10 years if the QPAM, or various affiliates or five percent or more owners of the QPAM, are convicted of certain crimes (a "Criminal Conviction"). Although there has been some uncertainty as to whether foreign Criminal Convictions were included in existing disqualification rules, the Proposed Amendment would remove any such ambiguity and provide that foreign Criminal Convictions, in addition to domestic Criminal Convictions, would make an asset manager ineligible to rely on the QPAM exemption.

Addition of new types of prohibited misconduct that would make an asset manager ineligible to rely on the QPAM exemption

The Proposed Amendment would add a new category of misconduct that may lead to ineligibility to rely on the QPAM Exemption for 10 years, referred to as “participating in Prohibited Misconduct.”

- “Prohibited Misconduct” would be defined as: (i) any conduct that forms the basis for a non-prosecution or deferred prosecution agreement that, if successfully prosecuted, would have constituted a Criminal Conviction; (ii) any conduct that forms the basis for an agreement, however denominated by the laws of the relevant foreign government, that is substantially equivalent to a non-prosecution agreement or deferred prosecution agreement described above; (iii) engaging in a systematic pattern or practice of violating the conditions of the exemption; (iv) intentionally violating the conditions of the exemption; or (v) providing materially misleading information to the DOL in connection with the conditions of the exemption. Prohibited Misconduct described in clauses (iii) through (v) above would be determined through “an investigation by the appropriate field office” of the DOL.
- “Participating in” such misconduct includes not only active participation but also knowingly approving of the conduct or having knowledge of such conduct without taking appropriate and proactive steps to prevent such conduct from occurring, including reporting the conduct to appropriate compliance personnel.
- When a QPAM’s ineligibility is linked to participating in Prohibited Misconduct, the DOL will provide the QPAM with a written warning and an opportunity to be heard. If the QPAM does not respond to the warning or fails to convince the DOL otherwise, the DOL will issue a “Written Ineligibility Notice” to the QPAM.

Requirement to include new upfront terms in the QPAM’s written management agreement

The Proposed Amendment would require a QPAM to include certain standards of integrity, considered by the DOL to be a fundamental requirement of a QPAM, in the QPAM’s written management agreement with its client Plans.

- Specifically, the Proposed Amendment would require the QPAM’s written management agreement to provide that in the event the QPAM, or an its affiliate or a five percent or more owner of the QPAM, (i) engages in conduct resulting in a Criminal Conviction or (ii) receives a Written Ineligibility Notice from the DOL, the QPAM would not restrict its client Plan’s ability to terminate its arrangement with the QPAM or withdraw from the applicable Plan Asset Entity managed by the QPAM for at least a period of 10 years.
- The QPAM would be prohibited from imposing any fees, penalties, or charges on the client Plan in connection with such termination or withdrawal (except for reasonable fees, appropriately disclosed in advance, that are specifically designed to prevent generally recognized abusive investment practices or to ensure equitable treatment of all investors in a pooled fund in the event such withdrawal or termination may have adverse consequences for all other investors, provided any such fees are applied consistently and in a like manner to all such investors).
- The QPAM’s written management agreement would be required to include a provision that the QPAM would indemnify, hold harmless, and promptly restore actual losses to each client Plan for any damages directly resulting from a violation of applicable laws, a breach of contract, or any claim arising out of the QPAM’s ineligibility to rely on the exemption as a result of a Criminal Conviction or receipt of a Written Ineligibility Notice. Actual losses include losses and costs arising from unwinding transactions with third parties and from transitioning Plan assets to an alternative asset manager as well as costs associated with any exposure to excise taxes under Section 4975 of the Code.

One-year winding-down period to minimize the impact of a QPAM losing the ability to rely on the exemption as a result of a Criminal Conviction or receipt of a Written Ineligibility Notice

Any QPAM that becomes ineligible to rely on the exemption as a result of a Criminal Conviction or receipt of a Written Ineligibility Notice must engage in a winding-down period, which is only available to existing Plan clients. During such one-year period, the QPAM must fully comply with the conditions of the exemption, it must ensure that it manages each Plan's assets prudently and loyally, and it must comply with certain additional conditions. Importantly, the QPAM may not engage in new transactions in reliance on the exemption for existing client Plans.

After the one-year winding-down period expires, the QPAM may not rely on the exemption until the expiration of the 10-year ineligibility period unless it obtains an individual exemption from the DOL permitting it to do so. The Proposed Amendment would also add new requirements with respect to any application for such an individual exemption.

Clarification of the requirement that the terms of the applicable transaction and related negotiations be the sole responsibility of the QPAM

The Proposed Amendment would clarify that a QPAM must not permit other "parties in interest" to make decisions regarding Plan investments under the QPAM's control, and that the QPAM must have sole responsibility over the terms of transactions, commitments, investment of Plan assets, and any associated negotiations.

- A "party in interest" should not be involved in any aspect of a transaction, aside from certain ministerial duties and oversight associated with Plan transactions, such as providing general investment guidelines to the QPAM.
- The Proposed Amendment would also provide that the exemption would apply only in connection with a Plan Asset Entity that is "established primarily for investment purposes" and that no relief would be available for any transaction that is planned, negotiated, or initiated by a "party in interest", in whole or in part, and presented to a QPAM for approval because the QPAM would not have sole responsibility with respect to such a transaction and the role of the QPAM is not to act as a mere independent approver of a transaction.

Addition of a recordkeeping requirement

The Proposed Amendment would require a QPAM to maintain records for six years demonstrating compliance with the exemption.

The Proposed Amendment provides that, if finalized, it would become effective 60 days after the date of publication of the final amendment in the Federal Register. The Proposed Amendment does not provide for any grandfathering of existing QPAMs or QPAM management agreements. Accordingly, if the Proposed Amendment is finalized in its current form, existing QPAM management agreements (including agreements governing a Plan Asset Entity) would need to be amended in order to comply with the revised conditions of the exemption.

We will continue to monitor any developments in this area and, as always, remain available to answer any questions you may have.

> DOL Cautions Against Cryptocurrency Investments in 401(k) Plans

On March 10, 2022, the DOL issued Compliance Assistance Release No. 2022-01 (the "Release") to caution 401(k) plan fiduciaries to exercise extreme care before considering whether to include investment options like cryptocurrency as part of their 401(k) plan's investment menu. In so doing, the DOL raised a number of concerns associated with offering these types of investment options.

Importantly, the Release focuses solely on 401(k) plan investments but not on other types of benefit plans. Although certain of the DOL's noted concerns (like concerns over valuation issues and compliance with custodial and recordkeeping requirements) would apply similarly to ERISA-covered defined benefit plans (which are the types of plans that are more likely to be investors in private investment funds), the Release did not specifically mention those types of plans.

For more information regarding the Release, please see here.

Whether and how this guidance will affect ERISA-covered defined benefit plan investments in private investment funds remains to be seen. For now, advisers should keep an eye on new developments in this area, as this is not likely to be the last we hear from the DOL on this issue.

To sign up to receive further alerts and information on ERISA developments, please see here.

Employment Law

> Salary Range Disclosure Laws

New York City

Effective November 1, 2022, New York City employers with four or more employees will be required to include a "good faith" salary range in every advertised job, promotion, or transfer opportunity within New York City.

The new legislation amends the New York City Human Rights Law to make it an unlawful discriminatory practice for a covered employer or its agent, or for an employment agency, to post or otherwise advertise a job, promotion or transfer opportunity without stating the minimum and maximum salary or hourly rate for the position in such posting or advertisement. In providing the salary range for a position, the range would need to "extend from the lowest to the highest salary the employer in good faith believes at the time of the posting it would pay for the advertised job, promotion or transfer opportunity." Employers need not disclose other forms of compensation or benefits available in connection with the position, including bonus or incentive compensation.

The law applies to positions that can or will be performed, in whole or in part, in New York City, whether from an office or remotely. The law applies whether the position is for a full- or part-time employee, intern, independent contractors, or any other category of worker.

For more information, see our blog post.

New York State

In June 2022, the New York State legislature passed a bill that, similar to the New York City law, would require employers with four or more employees to include in job postings – including those for promotion or transfer opportunities – the minimum and maximum salary for any position that can or will be performed within the state of New York, along with a job description.

If signed into law, this bill would amend the New York Labor Law to require covered employers that post a job, promotion, or transfer opportunity that can or will be performed, at least in part, in the state of New York to disclose the following:

- the compensation or a range of compensation for the job, promotion, or transfer opportunity; and
- the job description for the job, promotion, or transfer opportunity, if such description exists.

The bill defines range of compensation as the "minimum and maximum annual salary or hourly range of compensation for a job, promotion, or transfer opportunity that the employer in good faith believes to be accurate at the time of the posting of an advertisement for such opportunity."

In addition to the bill's disclosure requirement, employers must also keep and maintain "necessary records," which includes, but is not limited to, "the history of compensation ranges for each job, promotion, or transfer opportunity and the job descriptions for such positions, if such descriptions exist." Advertisements for positions paid by commission would be required to provide a general statement that explains the compensation will be based on commission.

As of today, the bill is awaiting the signature of New York Governor Kathy Hochul. If signed, it would become law 270 days later. For further information, please visit our blog.

Washington State

On March 30, 2022, Washington Governor Jay Inslee signed into law a bill that will require employers to include a salary or pay range, as well as information about other compensation and benefits, in each job posting. The bill revises the existing state law that requires only that employers provide the minimum wage or salary for a position to an applicant after an offer of employment has been made. The new law takes effect on January 1, 2023.

Specifically, the new law will require Washington employers with 15 or more employees to affirmatively disclose in all job postings a wage scale or wage range, as well as "all of the benefits and other compensation to be offered" in connection with the position, regardless of applicant request. For purposes of the law, "postings" means "any solicitation intended to recruit job applicants for a specific available position, including recruitment done directly by an employer or indirectly through a third party" and includes "any postings done electronically, or with a printed hard copy, that includes qualifications for desired applicants."

With regard to existing employees, under the new law, employers will effectively need to ensure that a wage scale or salary range is available for all roles subject to internal transfer.

While the law does not define "wage scale," "salary range," or "benefits," the term "compensation" is defined elsewhere in the same chapter of the law to mean "discretionary and nondiscretionary wages and benefits provided by an employer to an employee as a result of the employment relationship."

For further information, please visit our blog.

> Non-Compete and Non-Disclosure Agreements

District of Columbia

The District of Columbia's Ban on Non-Compete Agreements Amendment Act became effective and applicable to all employers with D.C. employees on October 1, 2022. The law generally prohibits employers from entering into or imposing non-compete agreements and policies on D.C. employees that restrict their outside work activities both during and post-employment, subject to certain exemptions.

The law—which excludes "highly compensated employees" (those making over $150,000 per year)—broadly prohibits non-compete agreements for employees who (i) spend more than 50% of their time working in D.C. or (ii) spend "a substantial amount of" their "work time for the employer" in D.C. and do not spend more than 50% of their work time in another jurisdiction, as well as new hires expected to meet either of these requirements.

For additional details, please see our blog posts from December 18, 2020, July 21, 2022, and September 29, 2022.

Washington State

On March 24, 2022, Washington Governor Jay Inslee signed into law the "Silenced No More Act," prohibiting agreements containing nondisclosure and nondisparagement provisions that prevent an employee or independent contractor from discussing certain violations of law. The Act applies to nondisclosure and nondisparagement provisions contained "in employment agreements, independent contractor agreements, agreements to pay compensation in exchange for the release of a legal claim, or any other agreement between an employer and an employee" or independent contractor.

Specifically, the Silenced No More Act renders void and unenforceable any provision in an agreement with a current, former, or prospective employee or independent contractor that bars the employee or contractor from "disclos[ing] or discuss[ing] conduct, or the existence of a settlement involving conduct, that the employee [or contractor] reasonably believed under Washington state, federal, or common law to be illegal discrimination, illegal harassment, illegal retaliation, a wage and hour violation, or sexual assault, or that is recognized as against a clear mandate of public policy," where the conduct occurred "at the workplace, at work-related events coordinated by or through the employer, between employees, or between an employer and employee, whether on or off the employment premises."

The Act does not prohibit agreements that restrict the disclosure of the amount paid in the settlement of a claim, nor does the Act prohibit an employer from protecting trade secrets, proprietary information, or confidential information that does not involve illegal acts.

With the enactment of this law, Washington became the second state (after California) to render provisions in employment and independent contractor agreements void and unenforceable if they prevent disclosures of certain illegal conduct. Violations of the Act can subject offenders to statutory damages of $10,000 or actual damages. For additional details regarding the Silenced No More Act, please see our blog post from March 29, 2022.

> Harassment and Discrimination

Federal Law

On March 3, 2022, President Biden signed into law the Ending Forced Arbitration of Sexual Assault and Sexual Harassment Act, which amended the Federal Arbitration Act to prohibit mandatory arbitration and class action waivers for sexual harassment and sexual assault claims.

Effective upon signing, the law prohibits enforcement of mandatory pre-dispute arbitration agreements, as well as agreements prohibiting participation in a joint, class, or collective action in any forum, "at the election of the person alleging conduct constituting a sexual harassment dispute or sexual assault dispute, or the named representative of a class or in a collective action alleging such conduct."

The law defines a "sexual harassment dispute" as one "relating to conduct that is alleged to constitute sexual harassment under applicable Federal, Tribal, or State law." Meanwhile, a "sexual assault dispute" is defined as one "involving a nonconsensual sexual act or sexual contact, as such terms are defined in section 2246 of title 18 or similar applicable Tribal or State law, including when the victim lacks capacity to consent."

The new restrictions apply "with respect to any dispute or claim that arises or accrues on or after the date of enactment of this Act," meaning that as of March 3, 2022, millions of American workers can elect to be released from existing arbitration agreements and/or class and collective action waivers as relating to sexual harassment and sexual assault claims that arise after that date. However, because the law only addresses *pre-dispute* arbitration and class/collection action waiver agreements, any agreement to arbitrate claims entered into by the parties *after the claims arise* remains enforceable.

For more information, please see our blog post from February 10, 2022.

New York

On July 19, 2022, Governor Hochul announced the launch of the state's confidential hotline for complaints of workplace sexual harassment, established in accordance with recently enacted legislation.

According to the website of the New York State Division of Human Rights ("SDHR"), the hotline will be operated by staff at the SDHR's Office of Sexual Harassment Issues ("OSHI") during regular business hours. OSHI staff will provide callers with "information about filing a sexual harassment complaint with the agency and, if the caller is interested in discussing their case with an attorney, the hotline will provide them with the name(s) and contact information of an attorney who is experienced in providing counsel related to workplace sexual harassment and who has volunteered to provide limited pro bono assistance."

Additional guidance from the New York State Department of Labor is expected, as the law requires the SDHR to work with the NYSDOL "to ensure that information on the hotline is included in any materials employers must post or provide to employees regarding sexual harassment." For additional information, please see our blog post.

Chicago

On April 27, 2022, the Chicago City Council passed an ordinance amending the Municipal Code to enhance the City's prohibitions on sexual harassment in the workplace. The amendments include, among other things, modified definitions of "sexual orientation" and "sexual harassment," a new written policy requirement for employers, increased sexual harassment prevention training requirements, and stricter penalties for violations. The amendments became effective on July 1, 2022.

The new ordinance amends the definition of sexual orientation in the Chicago Human Rights Ordinance, such that sexual orientation is now defined as "a person's actual or perceived sexual and emotional attraction, or lack thereof, to another person." The ordinance also amends the definition of sexual harassment to include sexual misconduct.

Under the new ordinance, employers must now have a written policy that is provided to employees in their primary language within the first calendar week of employment. The policy must include the following:

> The definition of sexual harassment, which is defined in the ordinance as "any (i) unwelcome sexual advances or unwelcome conduct of a sexual nature; or (ii) requests for sexual favors or conduct of a sexual nature when (a) submission to such conduct is made either explicitly or implicitly a term or condition of an individual's employment, or (b) submission to or rejection of such conduct by an individual is used as the basis for any employment decision affecting the individual, or (c) such conduct has the purpose or effect of substantially interfering with an individual's work performance or creating an intimidating, hostile or offensive working environment; or (iii) sexual misconduct, which means any behavior of a sexual nature which also involves coercion, abuse of authority, or misuse of an individual's employment position."

> A statement that sexual harassment is illegal in Chicago.

> A requirement that all employees participate in sexual harassment prevention training annually.

> Examples of prohibited conduct that constitute sexual harassment.

> Details on (i) how an employee can report an allegation of sexual harassment (including, as appropriate, instructions on how to make a confidential report, with an internal complaint form, to a manager, corporate headquarters or human resources, or other internal reporting mechanism); and (ii) information about legal services, including governmental agencies, that are available to employees who may be victims or sexual harassment.

> A statement that retaliation for reporting sexual harassment is illegal in Chicago.

The ordinance also requires increased sexual harassment prevention training, new posting and recordkeeping requirements, increased penalties, and an extended statute of limitations for reporting discrimination and harassment to the Chicago Commission on Human Relations. For additional information, please see our blog post from May 19, 2022.

> Technology in the Workplace

Federal Law

On May 12, 2022, both the U.S. Equal Employment Opportunity Commission ("EEOC") and the DOJ issued guidance for employers regarding the use of Artificial Intelligence ("AI") tools to assist in automated employment decision-making. This applies to employers that use various AI tools, such as software that can review resumes and evaluate candidates based on speech patterns and facial expressions, as well as "chatbots" that interview and screen applicants.

The EEOC's guidance notes the risk of inadvertent AI-related disability discrimination in violation of the Americans with Disabilities Act (the "ADA"). The EEOC guidance advises that use of AI in employment decision-making can violate the ADA if:

> "[t]he employer does not provide a 'reasonable accommodation' that is necessary for a job applicant or employee to be rated fairly and accurately by" the AI;

> "[t]he employer relies on an algorithmic decision-making tool that intentionally or unintentionally 'screens out' an individual with a disability, even though that individual is able to do the job with a reasonable accommodation"; or

> "[t]he employer adopts an [AI] tool for use with its job applicants or employees that violates the ADA's restrictions on disability-related inquiries and medical examinations."

The guidance further states that "[i]n many cases" employers are liable under the ADA for use of AI even if the tools are designed and administered by a separate vendor, noting that "employers may be held responsible for the actions of their agents . . . if the employer has given them authority to act on [its] behalf."

The guidance goes onto recommend "best practices" for employers using AI for employment related decision-making to avoid creating discriminatory outcomes. For more information on these best practices, please visit our blog.

New York

This past year, New York State enacted a law requiring employers to provide notice to employees of electronic monitoring of telephone, email, and internet access and usage.

As of May 7, 2022, all private employers, regardless of size, with a place of business in New York State to are required to provide written notice upon hire to new employees if the employer does or plans to monitor or intercept telephone or email communications or internet access or usage by the employee.

The notice must be in writing (either hard copy or electronic) and must be acknowledged by the employee either in writing or electronically. Employers are also required to post the notice in a "conspicuous place which is readily available for viewing" by employees subject to the monitoring. The written notice must inform employees that any and all telephone or email transmissions or conversations, or any internet access or usage, by means of any electronic device or system may be subject to monitoring at any and all times and by any lawful means.

Employers who violate the law will be subject to fines of up to $500 for the first offense, $1,000 for the second offense, and $3,000 for the third and each subsequent offense. For more information, see our blog post.

> Family and Medical Leave Developments

New York

The New York State legislature amended the New York Paid Family Leave Law ("NYPFLL") to allow employees to take leave to care for siblings with a serious health condition. In effect since 2018, the NYPFLL provides a phased-in system of paid, job protected leave for eligible employees: (i) to care for a new child following birth, adoption, or placement in the home; (ii) to care for a family member with a serious health condition; or (iii) for qualifying exigencies related to military duty. As of January 1, 2021, employees are eligible for up to 12 work weeks of leave in a 52-week period at 67% of their average weekly wage, up to a cap set up by the state.

The NYPFLL currently defines "covered family members" to include an employee's spouse or domestic partner, child (including a biological, adopted or foster child, step-child or child of a domestic partner, legal ward or one to whom the employee stands in loco parentis), parent (including a biological, adoptive or foster parent, step-parent, legal guardian, or one who stood in loco parentis to the employee as a child), parent-in-law, grandparent and grandchild. Effective January 1, 2023, the amendment will expand this definition to include an employee's biological, adopted, step, and half-sibling(s).

Employers in New York are encouraged to review their current NYPFLL policies and practices in advance of the amendment's effective date to ensure compliance with these updated requirements. For more information, see our blog post.

Maryland

On April 9, 2022, the Maryland state legislature overrode Governor Larry Hogan's veto to enact the Time to Care Act of 2022. The law creates a family and medical leave fund which provides temporary paid leave benefits to covered employees and participating self-employed individuals. The program will be administered by the state, and paid leave benefits will be made directly by the state to eligible individuals from the state's family and medical leave fund.

Under the Time to Care Act, eligible employees, who have worked at least 680 hours over the 12-month period immediately preceding the date on which leave is to begin, will receive up to a weekly maximum of $1,000 for up to 12 weeks of leave on an annual basis. Additionally, the legislation entitles employees taking leave to job protection for taking advantage of the new paid leave benefits. The payroll tax to fund the program will take effect on Oct. 1, 2023, and paid leave will be available on Jan. 1, 2025. For more information, see our blog post.

Delaware

On May 10, 2022, Delaware Governor John Carey signed into law a bill that will require private employers with 10 or more employees in Delaware to provide up to 12 weeks of paid family and medical leave beginning in January 2026, one year after payroll tax deductions to fund the program begin on January 1, 2025. Delaware becomes the latest state to implement legislation that requires employers provide some form of paid family and medical leave to employees, following Maryland.

The Healthy Delaware Families Act generally tracks the federal Family and Medical Leave Act in terms of coverage, eligibility, and protections; however, some aspects of the Act diverge from the FMLA.

Under the Act, paid leave will be available for eligible employees who:

- are caring for a child within the first year of the birth, adoption, or placement through the foster care system of the child ("parental leave");
- are caring for a family member with a serious health condition (defined, as it is under the FMLA, as an illness, injury, impairment or physical or mental condition that involves either inpatient care or continuing treatment by a health care provider) ("family care");

- have a serious health condition that renders them unable to perform the functions of their position ("medical leave"); or
- have a "qualifying exigency" (also defined, as it is under the FMLA, as specified exigencies that arise when an employee's family member is a member of the Armed Forces and is called to active duty).

"Family member" under the Act includes an employee's parent (including biological, adoptive, step and foster parent, or any individual who stood in loco parentis to the employee), child (including biological, adopted, and step child, legal ward, or a person to whom the employee stood in loco parentis), and spouse. This tracks the FMLA but is a narrower definition than used in some other states' acts (such as New York's), which have extended coverage to include family members such as siblings, grandparents/children, and in-laws.

For more information regarding the Act, please see our blog post from [May 18, 2022].

> Cannabis and the Workplace

District of Columbia

On July 13, 2022, Washington, D.C. Mayor Muriel Bowser signed into law the Cannabis Employment Protections Act of 2022. The legislation will not be effective until (or after) July 13, 2023, based on when it is included in an annual budget. Once effective, the law will prohibit most employers, with certain exceptions, from taking adverse action against employees or prospective employees for off-duty cannabis use.

Under the new law, employers may not "refuse to hire, terminate from employment, suspend, fail to promote, demote, or penalize an individual" due to such individual's:

- "use of cannabis,"
- "status as a medical cannabis program patient," or
- having "the presence of cannabinoid metabolites in [their] bodily fluids in an employer-required or requested drug test without additional factors indicating impairment."

Employees covered by the law, unless subject to an exception, include any "individual employed by or seeking employment from an employer," as well as unpaid interns. The law applies to all private employers in D.C., defined as any person who "for compensation, employs an individual," and "any person acting in the interest of such employer, directly or indirectly," but does not apply where the person employed is "the employer's parent, spouse, or children engaged in work in and about the employer's household." Certain public employers are also covered.

The law excludes employees whose "position is designated as safety sensitive," defined as a "an employment position as designated by the employer, in which it is reasonably foreseeable that, if the employee performs the position's routine duties or tasks while under the influence of drugs or alcohol, he or she would likely cause actual, immediate and serious bodily injury or loss of life to self or others." The law provides some examples of tasks and jobs that may render a position "safety sensitive," including, but not limited to: security officers, police officers, construction workers, power/gas line maintenance workers, employees handling hazardous materials, caretakers, medical practitioners, and workers whose jobs require them to frequently operate heavy or dangerous machinery.

The Bill's protections also do not extend to actions taken by employers where required by a federal statute, federal regulation or federal contract or funding agreement. Further, an employer would be permitted to take disciplinary or other adverse action against an employee – whether or not in a "safety sensitive" position – if such employee uses, consumes, possesses, stores, delivers, transfers, displays, transports, sells, purchases or grows cannabis at the employee's place of employment, while performing work for the employer, or during the employee's hours of work, or where the employee is "impaired" by the use of cannabis, as the term is defined above.

Employers in Washington, D.C. should make an effort to bring their policies into compliance with the law before it becomes effective. For updates and for more information, please continue to monitor our blog.

Philadelphia

As of January 1, 2022, Philadelphia employers are prohibited from requiring job applicants to submit to pre-employment drug tests for marijuana use. Specifically, under Philadelphia ordinance, it is now an unlawful employment practice for an employer, labor organization, or employment agency (or agent thereof) to require prospective employees to submit to testing for the presence of marijuana as a condition of employment.

Several categories of applicants are exempt from the law, including: (i) police officers and other law enforcement positions; (ii) positions requiring a commercial driver's license; (iii) positions requiring the supervision or care of children, medical patients, disabled or other vulnerable individuals; and (iv) positions in which the employee could significantly impact the health or safety of other employees or members of the public, as determined by the enforcement agency.

Also excluded from the law are circumstances where drug testing is required pursuant to: any federal or state law, regulation, or order that requires drug testing of prospective employees for "purposes of safety or security"; any contract between the federal government and an employer or any grant of financial assistance from the federal government to an employer that requires drug testing of prospective employees as a condition of receiving the contract or grant; or any applicants whose prospective employer is a party to a valid collective bargaining agreement that "specifically addresses the pre-employment drug testing of applicants."

Employers in Philadelphia should review their hiring processes to ensure compliance with these new requirements. For more information, see our blog.

Executive Compensation

> The Mobile Workforce and Related Complexities

COVID-19 work-from-home policies helped to usher in a host of changes to the work environment. Principally, some version of "working from home" or "remotely" appears to be here to stay for now. As a result, employees have more opportunities than before; they do not need to move to take a new job and they can move without having to change jobs. A positive for employers is greater access to talent — not just those individuals who are located near a specific office of the company. But, how do you retain employees with opportunities abound? Employers have both "carrots" and "sticks" in their toolbox to overcome this challenge.

Recently, we have seen an uptick in retention bonuses being offered. These bonuses can be designed to pay out solely based on continued employment or they could include performance conditions (or both).

Similarly, existing compensation programs can be designed to reward both specific company goals as well as "soft" goals that seek to develop a strong company culture. For example, there has been increased prevalence of performance metrics tied to environmental, social and governance issues affecting a company's business. On the flip side, employers could potentially use restrictive covenant agreements (i.e., noncompetition and non-solicitation of customer and employee clauses) to limit employee movement and reduce turnover. These are not perfect solutions. For example, many states already restrict the use of restrictive covenant agreements and other states are seeking to pass laws to restrict their use.

In addition to retention issues that are raised as a result of a more mobile workforce, "remote" work raises other complexities, including:

> **Employer withholding may be impacted**. Each state has its own laws that should be consulted. Many states assert the right to tax an employee's income if the employee works (or is deemed to be working) within the state. These states typically also require the employer to withhold state (and local) income taxes from the employee's wages, and the penalty for failure to withhold is requiring the employer to pay the tax (and interest and possibly penalties) that it failed to withhold. To comply with these requirements, employers might have to register and withhold in states where they did not previously do business.

> **Employees are exposed to potential double tax**. If an employee works remotely from a state other than the state where the employer has previously done business, the employer may be required to withhold income taxes in both states with respect to wages paid for work done (or deemed to be done) within each state, and the employee might not receive a tax credit in either state for the withholding tax paid to the other. In some cases, this may result in double taxation on their wages. For example, New York State has a rule that generally treats an employee who is principally assigned to an employer location in New York but works remotely out of state as if he or she were physically working in New York on those remote working days, so as to subject the employee's income to New York taxation. New York does not provide a credit for taxes paid to the state where the employee actually works. This means the employee can end up having to pay taxes in both New York and the state where they actually work.

> **Employers could have to pay additional taxes**. In many states, the mere presence of employees in the state can create "nexus" for the employer in that state, which could (i) subject the employer itself to state (and local) income taxes and tax filing obligations; (ii) obligate the employer to collect and pay over state sales taxes; and/or (iii) require the employer to register to do business in that state.

> **For non-exempt employees, it may be more difficult to track hours worked and meal breaks.**

> **Employers need to manage providing tools for remote work**. For example, laptop computers and phones are obvious, but things like ergonomic support, paper, and ink can be more complicated. Some state laws impose minimum requirements.

> Profits Interests vs. Phantom Carry

Compensation packages for private fund advisers typically include performance incentives that align their compensation with the private fund's performance and the timing of distributions made by the private fund. Traditional profits interests (carry) are often attractive, because they provide a way for compensation to be taxed at the capital gains rate rather than ordinary income rates. Also, profits interests can often be subject to forfeiture (or buy-back for an amount below fair market value) upon breach of a restrictive covenant; so profits interests can be used as a carrot to incentivize compliance with any such covenants. An important drawback, however, is that holders of profits interests generally have to be treated as partners, which means the sponsor is required to provide annual K-1s (even before they are vested) and cannot be treated as employees of the issuer.

"Phantom" carry arrangements are a way to mirror the economics of a profits interest, but without treating employees as partners. There are two key drawbacks to a phantom carry arrangement. First, payments under the arrangement are treated as ordinary income that is subject to withholding for income and employment taxes (at rates that are higher than capital gains rates). Second, phantom carry arrangements are subject to Section 409A of the Internal Revenue Code (and, for some advisers and private funds, Section 457A).[20] This means that phantom carry arrangements typically must specify a payment schedule that is not aligned with the timing of distributions made by the private fund pursuant to the LLC or partnership agreement. Failure to have a compliant payment schedule would result in accelerated income tax on the full value of the award (before the recipient is paid and before there is an underlying distribution by the fund to generate cash) plus an additional 20% tax. The taxes fall on the employee, but the employer also has a reporting obligation, each of which create additional risk.

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

- **Condition payment on the employee remaining employed until shortly before the payment is made.** This approach is useful for retention, but can cause problems if the private fund has a long investment horizon, because recipients would not have any "vested" interest if they resign or terminate employment involuntarily.
- **Specify a payment schedule that complies with the requirements of Section 409A.** (This approach is not available if the private fund is subject to Section 457A.) To comply with Section 409A, the arrangement must specify in advance that payment will be made upon a specified event (separation from service, death, disability, financial hardship, or a change in control) or at a specified time (or times). Structuring payments around a Section 409A-compliant payment schedule is complicated and requires the assistance of counsel well-versed in the Section 409A traps.

> Defensive Compensation Elements: Employment-Related Clawbacks

While we generally view performance compensation as a "carrot" to align the financial interests of service providers with those of private fund entities and their investors, it is important to not overlook the other side of the coin – disincentives.

Compensation clawbacks have long been a focus in the financial industry and public company spaces. Private funds can also consider adopting clawbacks with respect to certain compensation arrangements. Compensation clawbacks can serve a number of purposes. First, clawbacks can be structured to recoup payments that were made improperly (whether because of flawed accounting or otherwise), and in this

---

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

case would typically track closely to public company-style clawbacks contemplated by the Dodd-Frank Act (for which final SEC regulations have yet to be issued, but are expected to be imminently). Second, clawbacks can be structured with an eye toward retention – for example, a clawback of a significant signing bonus or relocation fringe benefit if a service provider resigns prior to a stated date (typically 12-24 months following commencement of service). Third, clawbacks can be structured to dis-incentivize certain types of behavior, for example misconduct or breach of restrictive covenants. This type of clawback functions like liquidated damages; it tends to be the most controversial with service providers and most complicated to enforce.

Compensation clawbacks can apply to a range of compensatory elements, including in the context of cash compensation and cash fringe benefits (for example, bonuses d – including signing bonuses, and relocation reimbursements), as well as carried interest and/or portfolio company equity or equity-linked incentive gains. In structuring a clawback provision and/or policy, consider the behavior that the clawback is intended to incentivize/dis-incentivize, the desired length of the clawback, and whether the clawback should be based on pre-tax or after-tax amounts. This final consideration is often negotiated, as clawbacks that occur in a tax year that follows the tax year of payment can lead to a service provider not being able to recover the full tax benefit of the repayment.

Compensation clawbacks may be further complicated by state laws concerning earned wages. To give a clawback provision and/or policy a better chance of success, clawbacks should be in writing and agreed to by the fund entity and service provider at the outset of service, and employment/labor counsel should be involved to address state-specific considerations. Enforcing a clawback may result in litigation and attendant negative publicity, so fund entities might wish to consider including arbitration clauses and otherwise relying on the clawback more for its chilling effect than for purposes of recovery of the underlying funds.

Notably, the clawbacks discussed above are separate and apart from clawbacks in fund documents that tie to fund performance (i.e., clawbacks that permit recovery of carry that is distributed before limited partners receive their full return, particularly prevalent in American waterfall structures). Interestingly, the issue of pre-versus post-tax recovery has come up in the context of these clawbacks in connection with the SEC's proposed rules under the Advisers Act, which if finalized would prohibit advisers from reducing the amount of their clawback obligation by actual, potential, or hypothetical taxes. These proposed rules are described in greater detail under the heading "SEC Policy and Rulemaking Updates".

> New Pay vs. Performance Disclosure for Public Companies

The SEC's final rule on Pay Versus Performance became effective on October 8, 2022, and requires new executive compensation disclosures for the upcoming proxy season for public companies (for annual proxy statements that include executive compensation disclosure for fiscal years ending on or after December 16, 2022). The new rule implements a requirement of the Dodd-Frank Act that public companies disclose "a clear description" of compensation paid to their top executives, including information "showing the relationship between executive compensation actually paid and the financial performance of the issuer." For practical considerations relating to the new rules please see our thoughts here.

Estate Planning

> Major Changes to Estate and Gift Tax Laws in Build Back Better Act Eliminated

At this time last year, estate planners were awaiting the final framework of the Build Back Better Act (H.R. 5376) (the "Act"). The initial proposal contained major changes to the estate and gift tax laws, which specifically targeted high-net-worth taxpayers. The final iteration of the Act eliminated those provisions, which would have included (among other things), changes in estate, gift and generation-skipping transfer tax exemption amounts, estate tax inclusion of grantor trusts, and changes to the treatment of sales or exchanges with grantor trusts. It remains to be seen whether Congress will attempt to re-introduce any of those proposals in future tax legislation.

> Inflation Indexing – Federal Estate and Gift Tax Exemptions Set to Soar

The federal lifetime estate and gift tax exemption has continued to increase from $11,700,000 in 2021 to $12,060,000 per individual (or $24,120,000 for a married couple) in 2022. The annual gift tax exclusion amount increased from $15,000 in 2021 to $16,000 per individual (or $32,000 per married couple) in 2022. The historically high exemption amounts, coupled with the economic downturn in the market, have created an optimal time to transfer wealth. Using tax-efficient wealth transfer strategies, donors can leverage their exemptions and take advantage of market volatility by transferring currently-undervalued property to trusts for descendants.

As inflation hits a new four-decade high, the prospective inflation adjustment to the federal lifetime gift tax exemption amount will be substantial over the next two or three years. Though it is too soon to calculate the 2023 inflation adjustment with precision, it will be approximately $860,000 per person ($1,720,000 for a married couple), and the annual gift tax exclusion will be $17,000 per person ($34,000 for a married couple). This means that effective January 1, 2023, married couples may be able to transfer close to $26,000,000 to trusts for descendants completely free of gift tax. By January 1, 2025, the exemption amount may be in the neighborhood of $14,000,000 per person ($28,000,000 for a married couple). But, under current law, the lifetime estate and gift tax exemption is due to be cut in half on January 1, 2026. Therefore, it is important for clients to consider taking advantage of those exemptions now.

> Increasing Interest Rates and Estate Planning Opportunities

Since March 2022, interest rates have drastically increased from their historic lows. Just as increasing rates make certain investment strategies more attractive, a higher interest rate environment brings certain estate planning techniques into focus.

One effective wealth transfer technique in this environment is the qualified personal residence trust ("QPRT"). A QPRT is created by transferring title to a personal residence, which could be either a principal home or a vacation home, to a trust that contains certain provisions required by the Internal Revenue Code. Generally, an individual is permitted to transfer no more than two residences to a QPRT. The trust provides that the trust creator (the "grantor") retains the exclusive right to live in the personal residence for a specified number of years (the "trust term"). During the trust term, the grantor continues to be responsible for paying property taxes and other expenses related to the maintenance of the personal residence. At the end of the trust term, title to the personal residence is distributed in accordance with the provisions of the QPRT (i.e., to children or a continuing trust for their benefit). During the trust term, the trustees are permitted to sell the residence and purchase a new one for the grantor. If the cost of the new residence is more than the proceeds from the sale of the old one, the grantor can pay the difference and co-purchase a new home with the trust. If the new residence costs less, the excess proceeds from the sale of the old residence can be returned to the grantor or remain in the trust with the grantor receiving an annuity from the cash (in an amount determined by certain tables published by the IRS) and with the remainder beneficiaries receiving any cash remaining at the termination of the QPRT.

Upon creating the QPRT, the grantor has made a gift. The value of the gift is determined by subtracting the value of the grantor's retained right to live in the personal residence from the fair market value of the personal residence at the time it is transferred to the QPRT. The value of the grantor's retained right to live in the personal residence is determined actuarially, using statistical tables and interest rates published each month by the Internal Revenue Service. The value of the retained interest and the gift depends on prevailing interest rates, the length of the trust term and the grantor's age. As interest rates increase, the value of the grantor's retained interest also increases, resulting in a decrease in the amount of the gift. Therefore, a QPRT can be a very effective strategy when interest rates are relatively high. Upon expiration of the trust term, the personal residence, including any appreciation in its value, passes pursuant to the terms of the QPRT without any further exposure to gift tax.

> Proposed Limitation to the Anti-Clawback Rule

Under the 2017 Tax Cuts and Jobs Act ("TCJA"), on January 1, 2018, the unified federal estate and gift tax exemption amount for individuals changed from $5 million to $10 million (adjusted annually for inflation as described above). Prior to 2019, there was concern that, if an individual died on or after January 1, 2026 (when the lifetime exemption is scheduled to decrease), any gifts made before that date that were covered by the higher exemption could be “brought back” into a taxpayer’s estate and become subject to estate tax at death. In 2019, the U.S. Internal Revenue Service (the “IRS”) issued final Treasury Regulation section 20.2010-1(c) that created a special rule, referred to as the “Anti-Clawback Rule,” ensuring that a donor's estate would not be taxed on completed gifts that were covered by the lifetime exemption amount at the time they were made.

In April 2022, the IRS issued proposed regulations (REG- 118913-21) seeking to limit the Anti-Clawback Rule. The proposed regulations provide that if the donor continues to have any retained rights in the transferred property during his or her lifetime, those gifts will not be treated as completed gifts and will not qualify for the Anti-Clawback Rule.

> A Cautionary Tale on Wealth Transfers – Key Takeaways from Smaldino v. Commissioner, T.C. Memo. 2021-127

A recent Tax Court case serves as an austere reminder that the substance and economic realities of wealth transfers must be supported by accurate and contemporaneous documentation. In *Smaldino*, Louis Smaldino, an affluent real estate investor, made gifts in 2013 to utilize his and his wife's federal gift tax exemptions. Mr. Smaldino gifted a 41% interest of a single-member LLC to his wife. The next day, Mrs. Smaldino used a portion of her gift tax exemption to make an identical gift to the Smaldino 2012 Dynasty Trust (the “Trust”), established by her husband, for the benefit of his descendants. Mr. Smaldino also gifted 8% of his interest in the LLC directly to the Trust. Gift tax returns were filed to report the transactions. The Smaldinos reported Mr. Smaldino's gift of 8% of the LLC interests to the Trust, and Mrs. Smaldino's gift of 41% of the LLC interests to the Trust. Upon review, the IRS argued that Mr. Smaldino had in fact gifted the entire 49% interest to the Trust himself, on the basis that there was no documentation recording the transfer of the 41% interest by Mr. Smaldino to his wife before she transferred it to the Trust.

Ultimately, the Tax Court agreed with the IRS and found that Mrs. Smaldino’s one-day ownership in the LLC lacked economic substance. There was no record to memorialize Mrs. Smaldino's admittance as a member or allocate any gains, losses, income or other tax attributes of the LLC to her on the LLC's tax returns. The Tax Court also looked unfavorably on the fact that the LLC's amended operating agreement simply expressed the end result – Mr. Smaldino’s and the Trust's 51% and 49% respective ownership interests in the LLC. Finally, the LLC interests were appraised in August, months after the effective date of the transaction. The Court made two inferences adverse to the Smaldinos’ gifting procedure: (1) the transfer documents were likely completed in August, and (2) Mrs. Smaldino effectively did not have the opportunity to be an owner of the LLC. The result of the Court’s holding was that Mr. Smaldino exceeded his gift tax exemption amount when he gifted the 49% membership interest to the Trust, and therefore owed gift tax on the transfer.

Smaldino v. Commissioner stands for the proposition that transfers of closely-held business interests must be handled just like an arm’s-length transaction. The parties should respect all necessary formalities and prepare appropriate documentation to memorialize the transfers, and the parties’ income tax returns must accurately reflect the transfers.

Shareholder Activism

> Mandatory Use of Universal Proxy Cards in Contested Elections

On November 17, 2021, the SEC adopted amendments to the proxy rules requiring the use of a “universal proxy card” in all non-exempt director election contests, except those involving registered investment companies and business development companies. A universal proxy card is one that lists all director nominees of the company and any shareholder that validly submits director nominations in a director election contest. The ultimate effect of mandating the use of a universal proxy card is that all shareholders voting in a contested election will have the ability to vote for a combination of nominees from each of the company’s and the dissident’s slate, in the same manner as if such shareholder appeared at the shareholder meeting in person. Previously, a shareholder voting by proxy would be required to elect to use either the company’s or the dissident’s proxy card and could not elect to “mix and match” nominees from each slate.

In its adopting release, the SEC noted that “mandating a universal proxy is a more efficient and effective means to achieve the objective of allowing shareholders to elect their preferred candidates through the proxy process” and that “the mandatory use of universal proxy cards will permit shareholders to choose their preferred mix of directors, taking into consideration both complementary skill sets and other board dynamics.” The SEC further provided that, absent their mandatory use, “use of universal proxy cards and the ability of shareholders to select their preferred mix of nominees would exist at the sole discretion of the registrant and would be subject to management’s self-interest.”

While, to date, there have been only a limited number of contested elections that have utilized a universal proxy card, some believe that the adoption of these rules may make it easier and cheaper for activist investors to run their campaigns, and may increase focus and attacks on individual directors rather than the platform of the company or dissident seeking their election.

In addition to the required use of a universal proxy card in the context of a contested election, the SEC adopted the following related amendments to the proxy rules to:

- revise the consent required of a bona fide nominee;
- eliminate the short slate rule, as a universal proxy card rendered this rule unnecessary;
- require shareholders presenting their own director candidates in the contest to solicit holders of a minimum of 67 percent of the voting power of shares entitled to vote in the election;

> establish notice and filing deadlines for both companies and dissidents to facilitate the preparation and dissemination of proxy materials under a mandatory universal proxy system; and

> prescribe formatting and presentation requirements for universal proxy cards to ensure information is presented clearly.

The final rule amendments became effective on August 31, 2022.

> **Proposed Amendments to Section 13(d) and Section 13(g) of the Securities Exchange Act**

Please see "SEC Policy and Rulemaking Updates" for a discussion on proposed amendments to Section 13(d) and Section 13(g) of the Securities Exchange Act**.**

Insurance

During 2022, Proskauer continued to work with a wide variety of private funds of all types and sizes on insurance matters, including reviewing and negotiating their insurance programs and assisting in recovering on their insurance claims through mediations, arbitrations, and litigations. A number of developments occurred during the past year – most significantly wide-ranging new rules proposed by the SEC with respect to private funds – that have made the need for careful review and negotiation of insurance programs for advisers, the private funds they manage, and key individuals more important than ever. Below are a few of the key developments and trends we saw in 2022, along with our thoughts on where we see things headed in 2023.

> **The SEC's Proposed Limitation on Indemnification of Fund Advisers Causes Need for Proactive Insurance Actions**

Private fund advisers have historically counted on receiving indemnification from the private funds they manage for the vast majority of lawsuits, investigations, or other claims that might be asserted against them. The broad indemnification provided by the fund has traditionally meant that the adviser was unlikely to have its own assets exposed to claims in most circumstances, even where the adviser did not have insurance or had inadequate insurance.

But the SEC has now proposed limiting the indemnification available to advisers substantially. Earlier this year, the SEC proposed a number of new rules governing private fund advisers and solicited comments on its proposed rules. Please see "SEC Policy and Rulemaking Updates." One of the proposed rules would prohibit an adviser from directly or indirectly:

> Seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, wilful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund.

The SEC's proposed rule would prohibit advisers from seeking indemnification from private funds or investors for some of the more common claims for which advisers currently receive indemnification and would thus significantly restrict the fund-indemnification upon which advisers have historically relied. Without indemnification from the private fund, insurance is the only thing standing between an adviser - and most importantly, individual principals, founders, officers, and directors - having to utilize their own assets to pay the costs of defending, settling, or paying a judgment for a claim. Having strong insurance coverage has always been important, but the SEC's new rule would make it paramount.

Although there is still uncertainty as to what rules the SEC will ultimately establish, we have seen a trend of prudent advisers beginning to proactively address this potential risk by negotiating as strong of coverage as they can reasonably obtain. The insurance market generally offers advisers competitive options and pricing, and opportunities to obtain meaningful coverage enhancements.

Predicting how insurance markets may respond to new SEC rules is perilous and uncertain. Rather than waiting until the SEC takes final action and risking adverse insurance markets, advisers can avail themselves of current strong market conditions and strengthen their coverage now. Every annual insurance renewal is a chance to reconsider the current insurance program, assess market alternatives, and work with the insurance broker and counsel to negotiate for stronger coverage. Advisers should focus on: whether their insurance coverage provides broad coverage and contains market-leading policy language; whether their policy limits are adequate to protect the firms and individuals if indemnification is unavailable; whether individuals are protected adequately; and whether policy retentions or deductibles should be restructured if those often substantial amounts cannot be indemnified by the private funds.

Advisers who act now and negotiate strong coverage before the SEC acts or insurance markets harden can ensure that they are in the strongest position possible to protect their firms and investment brand as well as personal assets of key members, no matter what indemnification or exculpation limits the SEC may enact in 2023.

> Continuing Contentious Coverage Environment

Another reason that we have seen more advisers focus carefully on negotiating strong insurance coverage during the past year is the continuation of the contentious claims environment. During 2022, insurers in the private fund space have continued to take aggressive positions in seeking to deny coverage, and we have represented a number of adviser clients in resulting coverage disputes. Insurers have attempted to deny coverage on numerous grounds in the past year, including based on policy definitions, policy exclusions, and public policy arguments. We have also witnessed many examples of insurers making the claim process difficult for their insureds, including refusing to provide consent to settlements, refusing to allow the insured to use its counsel of choice, and denying coverage based on alleged breaches of policy consent and cooperation provisions. This continued contentious claims environment reinforces the importance of carefully reviewing and negotiating coverage at the outset, as well as ensuring that the claim process (including any notice requirement) is carefully managed to avoid falling into any coverage traps.

> Increased Attention to Coverage for Government Investigations

While coverage for SEC and other government investigations has long been a key insurance coverage concern for advisers, this concern has risen even more to the forefront during the past year due to two developments. First, the SEC has increased its enforcement activity in the private fund space and proposed a number of new rules governing advisers that, if passed, would likely lead to even more enforcement actions. Second, the SEC's new proposed rules include a rule that would prohibit advisers from charging private funds for "fees or expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority." Thus, advisers are now exposed to an increased risk of SEC investigations as well as a potential rule that would bar charging expenses for such investigations to the private funds they manage. This makes obtaining broad insurance coverage for government investigations more important than ever.

Although many insurers' standard forms provide only limited coverage for investigations – as coverage is not triggered until late in the investigation (after significant costs have already been incurred) or limited to individuals only rather than advisers or private funds – if the policies are negotiated, advisers are commonly able to obtain coverage for the costs of defending government investigations from the very earliest stages. Given the wide availability and critical importance of this broad coverage, it is a significant missed opportunity not to seek and obtain such enhanced coverage.

> **Increased Attention to Protecting against Risks Arising from Portfolio Companies**

Private equity firms and activist hedge fund advisers continue to face risks from lawsuits against their individuals who serve as directors of portfolio companies and against the firm itself. During 2022, we represented several clients in seeking insurance coverage for such lawsuits under both the private funds' insurance policies and portfolio companies' policies. As the economy has worsened, and more portfolio companies face financial difficulties, the risk of such lawsuits and resulting coverage disputes with insurers has increased.

Coverage disputes in this scenario are both more likely and more difficult when strong coverage under both sets of policies has not been negotiated and attention has not previously been given to ensuring that the two sets of policies work together. Attention to capacity exclusions, allocation provisions, other insurance clauses, and outside capacity coverage agreements is critical. Additionally, especially careful attention needs to be given to the renewal of insurance policies for portfolio companies experiencing financial distress, as insurers often use those circumstances as a basis for adding exclusions and provisions that can significantly limit coverage, such as insolvency exclusions, creditor exclusions. and other problematic provisions. Careful review, negotiation, and coordination of portfolio company policies and private fund-level policies can help mitigate the risks arising from portfolio companies to funds and individuals.

> **Increased Focus on Protecting Individuals – Including When Serving In Outside Capacities**

In light of the various risks discussed above, including the SEC's new proposed rules, we have seen an increased focus on protecting individuals against the legal and regulatory risks they face for managing private funds and in serving in outside capacities, such as serving as directors of portfolio companies. This increased focus on individual protection has included: review and negotiation of adviser and private fund policies for protection of individuals in their various respective capacities; review and negotiation of portfolio company policies when individuals are serving on portfolio company boards; and an increased emphasis on obtaining dedicated insurance limits for individuals (called "Side A" policies") at the private fund-level and/or portfolio company-level and to negotiate enhancements to such policies. As more portfolio companies experience financial stress, threatening their ability to provide indemnification, insurance coverage for individuals becomes all the more important.

> **Increased Focus on Cyber Insurance, But More Challenging Cyber Market**

During the past year, we have seen an increased focus on cyber insurance for a number of reasons, including concern spurred by high-profile cyber extortion events, requirements of investors, and new proposed SEC rules that would require the implementation of certain cyber policies and procedures. At the same time, however, the market for cyber insurance has hardened – with increased premium costs and additional limitations on coverage – due to cyber insurers having paid out more and larger claims than they had anticipated for cyber events. The more challenging market has made it all the more important for careful analysis and review of potential insurance coverage, particularly because it is rare for all cyber risks of concern to fund clients to be covered under the same policy. Instead, it is common for cyber "crime" risks (for example, social engineering and fraudulent transfers) to be covered under a crime policy or endorsement to a fidelity bond, with other cyber risks (for example, data breaches and business interruption from cyber events) to be covered under a separate cyber policy. Coordinating these separate coverages is important to ensure that as broad a spectrum of cyber risks as possible are covered. Moreover, many insurers have substantially broadened the war exclusion recently to exclude coverage for, among other things, cyberattacks involving state actors or agents of a state. The language of this critical exclusion is not standardized and should be reviewed and negotiated thoroughly.

> Looking Ahead to 2023

There are a number of potential events in 2023 that could have signification ramifications on the insurance needs and markets for advisers and their private funds. What proposed rules the SEC passes and in what form will be of critical importance. The increased risks that come with a difficult economic environment – such as from portfolio company restructurings – will also likely have a significant impact. What appears certain, however, is that these events will only cause the already challenging claims environment to become even more difficult, particularly as insurers face their own financial pressures. Thus, it will remain critical for advisers and private funds to negotiate as strong coverage as reasonably possible when purchasing or renewing coverage in order to minimize the chance of claims disputes and put themselves in a position of strength if a dispute does arise.

Reorganization and Chapter 11

Over the past year, important decisions have been rendered by federal courts (i) relating to the viability of a novel legal strategy (the "Texas Two-Step") to address mass tort liabilities in bankruptcy, and (ii) addressing the ability of bankruptcy courts to provide nonconsensual releases of non-debtors from third-party claims.

> Addressing Mass Tort Liabilities in Bankruptcy — The Texas Two-Step

Bankruptcy is a powerful tool for entities in distress to obtain a fresh start from burdensome debts. However, the Bankruptcy Code does not provide a mechanism to address mass tort liabilities (other than specific provisions covering asbestos-related tort liabilities), which can hinder a debtor's ability to restructure in bankruptcy. A recent innovation — a legal strategy known as the "Texas Two-Step" — has leapt into the mainstream, offering debtors a novel way of restructuring around mass tort liabilities.

What is the Texas Two-Step?

"Step One" of the Texas Two-Step involves a company with mass tort liabilities reincorporating as a Texas corporate entity. The newly formed Texas corporation then engages in what is called a "divisive merger," under Texas law, which allows an existing company to divide itself without transferring its assets. The reincorporated Texas company (OldCo) divides into two separate entities (AssetCo and LiabilityCo) — LiabilityCo retains all (or most) of the OldCo's liabilities, while AssetCo retains all (or most) of its assets. AssetCo is then free to reincorporate in any state and in any form it desires, and continue operating without the associated mass tort liabilities.

"Step Two" of the Texas Two-Step involves LiabilityCo then filing for chapter 11 bankruptcy. To provide additional protection to AssetCo, LiabilityCo would indemnify AssetCo against any related mass tort claims. In exchange, AssetCo would enter into a funding agreement with LiabilityCo to backstop LiabilityCo's liabilities, and provide a basis for LiabilityCo's indemnification of AssetCo — potentially shielding the transaction from being unwound as a fraudulent transfer.

Johnson & Johnson—Viability of the Texas Two-Step

The viability of the Texas Two-Step as a strategy to address mass tort liabilities in bankruptcy was tested in connection with Johnson & Johnson's ("J&J") talc-related liabilities. In 1894, J&J began production of its talc-based baby powder. By 1985, more than 70 percent of Americans were using J&J's talc-based baby powder daily. However, starting in 2013, litigation against J&J relating to allegations that two of its talc products caused ovarian cancer or, in rare cases, mesothelioma, began to escalate, with lawsuits growing to over 38,000 cases to date. In 2015, through a series of transactions, Johnson & Johnson

Consumer Inc. ("Old JJCI"), an indirect subsidiary of J&J, assumed responsibility for all claims relating to J&J's baby powder.

Confronted with the prospect of decades of litigation and claiming the cost of the suits is unsustainable, Old JJCI engaged in the Texas Two-Step strategy. In simplified terms, in 2021, Old JJCI underwent Step One of the Texas Two-Step, and was converted to a Texas LLC through a series of transactions. On October 12, 2021, Old JJCI completed Step Two, and created LTL Management ("LTL") and New JJCI through a divisive merger. Through the divisive merger, LTL held all of Old JJCI's talc liabilities. By contrast, New JJCI received all other assets of the original Old JJCI business. As part of Step Two, LTL entered into a funding agreement (the "Funding Agreement") with J&J and New JJCI, which provided, among other things, that J&J and New JJCI would fund all costs and expenses (with certain exceptions) incurred during LTL's bankruptcy case up to the value of New JJCI.

Subsequently, LTL converted into a North Carolina limited liability company and filed for bankruptcy on October 14, 2021, two days after its formation.

The LTL Management Decision

Following the commencement of LTL's bankruptcy case, talc claimants sought to dismiss the bankruptcy case, asserting, among other reasons, that LTL filed its bankruptcy case in bad faith, the filing had no valid reorganization objective, and the case was filed solely to delay litigation. In contrast, LTL argued the implementation of the Texas Two-Step and LTL's bankruptcy filing were intended "to produce an equitable resolution of both current and future talc claims by means of a settlement trust that can promptly, efficiently, and fairly compensate claimants."

On February 25, 2022, the U.S. Bankruptcy Court for the District of New Jersey sided with LTL, allowing LTL's bankruptcy case to proceed. In denying talc claimants' request to dismiss the case, the court determined that bankruptcy was the best forum to resolve mass tort liability, and that the implementation of the Texas Two-Step prior to filing for chapter 11 did not harm talc claimants. In particular, the bankruptcy court noted that J&J and LTL's compliance with the statutory requirements for divisive mergers under Texas law was evidence that the bankruptcy filing was not intended to hinder creditors.

The bankruptcy court also rejected that the Texas Two-Step left LTL undercapitalized and placed talc creditors at greater risk. The bankruptcy court explained that the Funding Agreement allowed creditors, including talc claimants, to enforce claims against LTL, with the added benefit of having J&J and New JJCI backstopping such obligations, with the value of Old JJCI as a floor, and up to the value of New JJCI. With the filing of LTL's bankruptcy case, the ability to enforce LTL's rights under the Funding Agreement is now under the jurisdiction and oversight of the bankruptcy court to ensure that LTL pursues its rights against J&J and New JJCI—providing greater protections to talc creditors. As such, the bankruptcy court viewed the commencement of LTL's bankruptcy case as offering talc claimants the best opportunity to obtain equitable and timely recoveries.

On May 11, 2022, talc claimants obtained approval from the U.S. Court of Appeals for the Third Circuit Court to appeal the bankruptcy court's denial of their request to dismiss LTL's bankruptcy case.

Implications of the Texas Two-Step and the LTL Management Decision

It remains to be seen whether the Third Circuit will embrace the Texas Two-Step — and, if so, what limitations the court may impose to prevent any perceived abuses. At least until it is reviewed on appeal, the bankruptcy court's endorsement of the Texas Two-Step will have broad implications on the corporate bankruptcy landscape. However, given its novelty, the Texas Two-Step may succumb to other challenges, such as fraudulent transfer claims in connection with the overall transaction. Indeed, talc claimants in the LTL case have indicated their intent to seek standing to bring fraudulent transfer claims against non-debtor entities — to which LTL suggested it would provide its consent. Furthermore, three other cases, in the Western District of North Carolina (*In re DBMP LLC, In re Bestwall LLC*, and *In re Aldrich Pump LLC*), involve pending fraudulent transfer and breach of fiduciary duty claims in connection with Texas Two-Step transactions.

> **Non-Consensual Third Party Releases in Chapter 11 Plans of Reorganization**

Chapter 11 allows a distressed entity to restructure its debts and discharge claims held by creditors against the debtor. However, nonconsensual third party releases have been increasingly utilized by debtors in chapter 11 restructurings to preclude creditors of the debtor from pursuing claims against *non-debtor* third parties. Aside from specific provisions addressing asbestos cases, the Bankruptcy Code is silent as to whether such nonconsensual third party releases can be utilized by chapter 11 debtors. The U.S. District Court for the Southern District of New York addressed the viability of nonconsensual third party releases in *In re Purdue Pharma L.P.*, holding that the bankruptcy court did not have statutory authority to approve a chapter 11 plan's nonconsensual third party releases.

The Purdue Decision

On September 15, 2019, Purdue Pharma L.P. ("Purdue Pharma") commenced its chapter 11 case in the U.S. Bankruptcy Court for the Southern District of New York. Its bankruptcy was precipitated by its marketing, manufacturing, selling, and distribution of opioid pain medications, such as OxyContin, that resulted in a "veritable tsunami of litigation" against the company due to their contribution to the opioid epidemic. Purdue Pharma commenced its bankruptcy case to resolve the flood of opioid litigation against the company and other non-debtor affiliates, and to halt and resolve any further litigation and uncertainty surrounding Purdue Pharma's total opioid liability.

On September 17, 2021, the Bankruptcy Court confirmed Purdue Pharma's chapter 11 plan, which contained provisions releasing direct claims against members of the Sackler family (the private owners of Purdue Pharma) as well as other non-debtor entities. As consideration for the third party releases, the Sacklers agreed to contribute approximately $4.5 billion to fund charities and various recoveries under Purdue Pharma's chapter 11 plan.

The District Court later vacated the Bankruptcy Court's confirmation order, holding that the nonconsensual third party releases in the plan were unauthorized by the clear and express text of the Bankruptcy Code. The District Court noted that, "the sections of the Code on which the learned Bankruptcy Judge explicitly relied, whether read separately or together, do not confer on any court the power to approve the release of non-derivative third-party claims against non-debtors…"

Further, the District Court held that Bankruptcy Code sections 105(a), 1123(a)(5), 1123(b)(6) and 1129(a)(1), alone or as a whole, do not provide the bankruptcy court authority to approve nonconsensual third party releases. In fact, Congress' enactment of section 524(g) of the Bankruptcy Code, permitting nonconsensual third party releases in asbestos cases, indicated that Congress did not intend for nonconsensual third party releases to be used outside of the asbestos context. Therefore, the authority to grant nonconsensual third party releases is the exception, not the rule.

The District Court further noted there is no such "equitable authority" or "residual authority", or authority found in case law, that exists to grant bankruptcy courts the power to approve nonconsensual third party releases. In fact, the District Court noted that neither the Supreme Court nor the Second Circuit has even taken a position on nonconsensual third party releases.

Implications of the Purdue Decision

The *Purdue* decision signals the tide is turning against nonconsensual third party releases. While such releases remain viable in other jurisdictions, such as the Eastern District of Virginia (*see Patterson v. Mahwah Bergen Retail Group, Inc.*) and the Third Circuit (*see In re Millennium Lab Holdings II, LLC*, 945 F.3d 126, 139 (3d Cir. 2019)), debtors and non-debtors seeking to obtain releases in chapter 11 should expect to face greater push back from creditors and courts in light of the *Purdue* decision. Given the significant legal issues, and potential constitutional challenges, nonconsensual third party releases present, the Supreme Court may weigh in on the viability of such releases.

European Union and United Kingdom

> **ESG Disclosure Requirements and Taxonomy Regulation for Asset Managers – What Comes Next?**

On March 10, 2021, the new European regime on sustainability-related disclosures in the financial sector ((EU) 2019/2088) (the "Disclosure Regulation", or the "SFDR") came into force.

The SFDR introduced new transparency and disclosure requirements for "financial market participants", which includes investment firms and asset managers (including non-EU fund managers such as US fund managers, which market funds in the European Economic Area (the "EEA") under the National Private Placement Regimes (the "NPPR")). The SFDR is part of the wider European sustainable finance package that requires firms in scope to integrate ESG considerations into their investment decisions and advisory processes in a consistent manner across financial sectors. Within this sustainable finance package, there are two key pieces of regulation: the regulation on the establishment of a framework to facilitate sustainable investment ((EU) 2020/852) ("Taxonomy Regulation") and the aforementioned SFDR.

The Taxonomy Regulation aims to establish an EEA-wide classification system (or taxonomy) intended to provide firms and investors with a framework to identify the degree at which their economic activities can be considered to be environmentally sustainable. It serves to establish a common language and a classification tool to help investors and companies make informed investment decisions as to what can be considered environmentally sustainable economic activities. The Disclosure Regulation requires firms in scope to make disclosures at both the firm and product level.

Firm-level disclosures need to be made on the firm's website and includes information on their policies on the integration of sustainability risks in their investment decision making processes, which assumes that firms have such a policy. Firms with over 500 employees have to publish a due diligence statement on how the firm considers principal adverse impacts of investment ("PAI") decisions on sustainability factors. Where they do not consider adverse impacts of investment decisions on sustainability factors, clear reasons for why they do not do so, including, where relevant, information as to whether and when they intend to consider such adverse impacts have to be published on the firm's website.

At the product level, firms need to provide pre-investment disclosures to EEA investors before investing in the product. As a result, firms have to classify each financial product that they make available in the EEA and categorize it in three different ESG fund-types:

- Art. 6 fund ("grey/brown fund") for products that do not consider ESG factors (as contemplated by the SFDR);

- Art. 8 fund (“light green fund”) for products that promote a sustainable investment as one objective amongst other objectives;
- Art. 9 fund (“dark green fund”) for products that have sustainable investment as their main objective, such as an impact or climate fund.

There are minimal disclosure requirements for Art. 6 funds and the most onerous disclosure requirements fall on Art. 9 funds. The relevant disclosures should be included in the offering documentation such as the private placement memorandum or the AIFMD disclosure addendum, summarizing, amongst other things, how sustainability risks are integrated into investment decisions, including how ESG characteristics are met and how any index is compatible or consistent with those characteristics. “AIFMD” means the Directive 2011/61/EU of the European Parliament and the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and regulations (EC) No 1060/2009 and (EU) No 1095/2010.

These pre-investment disclosure requirements also apply to US managers marketing under the NPPR as they already have to comply with the AIFMD disclosure obligations and are required to prepare a disclosure supplement under Article 23 AIFMD.

Much of the detail behind the disclosures is further specified in the level 2 framework and regulatory technical standards (“RTS”) that were finalised in July 2022. The RTS are a consolidated set of technical standards, which provide additional detail on the content, methodology and presentation of certain existing disclosure requirements under SFDR and the Taxonomy Regulation and will come into effect on January 1, 2023. From January 2023 all asset managers in scope will be required to provide the disclosures under the SFDR and Taxonomy Regulation in the format prescribed in the RTS. Firms that promote ESG or have ESG as their objective, will need to assess and disclose whether the fund is taxonomy eligible and aligned by meeting the technical screening criteria associated with the relevant environmental objectives in the Taxonomy. An economic activity is considered “eligible” if it is included in the regularly updated list of activities covered by the delegated acts of the Taxonomy Regulation. These are the activities that have been selected by the European Commission, which are likely to make a substantial contribution to any one of the six environmental objectives. The six environmental objectives covered by the Taxonomy Regulation include two climate objectives on climate change mitigation and adaptation. The other four environmental objectives cover the sustainable use and protection of water and marine resources, the transition to a circular economy, pollution prevention and control, and the protection and restoration of biodiversity and ecosystems. Separate delegated acts, set down the technical screening criteria for the six environmental objectives identified under the Taxonomy framework, will need to be considered by asset managers and will enter into force on 1 January 2023.

An economic activity is considered “aligned” with one of the six environmental objectives if:

- it contributes substantially to the achievement of that objective (compliance with specific technical criteria);
- it does not harm any of the other five objectives (“Do No Significant Harm” criteria); and
- minimum safeguards (e.g., OECD, United Nations, etc. guidelines) are otherwise met.

Firms should now be reviewing the application of the SFDR and Taxonomy Regulation to the relevant products managed or being marketed in the EU to ensure the relevant disclosures pursuant to the prescribed format in the RTS are being met from January 2023.

> UK FCA proposals on ESG disclosures

The UK's Financial Conduct Authority ("FCA") published a discussion paper on 'Sustainability Disclosure Requirements and investment labels' seeking initial views from the industry on disclosure requirements under the new Sustainability Disclosure Requirements ("SDR") for asset managers and certain FCA-regulated asset owners, as well as a sustainable investment labelling system.

Disclosures will be required from both asset managers and investment products in regards to sustainability risks, opportunities and impacts. The UK government is also planning to release a green taxonomy, which will outline which economic activities count as green, and some companies and financial products will be required to report their environmental impact against these metrics.

While still in early stages of development, asset managers should note that the UK rules may go beyond the current EU disclosure framework, with a particular focus on transition plans and should consider the consultation due to be released from the FCA in Q3 2022.Rules Relating to the Pre-Marketing and Marketing of Funds since August 2021

In August 2021, rules concerning the marketing and premarketing of funds were introduced (being made up of Directive ((EU) 2019/1160) and Regulation ((EU) 2019/1156) aimed at reducing the regulatory barriers for the cross-border distribution of funds in the EU (the "CBDF Package"). Previously, the interlinked concepts of "pre-marketing" and "marketing" were interpreted differently between EU Member States and the CBDF Package introduced a new harmonized definition of "pre-marketing" of funds. The new 'pre-marketing' definition allows for fund specific information, including draft private placement memoranda or offering documents, to be provided to potential investors and for this to still fall within the scope of pre-marketing, provided certain disclaimers are included in the documentation and as long as it does not amount to "an offer or placement" to an investor, which would trigger a formal marketing notification requirement.

EU fund managers are now required to notify their local home state regulator within two weeks of beginning their pre-marketing. Non-EU Managers intending to pre-market in EU Member States are required to submit a pre-marketing notification in Member States who have implemented the CBDF package (including for example, Germany and Luxembourg) or will need to wait for registration approval under the private placement regime of the relevant Member State, before it commences any pre-marketing or marketing activity. Any third party carrying out premarketing or marketing activities on behalf of a fund manager must be authorized as an investment firm under MiFID, a CRD IV credit institution, a Undertakings for the Collective Investment in Transferable Securities ("UCITS") management company or an AIFM under AIFMD, or act as a tied agent in accordance with MiFID. In addition, the agent is directly subject to the pre-marketing rules in the CBDF Package. Fund managers should ensure that any potential placement agents and fund distributors have the appropriate authorizations.

The CBDF Package also introduces restrictions on the use of "reverse solicitation" in jurisdictions where there has been any prior marketing or pre-marketing activity, where there is a subscription by professional investor(s) in the relevant EU Member State within 18 months of the EU AIFM having begun pre-marketing, it is deemed to have taken place as a result of active "marketing" (triggering the requirement to make a formal marketing notification).

The CBDF Package included new de-notification requirements, which include that EU AIFMs must notify their home Member State regulator when intending to cease marketing of an alternative investment fund ("AIF"). This would mean that the EU AIFM will not be able to carry out pre-marketing in relation to the AIF and a "similar investment strategy" or "investment ideas" for 36 months after the de-notification.

The AIFMD marketing rules under the CBDF Package do not apply to marketing activities in the UK because the UK has not on-shored the relevant European legislation.

> New Prudential Rules for UK Investment Firms

The UK Investment Firms Prudential Regime ("IFPR") came into force on January 1, 2022 and will apply to UK investment firms authorized under the Markets in Financial Instruments Directive ("MiFID") as it is applied in the UK post-Brexit, which will include current "BIPRU" firms and "Exempt CAD" firms, as well as AIFMs that have MiFID top-up permissions (known as collective portfolio management investment firms ("CPMI")). The IFPR is based on the European Investment Firms Regulation ((EU) 2019/2033) ("IFR") and the Investment Firms Directive ((EU) 2019/2034) ("IFD") which came into force in June 2021 and the UK has adapted it for the prudential regulation of FCA investment firms.

The IFPR introduced new regulatory capital requirements for firms within its scope and, among other things, new remuneration, reporting and disclosure requirements.

The IFPR regime distinguishes between "small and non-interconnected investment firms" ("SNI" firms) and non-SNI firms. The level of compliance with certain rules that will apply to a firm within the scope of the IFPR is determined by whether or not the firm is an SNI or a non-SNI firm.

SNI firms are defined in the prudential sourcebook for MiFID firms ("MIFIDPRU 1"), prescribing a series of permission-based and quantitative thresholds for firms to determine whether they are an SNI. The FCA expects approximately 70% of firms to be SNI and firms that exceed the relevant thresholds will be known as "non-SNI".

The new regulatory capital requirements will require all firms subject to the IFPR to hold an "initial capital" requirement as well as an additional capital amount by reference to their "annual fixed overheads." A number of firms have been particularly impacted by the new regulatory capital requirements, such as Exempt CAD firms, which have seen their capital requirements significantly increase. Certain firms are able to benefit from temporary transitional provisions enabling them to gradually adjust to the additional requirements under the IFPR. For example, Exempt CAD firms will be able to gradually increase their capital over the course of five years from January 1, 2022.

All firms within scope of the IFPR will need to comply with the new MIFIDPRU Remuneration Code requirements which will vary, depending on the type of firm. The MIFIDPRU Remuneration Code applies to remuneration, including carried interest, paid to a firm's staff (which has a wide meaning under the FCA rules). In particular, SNI firms will have to comply with basic remuneration requirements, requiring them to establish and implement remuneration policies, while applying proportionality. Larger SNI firms will be subject to enhanced remuneration rules, which amongst other things, will also have to establish risk and remuneration committees, comply with pay-out process rules and provide certain additional remuneration disclosure.

> UK Issues Cybersecurity Warning

In January 2022, the UK's National Cyber Security Centre ("NCSC") published a reminder to organizations to take steps to protect their systems given the increased risk from and number of cyber threats. This reminder was reiterated by the Information Commissioner's Officer ("ICO"), the UK's data supervisory authority, following a reported uptick in cyber related data breaches in the UK of nearly 20% in the past two years. The UK's data protection legislation already provides that organizations should implement "appropriate technical and organisational measures to ensure a level of security appropriate to the risk" to protect personal data. When designing and assessing "appropriate" measures, organizations in the UK (including funds, sponsors and advisers) should also now take account of the specific guidance on ransomware recently published by the ICO.

UK Tax

> HMRC Announces Welcome Changes to the QAHC Regime

On July 20, 2022, the UK government published draft legislation for the Finance Bill 2022-2023. Of particular interest are amendments to be made to the qualifying asset holding company ("QAHC") regime that was introduced on April 1, 2022.

The regime is part of the UK government's attempt to increase the attractiveness of the UK as a jurisdiction for asset management and introduces a simplified tax regime applicable to QAHCs that should, broadly, tax investors as if they had invested directly in the underlying assets. Please see our submission to the 2021 PIF Annual Review and Outlook here for the circumstances in which the regime is available and its benefits.

The QAHC regime was introduced reasonably quickly and contained some limitations on how an asset holding company owned by a private fund could qualify as a QAHC. In particular, one of the main conditions to qualify as a QAHC is that the asset holding company is owned at least 70% by what are described as Category A investors. In the context of private funds, the most useful Category A investor is a "qualifying fund". That is a collective investment scheme (as defined for UK purposes) which meets a "genuine diversity of ownership" test. The "genuine diversity of ownership" is based, broadly, on the fund being widely marketed.

This requirement raised questions about the QAHC qualification of asset holding companies that were owned by either a number of parallel fund vehicles (as will often be the case to cater for different classes of investors) or by a master fund itself owned by feeder funds into which the investors invest.

The recent amendments to the regime have been introduced to ensure the conditions to be a QAHC better align with the initial intended scope of the regime by extending the "genuine diversity of ownership" tests to parallel funds and master funds where, looked at in aggregate with the other parallel funds or the feeder funds, the test would be satisfied.

As HM Revenue & Customs ("HMRC") notes, in a parallel fund structure, the interests in one fund may be widely marketed and made available, but certain investors will then invest via a different fund based on their particular characteristics. That parallel fund might not itself be widely marketed. Similarly for master/feeder structures, the overall fund structure is marketed but the master fund itself, which will be the investor in the asset holding company, is not directly marketed. It was not clear under the existing rules whether the diversity of ownership condition would be satisfied by these common fund structures.

To rectify this unintended issue, the amendment to the QAHC rules relevant to parallel fund structures provides that a fund will be treated as meeting the diversity of ownership condition where it is closely associated with another investment fund that satisfies the condition because it is widely marketed and made available. The vehicles must also satisfy conditions requiring investments in substantially the same assets, holding investments using the same structures on substantially the same terms and in the same ratios and the management of the funds to be substantially coordinated such that they act together in relation to their investments as if they were a single fund. HMRC notes that this means funds will be prevented from being treated as parallel if they each own shares in the same potential QAHC of different classes and those shares carry materially different rights (i.e. not substantially the same asset). Additionally, the updated legislation will not apply to a parallel fund if the main purpose, or one of the main purposes, of the arrangements that result in it being a parallel fund is so that the diversity of ownership condition is satisfied.

To deal with the master/feeder fund structure, the master fund (referred to as the “aggregator fund” in the rules) can be treated as meeting the diversity of ownership condition provided that the feeder funds feeding/investing into it meet that condition (or are treated as doing so by reason of the change to the rules referred to above).

The changes for parallel funds and master/feeder funds will apply from a date to be confirmed.
In addition to this, the amendments have dealt with another, unconnected issue with the existing rules. To be a “qualifying fund” (and so a Category A investor in a QAHC), the fund vehicle has to be a collective investment scheme (“CIS”) for UK law purposes. Certain types of non-UK vehicles that would be a collective investment scheme in general terms might not be if they are constituted as a body corporate under their law of establishment. The QAHC rules are amended to state that fund entities that would be a CIS if they were not a body corporate are treated as if they were a CIS and so can be qualifying funds provided that they meet the other conditions for them to so qualify. This change is retrospective and applies from April 1, 2022.

Finally, in relation to calculating the ownership of a QAHC, there is an anti-fragmentation rule that aggregates the different interests of a direct investor in a company with their indirect interests. This rule is now extended so that it applies in circumstances where interests are held indirectly through one or more QAHCs. This amendment limits the QAHC qualification by excluding from the regime investment structures involving more than one QAHC in which the combined percentage owned by non-Category A investors is greater than 30%. This change came into force on July 20, 2022. These changes are very welcome and remove significant barriers to a wide uptake of UK-based QAHCs in fund structures.

In addition, on July 27, 2022, HMRC issued new guidance that clarifies HMRC’s approach to whether corporate lending vehicles used by credit funds should be treated as carrying on an investment activity or a trade.

Some key conditions for the availability of the QAHC regime are that:

> the company’s main activity is carrying on an investment business and any other activities are ancillary to that business and are not substantial;

> its investment strategy does not involve the acquisition of listed securities; and

> none of its shares are listed or traded on a recognised stock exchange.

So, where a company is engaged in any trading activity, the regime will not be available unless the trade is merely ancillary to the main investment business and is not substantial. Following the introduction of the regime there was some uncertainty among asset managers as to whether credit funds which engage in loan origination (or other activities related to debt) might be considered to be carrying on trading activity and/or whether any fees they received in connection with their main lending activities (such as arrangement fees, facility fees and syndication fees) might be considered to be trading income. If either the basic activity were considered trading or the fees were treated as trading income which was more than insubstantial in the context of the company’s activities as a whole, the regime would be unavailable. Depending on the characterisation of standard loan origination activities, this could mean that a significant number of credit funds could not use the regime and this would have had the effect of undermining the policy objectives of the regime in the context of such funds.

Following discussion with industry stakeholders, HMRC has updated the relevant section of its published QAHC guidance in the context of credit funds. In summary, the guidance now confirms that loan origination is not in itself indicative of a trade and that, where loans are originated with the intention of being held on a medium to long term basis as part of the QAHC's investment strategy, it is likely that this will be part of its (main) investment business. With regard to fees, the guidance states that fees that are earned for originating loans, such as arrangement fees, are likely to be investment income and simply part of that main investment business if the lending itself is an investment activity. However, fees received for arranging loans for others, such as syndication fees, might well be trading income arising from a separate business activity to any investment business that the company might also carry on. The guidance indicates that the best test of whether the syndication fees are ancillary and insubstantial might be the value of those fees relative to the investment returns received by the company.

Similarly, with regard to the acquisition of distressed debt, the updated guidance provides that, where such assets are acquired with the intention of being held for the medium to long term, this is likely to constitute investment activity, even where the assets are disposed of prior to termination of the loan on an opportunistic basis. Conversely, greater levels of activity in relation to distressed assets such as leading a restructuring or insolvency process (and generating fees from such activities) may be indicative of a trade. However, this is a question of fact to be assessed on a case by case basis.

This updated guidance provides a welcome clarification of HMRC's interpretation of how the QAHC legislation should apply to lending/debt acquisition companies set up by credit funds and should provide a high measure of comfort to asset managers in the credit sphere who are considering using QAHCs within their fund structures. The guidance also provides insight on HMRC's view as to whether particular loan related activities constitute trading or investment activities as a general matter and, as such, may be more widely useful for credit funds that do not envisage the use of QAHCs within their structures.

> ATAD 3 and shell companies

On December 22, 2021, the European Commission presented an initiative to fight the use of "shell companies", known as the Anti-Tax Avoidance Directive 3 ("ATAD 3" or the "Directive"). The objective of the initiative is to ensure that companies that have no or minimal economic activity are unable to benefit from double tax treaties or EU tax directives under which businesses could minimise withholding taxes on dividends, interest and royalties.

ATAD 3 will, if adopted by the European Council in due course, enter into force on January 1, 2025 with a 'reference period' of the two preceding years to assess whether a company presents a risk for being misused for tax purposes starting as of January 1, 2023.

ATAD 3 attempts to resolve the misuse of investment structures that do not perform any actual economic activity, specifically such investment structures involved in cross-border activities.

The Directive outlines gateway indicators which help to determine whether an undertaking is "at-risk" of being a shell company. If these indicators are met, the undertaking will be considered at-risk, and subject to further reporting to determine whether it meets minimum substance requirements.
Only the undertakings that are in scope, not-carved-out (listed below) and that cross all gateways are considered at risk:

- more than 75% of the revenues of the undertaking in the preceding two tax years consists of passive income including interest, royalties, dividends and capital gains, income from financial lease or real estate; and
- the undertaking receives the majority of its relevant income through transactions linked to another jurisdiction or passes this relevant income on to other companies situated abroad (cross-border element); and
- the undertaking outsourced the administration of day-to-day operations and the decision making on significant functions in the preceding two tax years.

However, an undertaking at risk can request an exemption from the reporting obligation by providing sufficient evidence to the relevant tax authorities that its interposition does not reduce the tax liability of its beneficial owner or of the group as a whole.

At a high level, the following undertakings are carved-out:

- listed entities;
- regulated financial undertakings (such as AIF or AIFMs, UCITS and their management companies and securitisation special purpose entities);
- undertakings that have the main activity of holding shares in operational businesses in the same member state (i.e. domestic holding situations);
- undertakings with holding activities that are resident for tax purposes in the same member state as the undertaking's shareholder(s) or the ultimate parent entity (i.e. sub-holding situations); and
- undertakings with at least five full-time equivalent employees or members of staff exclusively carrying out the activities generating the overall income.

Where an undertaking is qualified as at risk, it may be able to demonstrate, through reporting and adequate documentation in its annual tax return, that it complies with the minimum substance indicators laid down in the Directive. In such a case, information exchange and the reporting requirement shall apply but not the direct tax consequences provided for in the Directive. However, if the minimum substance indicators are not met, the undertaking is presumed to be a shell.

The minimum substance indicators are the following:

- the undertaking has its own premises or premises available for its exclusive use;
- the undertaking has at least one active bank account in the EU; and
- (i) at least one qualified director of the undertaking that is authorised to take decisions in relation to the activities, is:
    - (a) a tax resident in the member state of the undertaking; and
    - (b) is not employed by a non-associated enterprise and does not perform the function of director in another non-associated enterprise, or

- (ii) alternatively, the majority of the full time employees of the undertaking is tax resident in the Member State of the undertaking and are qualified to carry out the activities.

If an undertaking fails to meet these minimum substance criteria, direct tax consequences will apply such as the inability to access the Parent-Subsidiary and Interest and Royalties EU Directives. Additionally, the undertaking may no longer be able to obtain a certificate of tax residence, or it may be provided with a certificate that includes the warning that the undertaking lacks substance. This in turn would adversely impact its access to tax treaty benefits.

As a last safe harbour, the presumption of being a shell may be rebutted with additional evidence on:

- information on the commercial rationale behind the establishment of the undertaking;
- information on the employee profiles; and
- concrete evidence that decision-making concerning the relevant income generating activity takes place in the Member State of the undertaking.

On May 12, 2022, the Committee on Economic and Monetary Affairs of the European Parliament (ECON) published a draft report with proposed amendments to the initial ATAD 3 proposal which includes some relaxations, notably for outsourcing to associated enterprises in the same jurisdiction, but it is still possible that the European Council might reject them.

Businesses should take a critical look at their structures in order to identify any undertakings that may be considered to lack economic substance and be impacted by the implementation of ATAD 3. It is important to note that ATAD 3 will only be legislated by EU Member States but it includes rules to be applied by Member States in structures that include third countries.

China

> China Issued New Negative List for Foreign Investments

Since 2015, foreign investment control in China has been taking the form of a “negative list.” A negative list delineates the industry sectors in which foreign investments are prohibited or restricted, while foreign investments in industry sectors outside of the negative list are generally permitted and receive national treatment. There are currently two sets of negative lists for foreign investments in China, namely a national negative list which applies nationwide, and a free trade zone (“FTZ”) negative list which applies in certain FTZs. The FTZ negative list usually offers broader investment access than the national negative list. Chinese regulators update such negative lists on a regular basis.

On December 27, 2021, the National Development and Reform Commission of China (“NDRC”) and the Ministry of Commerce of China (“MOFCOM”) jointly issued the *Special Administrative Measures for Foreign Investment Access (2021 Edition)* (the “2021 National Negative List”) and the *Special Administrative Measures for Foreign Investment Access in Pilot Free Trade Zones (2021 Edition)* (the “2021 FTZ Negative List,” together with the 2021 National Negative List, the “2021 Negative Lists”). The 2021 Negative Lists took effect on January 1, 2022 and superseded the earlier versions of the national and FTZ negative lists issued in 2020.

Set out below is a brief summary of the 2021 Negative Lists:

1. Greater access to more industry sectors

The number of restricted and prohibited industry sectors for foreign investments has been reduced from 33 to 31 in the 2021 National Negative List and from 30 to 27 in the 2021 FTZ Negative List.

The 2021 Negative Lists lifted foreign shareholding restrictions in the vehicle manufacturing industry. Foreign investors are now allowed to establish wholly foreign-owned enterprises for whole vehicle manufacturing, including special purpose vehicles, new energy vehicles, commercial vehicles and passenger vehicles, while in the past, the shareholding ratio of Chinese shareholders in a whole vehicle manufacturer had to be at least 50%. Further, there is no restriction on the number of joint ventures that can be founded by foreign investors in China to manufacture the same types of vehicles in the 2021 Negative Lists, while in the past, one foreign investor may only establish up to two such joint ventures.

The 2021 Negative Lists also removed the prohibition on foreign investments in the manufacturing of satellite television broadcast ground receiving facilities and critical components thereof, and opened up the manufacturing of such facilities and components to foreign investments.

Moreover, the 2021 FTZ Negative List removed some restrictions in the survey services sector. Foreign investors are now allowed to invest in market survey services in China through wholly foreign-owned enterprises or Sino-foreign joint ventures established in a FTZ. However, foreign shareholding restrictions applicable to the conduct of rating survey of radio listeners and television viewers remain, i.e., Chinese shareholder(s) must have a controlling stake in such business. Foreign investors are now able to establish Sino-foreign joint ventures in a FTZ to conduct a social survey business, subject to the restrictions that Chinese shareholding ratio in this type of joint venture cannot be lower than 67% and the legal representative of this type of joint venture must be a Chinese national.

2. Clearer scope of application

The 2021 Negative Lists contain a new explanatory note clarifying that FIEs should also comply with such negative lists. “FIEs” refer to companies invested and established by foreign investors in China. FIEs are incorporated as Chinese companies with foreign ownership. This new explanatory note means that equity investments made by FIEs within China will be treated as foreign investments for the purposes of industry sectors prohibited or restricted under the negative lists. This approach in treating FIEs’ equity investments within China is not something new and has been implemented by Chinese regulators in the past. The purpose of this approach is to prevent foreign investors from circumventing the market access requirements contemplated by the negative lists by, for instance, making investments in restricted or prohibited industry sectors through FIEs.

3. New requirements on review of Chinese companies’ overseas listing

The 2021 Negative Lists for the first time include provisions regulating overseas listing by Chinese companies operating in prohibited industry sectors. Under the 2021 Negative Lists, Chinese companies operating in industry sectors prohibited from foreign investment are required to obtain the approval of relevant Chinese regulators before listing on an overseas stock market. In addition, foreign investors in such overseas listed Chinese companies are not allowed to participate in the operation and management of such companies. The shareholding ratio of foreign investors in any of such overseas Chinese companies after completion of their overseas listings cannot exceed the following thresholds: (i) the shareholding ratio of a single foreign investor and its affiliates must not exceed 10% of all the shares of the company; and (ii) the shareholding ratio of all foreign investors and their affiliates must not exceed 30% of all the shares of the company.

Additionally, we understand that the China Securities Regulatory Commission ("CSRC") is in the middle of revising existing rules and regulations on overseas listing of Chinese companies to implement the above requirements. See details in the section titled "China Is Revising Overseas Listing Rules" below.

> China Is Revising Overseas Listing Rules

On December 24, 2021, three days before the issuance of the 2021 Negative Lists, the State Council of China and the CSRC, respectively, released a draft of the *Provisions of the State Council on the Administration of Overseas Securities Offering and Listing by Domestic Companies* and a draft of the *Administrative Measures for the Filing of Overseas Securities Offering and Listing by Domestic Companies* (collectively, the "Draft Rules") for public comments.

The Draft Rules propose a unified filing-based regulatory framework for overseas listings of Chinese businesses, which is intended to streamline regulatory oversight by Chinese regulators. At present, the CSRC only oversees direct overseas listings of companies incorporated in China, which requires the CSRC's approval; while indirect overseas listings of Chinese businesses through offshore holding companies incorporated to hold China-based assets of such businesses falls outside of the CSRC's oversight. The Draft Rules, if passed, will extend the CSRC's authority to regulate such indirect overseas listings of Chinese businesses, and change the approval system for direct overseas listings of Chinese companies into a filing system. This means, if the Draft Rules are passed, both direct and indirect overseas listings of Chinese businesses will require filings with the CSRC.

Another noteworthy feature of the Draft Rules is that they also apply to VIE-structured overseas listings of Chinese businesses. This is interpreted by practitioners to be a signal of Chinese regulators' acknowledgement of VIE-structured overseas listings of Chinese businesses. By way of background, VIE (or Variable Interest Entity) refers to an entity controlled by an investor not by ordinary ownership but through a series of controlling agreements, which enable the investor to consolidate the financials of such entity into its financial statements. In a typical VIE structure, founders of a Chinese business set up an offshore listing vehicle which, via a series of contractual arrangements, exerts effective control over, and enjoys the economic benefits of, the founders' Chinese operating companies (being the listing assets). Many Chinese businesses like Alibaba and Tencent adopted the VIE structure to circumvent China's restrictions on foreign ownership in their industries and to achieve their listings on overseas stock markets. Although the VIE structure has been broadly adopted by Chinese businesses in their overseas listings in practice, Chinese regulators have been silent on the questions of whether they have jurisdiction over such VIE-structured overseas listings and whether VIEs are legitimate at all given that they circumvent China's industry-specific foreign investment restrictions. Market stakeholders therefore have been relying on the resulting regulatory grey area in the past. Now, the Draft Rules, if passed, together with the 2021 Negative Lists, will put VIE-structured overseas listings of Chinese businesses under the oversight of Chinese regulators.

Thus far, the Draft Rules have not yet been officially passed. Also, certain provisions of the Draft Rules remain to be clarified by Chinese regulators before they can be implemented.

> China's New Data Security Law and Personal Information Protection Law

China's data security and privacy laws have been developing rapidly in recent years. On June 10, 2021, the Standing Committee of the National People's Congress ("NPC") of the People's Republic of China ("China" or the "PRC") passed the Data Security Law of the PRC ("DSL"), which took effect as of September 1, 2021. On August 20, 2021, the Standing Committee of the NPC passed the Personal Information Protection Law of the PRC ("PIPL"), which took effect as of November 1, 2021. The DSL, the PIPL and the Cybersecurity Law of the PRC ("CSL", which took effect as of June 1, 2017) form the three pillars of China's data protection regulatory framework, which govern data security, personal information protection and cybersecurity, respectively. On December 29, 2021, China issued an official English translation of PIPL. Throughout 2022, China has released incremental changes to PIPL and DSL through regulations.

The DSL

As China's first national law governing data security, the DSL represents the Chinese government's continuing efforts to protect data security and regulate cross-border data transfers.

Scope and extra-territorial applicability. The DSL not only regulates data processing activities carried out within the territory of China, but also regulates data processing activities performed outside of China that could jeopardize the national security or public interest of China or the legitimate rights and interests of citizens or organizations in China.

Hierarchical data classification management and protection system. The DSL provides for a hierarchical data classification management and protection system that takes into account the importance of specific types of data to China's economic and social development, as well as the degree of harm that could result from a security incident. Under this system, some special data, including important data and national core data, are protected by stricter regulatory measures.

> ***National Core Data***. National core data is a new category of data introduced in the DSL. The DSL defines national core data as data related to national security, the lifeline of the national economy, important aspects of people's livelihoods and major public interests. Under the DSL, national core data is subject to stricter regulations and more enhanced processing restrictions than important data or general data.

> ***Important data***. The concept of important data was first introduced in the CSL, in which network operators in China are required to categorize data and create backups and encryption measures for the protection of important data. For important data under the DSL, business operators must appoint a responsible person, establish a specific internal department for the protection of important data, carry out risk assessments on a regular basis, and report the results to the relevant Chinese regulators.

Data localization requirement and restrictions on cross-border data transfer. The DSL introduces separate frameworks for the regulation of cross-border transfers of important data by critical information infrastructure ("CII") operators and non-CII operators. For CII operators, cross-border transfers of important data collected and generated by them in China is governed by the CSL and is subject to a security assessment by the relevant Chinese regulators. For non-CII operators, the DSL provides that the Cyberspace Administration Office ("CAC"), China's top cyberspace regulator, will formulate and issue separate rules applicable to cross-border transfers of important data collected and generated by non-CII operators in China. The DSL expressly prohibits provision of any data stored in China to judicial or law enforcement agencies outside of China without prior approval from the relevant Chinese governmental authorities.

Government access to data and export control. Under the PIPL, individuals and entities are required to cooperate with the public security and state security authorities that need to access data for the purpose of safeguarding national security or investigating crimes. This provides a legal basis for the Chinese government to access data of businesses. The PIPL includes provisions that expands China's export control regime to cover the export of data and provides a legal basis for the Chinese government to impose reciprocal measures on any country or region that imposes discriminatory prohibitions, restrictions or other similar measures against China in terms of investment and trade related to data and data development and use technologies.

Legal liabilities for violations. The DSL imposes severe punishments for entities violating the law, including suspension of business, revocation of business license, fines up to RMB 10 million (approximately US$1,560,000), and potential criminal penalties. Individuals directly responsible for a violation may be subject to a personal fine up to RMB 1 million (approximately US$156,000) and potential criminal penalties. Entities may be punished for a failure to cooperate with the Chinese regulators' data requests, and for providing data to foreign judicial or law enforcement agencies without approval from the relevant Chinese governmental authorities.

The PIPL

As China's first comprehensive legislation on personal information protection, the PIPL sets forth detailed rules with respect to data privacy and personal information protection in China.

Scope and extra-territorial applicability of the PIPL. The PIPL not only regulates data processing activities carried out within the territory of China, but also regulates data processing activities performed outside of China involving personal information of individuals located in China where the processing is (a) for the purpose of providing products or services to individuals located in China, (b) for the purpose of analyzing and evaluating the behaviors of individuals located in China, or (c) for other purposes provided by laws and regulations. Under the PIPL, offshore companies engaging in the processing of personal information of individuals located in China are required to designate an agency or a representative in China to be responsible for matters related to personal information protection. The name and contact details of such local agency or representative are required to be provided to the relevant Chinese regulators.

Personal information and sensitive personal information. The PIPL defines personal information as any type of information that is recorded electronically or by other means and identifies or can be used to identify a specific individual, excluding anonymized information. The PIPL defines sensitive personal information as the personal information the leakage or illegal use of which may lead to harm to the dignity of individuals or serious harm to personal safety or property, including information relating to biometric characteristics, religious beliefs, specially designated status, medical health, financial accounts, individual location tracking, and the personal information of minors under the age of 14, and sets out more stringent obligations on processors handling sensitive personal information.

Legal grounds for processing personal information. Under the PIPL, processing of personal information is not permitted unless a legal ground for such processing exists. In addition to the "notification and consent" legal ground for processing personal information provided in existing personal information protection rules and regulations, the PIPL also includes the following legal grounds for processing personal information:

- necessity for concluding or performing contracts to which the individual concerned is a party;
- necessity for employees and human resources management in accordance with legally adopted internal regulations and legally concluded collective contracts;
- necessity for performing legal duties or legal obligations;
- to respond to public health emergencies, or necessity for the protection of the life, health, and property of individuals in an emergency;
- processing, within a reasonable scope, of personal information for news reporting and supervision of public opinion for the public interest; and

> processing, within a reasonable scope and in accordance with the PIPL, of personal information that has been made public by the concerned individual or through other lawful means.

Data localization requirement and restrictions on cross-border data transfer. Under the PIPL, CII operators and entities that process personal information that reaches a certain threshold (to be specified in subsequent implementation rules) must (i) store locally in China the personal information they collect and generate in China and (ii) pass a security assessment administered by the CAC and other enforcement authorities to the extent they seek to transfer personal information outside of China.

Other personal information processors may conduct cross-border transfer of personal information upon satisfying one of the following requirements: (a) passing a security assessment by the CAC, (b) obtaining certification of data security by a professional body recognized by the CAC, (c) entering into an agreement with the overseas recipient with provisions governing the rights and obligations of the parties based on a template contract to be released by the CAC, or (d) other requirements as provided by relevant laws and regulations.

Legal liabilities for violations**.** Depending on the severity of the violation, the PIPL confers the relevant Chinese regulators with different powers to address any violation of the PIPL, including issuing a correction order or warning, confiscating unlawful gains, ordering the suspension or cessation of a business, revocation of business license and/or imposing fines up to RMB 50 million (approximately US$7.8 million) or 5 per cent of the personal information processor's turnover in the previous year. In addition, individuals directly responsible for a violation may be subject to a personal fine ranging from RMB 100,000 (approximately US$15,600) to RMB 1 million (approximately US$156,000), and may also be prohibited from holding certain management and director positions for a certain period of time.

Hong Kong

> **Regulation of virtual assets**

Regulators in Hong Kong (which includes the Securities and Futures Commission ("SFC") and the Hong Kong Monetary Authority ("HKMA"), and collectively, "Regulators") have moved to introduce and are continuing to develop, in tandem with the Hong Kong Government, regimes to regulate services provided by licensed intermediaries in relation to virtual assets. These moves will include the introduction of a new licensing regime for centralised virtual asset exchanges trading non-security tokens in Hong Kong which is to be regulated by the SFC (see below). The customer due diligence and record-keeping requirements under Hong Kong's anti-money laundering legislation are also to be extended to cover the activities of virtual asset service providers (see below).

The backdrop to this is the SFC's awareness based on industry reports that the number of "traditional" hedge funds investing in virtual assets has increased markedly in the last couple of years, with a high proportion considering investing in such assets. Given that investing in virtual assets is becoming much more widespread, the SFC has continued with its approach of "same business, same risk, same rules". This regulatory approach adopts the stance that to provide better protection to investors in Hong Kong, licensed corporations in Hong Kong with portfolios (or portions of portfolios) under their management investing in virtual assets should be subject to and observe essentially the same regulatory requirements, regardless of whether those assets amount to "securities" or "futures contracts".

The SFC has to date granted a licence to one virtual asset trading platform operator in Hong Kong, and in April, announced that it had granted approval-in-principle to a second virtual asset trading platform operator, with the licence grant subject to the operator's submission of further information.

Additionally, in June 2022, the SFC published a further warning to investors of the risks associated with investing in non-fungible tokens. The SFC also clarified that generally, where an NFT is a genuine digital representation of a collectible, the activities related to it do not fall within the SFC's regulatory remit. However, it also noted that it had recently seen NFTs which crossed the boundary between a collectible and a financial asset, such as, fractionalised or fungible NFTs structured in a form similar to "securities"[21], or interests in a "collective investment scheme"[22] ("CIS"). In circumstances where an NFT constitutes an interest in a collective investment scheme, marketing or distributing of interests in the CIS may constitute a "regulated activity", which would require the party carrying out the activity, whether in Hong Kong or targeting Hong Kong investors, to obtain a licence from the SFC, unless an exemption applies. Further, where an arrangement in relation to an NFT involves an offer to the Hong Kong public to participate in a CIS, authorisation requirements under the Securities and Futures Ordinance ("SFO") are also likely to be triggered.

Joint circular on intermediaries' virtual asset-related activities

On January 22, 2022, the SFC and the HKMA issued a joint circular ("Joint Circular") in response to enquiries from intermediaries about distributing virtual asset-related products ("VA-related products") to investors. The Joint Circular provided updated guidance generally to intermediaries engaging in virtual asset-related activities (VA-related activities)[23], and expanded on the SFC's approach of "same business, same risk, same rules" when it comes to VA-related activities. Following a transition period allowed by the Regulators, for those intermediaries who were already engaged in VA-related activities at the time it was issued, the terms of the Joint Circular are now fully in effect. All other intermediaries not then engaged in VA-related activities are required to comply with the requirements in the Joint Circular they can introduce these services. Additionally, intermediaries intending to engage in VA-related activities, which include the distribution of VA-related products and the provision of VA dealing services, are required to notify the Regulators in advance.

A. Distribution of VA-related products

Given the risks associated with VA-related products and the view of the Regulators that they are not reasonably likely to be understood by retail investors, these products are very likely to be considered to be "complex products"[24]. And given also the uneven global virtual asset regulatory landscape, the Regulators consider that the following investor protection measures, in addition to the requirements under Hong Kong's existing "complex product" regime, should be imposed to cover specific risks associated with these products:

Selling restrictions: Other than for a small suite of products (see below), VA-related products which are

[21] Defined in Schedule 1 of the SFO.
[22] Defined in Schedule 1 of the SFO.
[23] The Joint Circular supersedes the previous SFC circular of 1 November 2018 issued to intermediaries in relation to the distribution of VA funds.
[24] "Complex product" refers to an investment product whose terms, features and risks are not reasonably likely to be understood by a retail investor because of its complex structure (see the Code of Conduct for Persons Licensed by or Registered with the SFC (the "Code of Conduct")).

considered complex products should only be offered to professional investors ("PI")[25].

Virtual asset-knowledge test: When dealing with individual PIs[26] (although worth noting that both institutional PIs and qualified corporate PIs are exempted), intermediaries will need to assess whether clients have knowledge of investing in virtual assets or VA-related products prior to effecting a transaction in those products on their behalf (a one-off knowledge assessment conducted by an intermediary prior to entering into a transaction in a VA-related product is acceptable). If a client does not possess such knowledge, the intermediary may only proceed if, by doing so, it would be acting in the client's best interests and it has provided training to the client on the nature and risks of virtual assets. Intermediaries should also ensure that their clients have sufficient net worth to be able to assume the risks and bear the potential losses of trading VA-related products.

However, the Regulators recognise that a limited suite of VA-related derivative products are traded on regulated exchanges as specified by the SFC (i.e. in subsidiary legislation) and, in the case of exchange traded VA derivative funds, they are authorised or approved for offering to retail investors by the respective regulator in a jurisdiction designated in the Joint Circular. For the distribution of these products, the "professional investors only" restriction will not be imposed. However, as they will still be considered complex exchange-traded derivatives, under the complex product regime, where there has been no solicitation or recommendation, intermediaries may distribute them without the need to comply with the suitability requirement, but must comply with the existing requirements for derivative products[27]. Intermediaries must also conduct a virtual asset-knowledge test as an additional safeguard.

In the Joint Circular, intermediaries are also reminded to observe the selling restrictions in Hong Kong and other jurisdictions which may be applicable to a particular VA-related product, in particular, the provisions in Part IV of the SFO which prohibits the offering to the Hong Kong public of investments which have not been authorised by the SFC.

Intermediaries are also required to observe the "suitability obligations"[28] (where applicable). These include:

- ensuring that any recommendations or solicitations made are suitable for clients in all circumstances;
- ensuring compliance with relevant "know your client" provisions of the Code of Conduct where the VA related-product is a derivative product; and
- conducting proper due diligence on the products, which would include, amongst others, understanding their risks and features the targeted investors and the products' regulatory status. Additional due diligence requirements for unauthorised VA funds are set out in an appendix to the Joint Circular.

Intermediaries should also provide warning statements to clients (which can be a one-off disclosure) specific to virtual assets, and examples of these are set out in appendix to the Joint Circular.

---

[25] Professional investor is defined in Schedule 1 of the SFO and the Securities and Futures (Professional Investor) Rules.

[26] This refers to individuals falling under section 5 of the Securities and Futures (Professional Investor) Rules.

[27] Principally, paragraphs 5.1A and 5.3 of the Code of Conduct.

[28] The Suitability Requirement is set out in Paragraph 5.2 of the Code of Conduct and requires a licensed intermediary, when making a recommendation or solicitation, to ensure the suitability of the recommendation or solicitation for the client is reasonable in all the circumstances, having regard to information about the client of which the licensed intermediary is or should be aware through the exercise of due diligence.

B. Provision of virtual asset dealing services (VA dealing services)

Given the concerns of the Regulators over the lack of regulation applicable to VA trading platforms both in Hong Kong and overseas, to provide adequate investor protection, they consider it appropriate and necessary to require intermediaries to partner only with SFC-licensed VA trading platforms[29] for the provision of VA dealing services, whether by way of introducing clients to the platforms for direct trading or establishing an omnibus account with the platforms. These services should only be provided to PIs.

Whilst VA dealing services may involve trading in non-security virtual assets which fall outside the SFC's regulatory jurisdiction, these services may have an impact on an intermediary's fitness and properness to conduct regulated activities. Trading activities involving virtual assets also form part of the dealing services provided by intermediaries[30]. Accordingly, intermediaries are expected to comply with all the regulatory requirements imposed by the Regulators when providing VA dealing services, irrespective of whether or not the virtual assets involved are securities. In addition, those services should only be provided to the intermediaries' existing clients to which they provide services in Type 1 regulated activity.

The expected conduct requirements for intermediaries' provision of VA dealing services under an omnibus account arrangement will be imposed by the SFC as licensing conditions[31]. A single licensing or registration condition will require intermediaries to comply with the prescribed terms and conditions ("Terms and Conditions"). The standards contained in those terms and conditions are aligned with the requirements under the SFC's framework for VA trading platforms to the extent that they relate to the performance of the dealing function carried out by intermediaries.

C. Provision of virtual asset advisory services

The Joint Circular also provides that the provision of advisory services in virtual assets ("VA-advisory services") forms part of an intermediary's advisory business and may therefore affect its fitness and properness to conduct regulated activities. Currently, the Regulators are only prepared to allow intermediaries licensed or registered for Type 1 (dealing in securities) or Type 4 (advising on securities) regulated activities to provide VA-advisory services. Reflecting the general approach to regulation of intermediaries in this area, when providing advisory services they are expected to comply with all the regulatory requirements imposed by the Regulators, regardless of the nature of the virtual assets. Additionally, those services may only be provided to clients to whom intermediaries are already providing services in Type 1 or Type 4 regulated activities (i.e. other than for virtual assets).

Also in line with the expressed overall regulatory approach, with respect to intermediaries providing VA-advisory services, they should (i) comply with the conduct requirements for VA-advisory services are set out in the Terms and Conditions, (ii) observe the suitability obligations, (iii) offer such services only to PIs, and (iv) conduct a virtual asset-knowledge test before providing them.

---

[29] Hong Kong has a comprehensive framework for VA trading platforms from an investor protection perspective. The framework imposes requirements on key areas such as custody of client assets, know-your-client, AML/CFT, prevention of market manipulation, admission of virtual assets for trading, cybersecurity and risk management. See the SFC's Position Paper on Regulation of VA trading platforms published on November 6, 2019.

[30] Currently, the SFC and the HKMA are only prepared to allow intermediaries licensed or registered for Type 1 (dealing in securities) regulated activity to provide VA dealing services.

[31] See Appendix 6 of the Joint Circular - Licensing or registration conditions and terms and conditions for licensed corporations or registered institutions providing virtual asset dealing services and virtual asset advisory services.

> Anti-Money Laundering Ordinance and Counter-Terrorist Financing (Amendment) Bill 2022

In June, the Government introduced in the Legislative Council the Anti-Money Laundering and Counter-Terrorist Financing (Amendment) Bill 2022, which seeks to introduce a new licensing regime for any entity operating a centralised virtual asset exchange in Hong Kong to be regulated by the SFC.

This bill which is currently passing through the bills committee stage of the legislative process, is intended to meet Hong Kong's obligations under the Financial Action Task Force's Recommendations for combating money laundering and terrorist financing. As such, it will amend the Anti-Money Laundering and Counter-Terrorist Financing Ordinance ("AMLO") to (i) establish a licensing regime for virtual asset service providers ("VASPs") to be administered by the SFC, and (ii) apply the customer due diligence and record-keeping requirements under Schedule 2 of the AMLO to VASPs dealers when they conduct certain transactions. A virtual asset service refers to the operation of a virtual asset exchange providing through means of electronic facilities such services as offering to sell or purchase any virtual asset in exchange for any money or any virtual asset and in providing such services, client money or a client virtual asset would come into direct or indirect possession of the service provider.

As the Bill provides a brand new licensing regime which will extend to some pre-existing activities, it will provide for a transitional deeming provision so that a the licensed corporation that has been carrying on the business of providing the virtual asset service in Hong Kong immediately before March 1, 2023, and has satisfied the required conditions for the deeming provision to apply, will be deemed to have been licensed to provide the virtual asset service after March 1, 2023 until the licence application is withdrawn, refused or granted.

> AML Guidelines for "Cross-border correspondent relationships" now in effect

In our 2021 review, we reported that the SFC had published revised Anti-Money Laundering and Counter-financing of Terrorism (AML/CFT) Guidelines (for licensed corporations), which came into effect on September 30, 2021, with the exception of the new cross-border correspondent relationships requirements, which are now in effect as from March 30, 2022. "Cross-border correspondent relationships" refers to the provision of services for dealing in securities, dealing in futures contracts, or leveraged foreign exchange trading, by a licensed corporation to another licensed corporation located in a place outside Hong Kong. An example of this type of relationship would be where a securities firm located in Hong Kong, as a correspondent institution, executes securities transactions on a stock exchange for a securities firm operating outside Hong Kong, which acts as a respondent institution for its underlying local customers.

These latest were introduced in the Guidance for a Risk-Based Approach for the Securities Sector (October 2018) of the Financial Action Task Force which requires financial institutions to apply additional due diligence and risk mitigating measures for business relationships in the securities sector that are similar to cross-border correspondent banking relationships.

> Climate-related Risks for Fund Managers

In our 2021 review, we reported that the SFC had issued amendments to the Fund Manager Code of

Conduct ("FMCC")[32] as well as a circular setting out expected standards for fund managers managing CISs to take climate-related risks into consideration in their investment and risk management processes and make appropriate disclosures. The new requirements which cover four key elements, namely governance, investment management, risk management and disclosure, were to be implemented in phases. The SFC's circular set out the expected standards for complying with the amended FMCC, including (i) baseline requirements for all fund managers of CISs, and (ii) enhanced standards for fund managers with CIS under management equal to or in excess of HKD 8 billion[33] in fund assets in the previous reporting year ("Large Fund Managers")[34].

After a 12-month transition period to allow fund managers to prepare for compliance, the baseline requirements came into effect for Large Fund Managers on August 20, 2022. The baseline requirements for other fund managers, and the enhanced standards for Large Fund Managers, will come into effect on November 20, 2022.

It should be noted that the above requirements are not mandatory for discretionary account managers.

> Upgrading of Industry Practitioners' Competency Standards now in effect

In our 2021 review, we reported that the SFC had published revised Guidelines on Competence, Guidelines on Continuous Professional Training and Fit and Proper Guidelines, with the enhanced entry requirements for licence applicants and the ongoing competency standards for intermediaries and individual licensees. These revised Guidelines which represent the first major update to the Guidelines on Competence since 2003, became effective on January 1, 2022.

> Stock Connect Developments

Stock Connect was launched in 2014, followed by Bond Connect in 2017, to provide mutual market access between the Mainland (including Shanghai and Shenzhen Connect), on both a Northbound (i.e. by investors through Hong Kong trading in the Mainland markets) and Southbound basis (by investors from Mainland China Hong Kong trading in the Hong Kong market).

Swap Connect

In a joint announcement made in July, 2022, by the People's Bank of China, the SFC and the HKMA, it has been agreed that each of China Foreign Exchange Trade System (National Interbank Funding Center) and Shanghai Clearing House ("Mainland Infrastructure Institutions"), together with OTC Clearing Hong Kong Limited, will collaborate to develop mutual access between the Hong Kong and Mainland interest rate swap markets (Swap Connect).

Under Swap Connect, investors will be able to participate in the financial derivatives markets in the Mainland and Hong Kong through a connection between Infrastructure Institutions in both places. At the initial stage, Northbound Trading is to commence first, allowing investors from Hong Kong and other

---

[32] The Code sets out conduct requirements for persons licensed by or registered with SFC whose business involves the management of CISs (whether authorised or unauthorised) and/or discretionary accounts (in the form of an investment mandate or pre-defined model portfolio).

[33] Approximately USD 1 million. This threshold does not include assets under discretionary account management.

[34] If a Fund Manager's monthly CIS AUM no longer meets the threshold for any three months during the current reporting year, it is not mandatory to comply with the enhanced standards in the following reporting year. The SFC does however encourage fund managers to observe the enhanced standards voluntarily to maintain consistency and facilitate comparison.

countries and regions ("Overseas Investors") to participate in the Mainland interbank financial derivatives market through mutual access between Hong Kong and Mainland Infrastructure Institutions in respect of trading, clearing and settlement. Southbound Trading, which allows Mainland investors to access the Hong Kong financial derivatives market through mutual access between Infrastructure Institutions in both places, will be explored in due course.

This will facilitate Overseas Investors to trade in the Mainland interbank financial derivatives market and hedge their risks. Initially, interest rate swaps will be eligible with other products to be included in due course depending on market conditions.

The official launch of Swap Connect is scheduled to occur in January, 2023.

Inclusion of ETFs in Stock Connect

With effect from July 4, 2022, following a joint announcement in June, 2022, by the China Securities Regulatory Commission ("CSRC") and the SFC, eligible exchange-traded funds ("ETFs") have now been included in Stock Connect by the Mainland and Hong Kong exchanges.

The principal arrangements for the regime are made with reference to those under Stock Connect and follow existing fund operations, as well as the laws, regulations and operational models governing trading and clearing in the two markets.
Other arrangements are as follows:

> Eligible ETFs. The eligibility of Mainland and Hong Kong ETFs will be determined based on various factors such as the fund size and whether the index tracked by the fund comprises mainly eligible stocks under Stock Connect. Detailed eligibility criteria will be published by the Mainland and Hong Kong exchanges.

> Means of investment. Under Stock Connect, investors may trade ETFs only on secondary markets and no subscriptions or redemptions are allowed.

> Investment quota. The investment quota for ETFs and stocks will be aggregated for calculation and administrative purposes.

ETFs will be officially included in Stock Connect only after the trading and clearing rules and systems have been finalised, all regulatory approvals have been granted, market participants have sufficiently adapted their operational and technical systems, all necessary arrangements for cross-boundary regulatory and enforcement cooperation have been put in place, and investor education measures have been determined. A separate announcement it to be expected with the official launch date.

Enhancement of Stock Connect trading calendar

In August, 2022, the CSRC and the SFC announced that they had agreed to make certain adjustments to the trading calendar for Stock Connect to enhance trading under which each of the Shanghai Stock Exchange, Shenzhen Stock Exchange and Stock Exchange of Hong Kong Limited will concurrently allow Stock Connect trading on all the days which are trading days in both markets but on which Stock Connect trading is now closed because clearing services are unavailable. The China Securities Depository and Clearing Corporation Limited and Hong Kong Securities Clearing Company Limited will make corresponding adjustments to settlement arrangements and related business practices on the additional trading days.

The new arrangements are expected to be finalised and commence operation by February, 2023.

> SFC Consultation Paper on Proposed Amendments to Enforcement-related Provisions of the SFO

In its Consultation Paper issued in June, 2022, the SFC has proposed amendments to a number of unrelated key areas of the SFO to address what it sees as deficiencies in the legislation which emerged in practice since the SFO was enacted.

Part 1 – Amendments to section 213 of the SFO to expand the basis on which the SFC may apply for remedial and other orders against a regulated person

In its Consultation Paper issued in June, 2022, the SFC has proposed to expand the scope of section 213 of the SFO to fill a gap in its enforcement powers that will give the SFC a cause of action to apply to the Court for injunctions and other orders against a regulated person e.g., a licensed corporation. Whilst the scope of section 213 is broad, it is nevertheless limited to instances of breach of statutory provisions, encompassing the SFO, certain provisions of Hong Kong's companies' legislation and its anti-money laundering legislation. It does not extend to circumstances in which the SFC has found a regulated person guilty of "misconduct" or not to be a "fit and proper" person to remain a regulated person under other provisions of the SFO under which the SFC has power to take disciplinary action against the regulated person, where the breach was confined to a breach of a code or guideline issued by the SFC (e.g., the Code of Conduct), not involving a breach of any provision of the legislation referred to above. In these instances, the SFC is lacking the statutory power to directly require the regulated person to take any steps to restore, compensate or otherwise protect the interests of investors or clients who may have been adversely affected by the regulated person's conduct. The proposed expansion of section 213 would give the SFC these added grounds to apply to the Court for appropriate orders against any regulated person where it had made a finding that the person had been guilty of "misconduct" or was not a "fit and proper" person to remain a regulated person.

Part 2 – Amendment to exemption for marketing to PIs

The SFC has proposed an amendment to the exemption which is available under the Part IV of the SFO for the marketing of securities or structured products, or interests in CISs (i.e. including private funds), to PIs (i.e. non-retail investors) ("PIs") in Hong Kong. This exemption is invariably relied upon by fund managers and general partners when marketing their funds to potential investors in Hong Kong.

This proposal follows a case brought by the SFC alleging breach of the general prohibition on marketing following the issue by the defendants of an advertisement of a CIS which had not been "authorised" by the SFC, and which appeared to have been made to the public, and arguing that the PI investor exemption was not available[35], the SFC found itself wrong footed by the decision of the Court of Final Appeal. The Court considered that the wording of the exemption would apply if the investment product is or intended to be sold to PIs, even if unauthorised advertisements for investment products are issued to the general public. The SFC's view of this outcome was that provided an issuer could demonstrate a mere intention to sell investment products only to PIs, that fact would be sufficient for the issuer to claim

[35] SFC v (1) Pacific Sun Advisors Limited and (2) Mantel, Andrew Pieter, FACC 11 of 2014 dated 20 March 2015.

the benefit of the exemption from the authorisation regime. Liability for breach of the prohibition would crystallise at the time when an advertisement is issued to a person who is not a PI.

The proposed amendment would limit the scope of the exemption to advertisements which are issued to PIs.

This would not necessitate a change to existing market practice in Hong Kong which already reflects the SFC's view of how the exemption should properly operate. The distribution of marketing materials is typically made only to persons who have been pre-screened for PI status through a tightly controlled process to ensure that the benefit of the exemption will be available.

Part 3 – Amendments to the insider dealing provisions of the SFO

The SFC is proposing that the scope of the insider dealing provisions contained in the SFO be expanded to cover: (a) insider dealing perpetrated in Hong Kong with respect to overseas-listed securities or their derivatives, and (b) insider dealing perpetrated outside of Hong Kong, if it involves any Hong Kong-listed securities or their derivatives.

The SFO contains both separate civil and criminal regimes in respect of insider dealing which exist side by side and which mirror one another. These regimes apply to insider dealing with respect to: (a) securities listed on a recognised stock market or their derivatives (i.e. Hong Kong-listed securities or their derivatives), and (b) securities which are dual-listed in Hong Kong and another jurisdiction. However, there is a gap in the coverage of these regimes which has prevented the SFC in several examples cited by it from being able to pursue appropriate remedies for the benefit of the wider market. In particular, the regimes do not provide for market misconduct or the offence of insider dealing which has been perpetrated in Hong Kong with respect to securities listed on stock markets outside of Hong Kong or their derivatives, nor do they expressly apply to any acts constituting insider dealing which have been perpetrated outside Hong Kong in respect of Hong Kong-listed securities or their derivatives.

It is also proposed that both regimes be amended with respect to the widening of the regimes to include overseas-listed securities or their derivatives, so that a person suspected of perpetrating in Hong Kong insider dealing in respect of overseas-listed securities or their derivatives is not to be regarded as having engaged in insider dealing, unless his conduct would have also been unlawful had it been carried out in the relevant overseas jurisdiction. Additionally, the SFC takes the view believes that, where appropriate, the defences available under the SFO for insider dealing should also be available for insider dealing involving overseas-listed securities or their derivatives. The SFC therefore proposes that amendments be made to extend the "off-market transaction" exemption under the civil regime to insider dealing in respect of overseas-listed securities or their derivatives where transaction counterparties have information symmetry.

> SPACs

Following publication in December 2021 of the Consultation Conclusions of the HKEx, the Main Board Listing Rules were amended to implement its proposals to create a listing regime for SPACs in Hong Kong. Hong Kong has not previously had a regime for SPACs, and has adopted this new regime to fall into step with other markets around the world. The amendments which mostly were incorporated into a new Chapter 18B of the listing rules, took effect from 1 January, 2022.
Notable features of this new regime are:

- Restrictions on marketing to and trading by the public: The Exchange must be satisfied that adequate arrangements have been made to ensure that the SPAC's securities will not be marketed to or traded by the public in Hong Kong (without prohibiting marketing to or trading by PIs). For this reason a SPAC will be required to have a board lot size and subscription size of a value of at least HKD 1,000,000 for its SPAC shares.
- Open market requirements: For each class of securities new to listing by a SPAC, at the time of listing, there must be an adequate spread of holders of the securities to be listed which must, in all cases, be at least 75 professional investors, of whom at least 20 must be institutional PIs that must hold at least 75% of the securities to be listed.
- Issue Price: Each SPAC Share for which a listing is sought must have an issue price of at least HKD 10.
- Minimum fund raising size: At the time of listing, the gross funds raised by a SPAC from its initial offering must be at least HKD 1,000,000,000.
- SPAC promoter requirements: At listing of the SPAC and on an ongoing basis for the lifetime of the SPAC, the Exchange must be satisfied as to the character, experience and integrity of all SPAC promoters and that each is capable of meeting a standard of competence commensurate with its position. To demonstrate this, a SPAC must ensure that: at listing and on an ongoing basis, at least one of its SPAC promoters is a firm that holds a Type 6 licence (advising on corporate finance) and/or a Type 9 (asset management) licence, and at least one of these SPAC promoters must be the beneficial holder of at least 10% of the promoter shares issued by the SPAC.
- SPAC directors requirements: At listing of the SPAC and on an ongoing basis for the lifetime of the SPAC, the board of a SPAC must include at least two individuals licensed by the Commission to carry out Type 6 (advising on corporate finance) and/or Type 9 (asset management) regulated activities for an SFC licensed corporation.
- Dealing restrictions: Each of the following persons and their close associates are prohibited from dealing in any of the SPAC's listed securities prior to the completion of a De-SPAC transaction: (i) SPAC promoters and their respective directors and employees; (ii) SPAC directors; and (ii) employees of the SPAC.
- Escrow account: The SPAC must hold 100% of the gross proceeds of its initial offering (excluding proceeds raised from the issue of promoter shares and promoter warrants) in a ring-fenced escrow account domiciled in Hong Kong. The account that holds the proceeds must be operated by a trustee or custodian whose qualifications and obligations are consistent with the requirements of the local Code on Unit Trusts and Mutual Funds.
- Material change in SPAC promoters and SPAC directors: In the event of a material change in: (i) any SPAC promoter who, alone or together with its close associates, controls or is entitled to control 50% or more of the promoter shares in issue (or the single largest SPAC promoter, where no SPAC promoter controls or is entitled to control 50% or more of the promoter shares in issue); (ii) any SPAC promoter referred to above in "SPAC Promoter Requirements"; (iii) the eligibility and/or suitability of a SPAC promoter referred to in (i) or (ii); or (iv) a director referred to above in "SPAC Directors Requirements", the continuation of the SPAC following such a material change must be approved by: (a) a special resolution of the shareholders of the SPAC at a general meeting within one month from the date of the material change; and (b) the Exchange.

- > Completion of De-SPAC Transaction: The SPAC is required to publish an announcement of the terms of a De-SPAC transaction within 24 months of the date of its listing, and to complete a De-SPAC transaction within 36 months of the listing date. The SPAC can submit a request to the Exchange for an extension of either deadline. The Exchange may suspend the trading of a SPAC that: (i) fails to obtain the required approvals for the continuation of the SPAC following a material change referred to above in "Material change in SPAC promoters and SPAC directors"; or (ii) fails to meet any of the deadlines (extended or otherwise) referred to above.
- > Successor Company: A successor company must meet all new listing requirements of the listing rules. At the time of entry into a binding agreement for the De-SPAC transaction, a De-SPAC target must have a fair market value representing at least 80% of the funds raised by the SPAC from its initial offering (prior to redemptions).

The HKEx has also published a Guidance Letter on SPACs for the benefit of applicants for listing.

Latin America

> Attention to Fund Structuring and Restructurings

Fund structuring is an ever-evolving area in Latin America due to constant shifts in tax rules (and the interpretation thereof) and fund regulations. In Brazil, for instance, there are no private investment funds; every investment fund is subject to registration with, and oversight by, the Comissão de Valores Mobiliário – CVM (the Brazilian Securities and Exchange Commission).

This means sponsors and counsel should not only be mindful of applicable U.S. and English laws and regulations, but also design structures and fund terms to address local concerns and allow flexibility for restructurings, such as reallocations of limited partners, redomiciliations and a more liberal approach to the use of AIVs. Familiarity with the local industry trends, laws and regulations and working very closely with counsel are essential to successful mandates.

For instance, due to proposed changes in Brazilian tax rules, Brazilian counsel have been advising Brazilian sponsors forming private equity funds/FIPs to use Delaware limited partnerships rather than Delaware limited liability companies in their fund structures.

Transfer Taxes

When structuring or restructuring or funds in Latin America, sponsors should also pay special attention to potential taxes levied on transfers of interests in portfolio companies. In certain jurisdictions, such as Uruguay, such taxes may apply to any change in ownership, regardless of any capital gain on the respective transfer.

> Market Trends and Investment Opportunities

We are seeing a growing trend of significant investment opportunities in Brazil, especially in the infrastructure sector. In the last few years, the Brazilian government has focused on proposing a series of economic liberal reforms in order to make the country even more appealing for foreign investors. This includes making the Brazilian Central Bank independent – its governor now has a four-year renewable mandate which beginning does not coincide with that of the President of Brazil, the one in charge of appointing the governor.

One of the main objectives is to draw investors' attention to the country's infrastructure development necessity. Brazil has now approved a basic sanitation legal framework, the privatization of its largest state-owned electric company (Eletrobras), as well as the concession of numerous toll roads and airports around the country, to name just the most relevant projects. There were 84 different infrastructure concessions since 2018 at the federal level alone.

Brazil's infrastructure needs makes it a great candidate to receive investments from around the world in the coming years. This years' presidential and general election results might have an influence on this trend, depending on the views of the winning candidate about the participation of private players in the economy, and especially in the infrastructure sector. Nevertheless, whatever the outcome of the elections is, the path is paved so that, if it is in the interest of the winning party, investments will continue for the next few years.

> Proposed New Regulatory Framework for Investment Funds

In our 2021 report, we had informed that CVM was replacing the current rules regulating the existing funds types in Brazil in response to the enactment of the Brazilian Economic Liberty Act (Law No. 13,874/19), which introduced a new statutory landmark for investment funds, among other important improvements to the corporate Brazilian legal system and other business-friendly legal topics.

As of the release day of this report, CVM is still analyzing the comments received during the public consultation from market players such as managers, industry associations, law firms and others. CVM is expected to publish the new rule in the near future.

In last year's report we highlighted, among other changes, that the new rules are expected to:

- limit liability to all fund investors as a general rule (including for existing funds at the time of enactment), unless investors explicitly opt-out of such regime; and to
- allow for funds to create segregated portfolios with several liability for all fund types, including the creation of classes of interests subject to different governance and economic rights within the same segregated portfolio (restricted to certain accredited investors).

Although the Brazilian Economic Liberty Act and the CVM proposed new rule for funds regulation clearly establish that funds investors can have limited liability, a recent Supreme Court of Justice decision determined that investment funds can have its corporate veil pierced in cases where a debtor uses the fund's structuring with a clear intention of defrauding its creditors, which is similar to rules already applicable to Brazilian limited liability companies. The facts of the case in question took place before the enactment of the Brazilian Economic Liberty Act, but this shows that Brazilian Courts may not deem a fund's limited liability as absolute even if so established under the new rules. Proskauer will keep following the next steps on Brazil's new funds regulation rules.

> New Regulatory Framework for Offerings of Securities

In our 2021 report, we had reported that CVM proposed a new rule regulating the offering of securities, including quotas of investment funds, in Brazil. After analyzing the comments sent out by market participants, on July of 2022 CVM enacted CVM Resolution No. 160 which has brought progress in different areas and is expected to modernize the Brazilian capital markets in the coming years.

Resolution No. 160 will become effective on January 1, 2023, upon which it will replace the two current rules for offering of securities in Brazil: offerings under restricted placement efforts pursuant to CVM Instruction No. 476 (which are exempted from registration with the CVM) and full-fledged public offerings pursuant to CVM Instruction No. 400 (which are subject to prior analysis and registration with the CVM).

Resolution No. 160 creates new accreditation criteria for investor: "professional investors," "qualified investors" and "retail investors." All non-Brazilian investors will be deemed to be professional investors thereunder.

As we highlighted in our report of last year when the new rules were still under discussion, the distribution of interests (quotas) of Brazilian closed-ended funds to professional investors will be subject to automatic registration with the CVM and the limitation on number of investors currently applicable to restricted placement efforts (which limits offering efforts to 75 investors and investment by up to 50 investors) will no longer apply, creating a more efficient pathway to distribute funds to a larger number of accredited investors.

Another important evolution of the new rule comes from the fact that the placement of *fundos exclusivos* (funds of one) will no longer be subject to the rules regulating public offerings and shall be treated for all purposes as privately placed funds. Also, it is expected the new rule regulating funds in Brazil is enacted by CVM, the definition of an exclusive closed fund will probably also include funds created to receive investments from a group of investors connected from a unique and inseparable interest.

Lastly, we want to highlight the inclusion of a safe harbor allowing for international securities to be offered to Brazilian investors, subject to the rules below. In the current rule that is being replaced by Resolution No. 160 there are no exemptions or safe harbors available for international securities to be offered to Brazilian investors. This has so far limited the participation of Brazilian investors in non-Brazilian debt and equity offerings. This safe harbor will apply as long as (a) the securities are listed on a foreign exchange; (b) the offering is settled outside Brazil in foreign currency and (c) the securities are purchased by professional investors. The securities acquired under this safe harbor may not be resold in any Brazilian exchange.

> **Provisional Measure No. 1,137: Reduction of Income Tax for Foreign Investors and Changes the Tax Scrutiny over FIP Ownership Structures**

On September 2022 the Brazilian government enacted the Provisional Measure No. 1,137, which reduced to zero the income tax over income received by foreign investors from investments in (a) securities issued in a public offering by private companies (except for financial institutions) and (b) receivables funds (FIDCs), as long as such fund invests in credits that do not come from financial institutions.

Income tax over dividends was also reduced to zero for foreign investors investing in private equity infrastructure funds (*fundos de investimento em participações em infraestrutura*, or "FIP-IE") and private equity research, development and innovation funds (*fundos de investimento em participação na produção econômica intensiva em pesquisa, desenvolvimento e inovação* ("FIP-PD&I"). This has equalized the FIP-IE and FIP-PD&I to the Brazilian private equity investment funds (*fundos de investimento em participações*, or FIPs) in terms of taxation over dividends.

Provisional Measure No. 1,137 also revoked some of the requirements for the application of a 15% tax rate over the capital gain obtained in the redemption of FIP quotas and the zero income tax rate over dividends coming from FIPs and FIP-IEs:

- the rule that determined that for the 15% tax rate to be applicable, at least 67% of the FIPs portfolio should be invested in corporations, debentures convertible in to stock and subscription bonuses;
- the rule that required that no investor owned or was entitled to economic interest of the fund

in excess of 40% (directly or indirectly) (the so-called “40% Test”);

> the rule that conditioned the zero income tax rate to FIPs and FIP-IEs not holding more than 5% of its net assets in debt securities.

The zero income tax rate will not be applicable to foreign investors residing in tax havens or beneficiary of a privileged tax regime, as determined by applicable Brazilian laws.

Provisional Measure No. 1,137 will start producing effects on January 1st, 2023. Other than this, given the nature of Provisional Measures in Brazil, Provisional Measure No. 1,137 can last up to 120 days without Congress and Senate approval. If the 120 days passes and the Provisional Measure has not been converted into a law, its effects will wear off and the previous tax rules will once again be applicable. We cannot anticipate if conversion into a law will be approved, but we continue to follow this matter closely and engage in discussions with stakeholders and regulators.

> **Growth of Credit Funds Opportunities**

In order to curb rising inflation, basic interest rates have been raised across Latin America. For instance, in Brazil it has been increased from 6.25% per year in October 2021 to the current rate of 13.75% per year. This macroeconomic development has attracted the interest of investors for the year of 2022 and beyond.

Apart from increases in Brazilian interest rates, Brazilian courts now allow certain non-financial institutions, including credit funds (*fundos de investimento em direitos creditórios* – FIDCs), to, in practice, charge interest above 12% per year (the original ceiling for all non-financial institutions under the Usury Law) on debt securities (such as debentures). Those decision have added predictability on how Brazilian courts will likely treat investments in credit instruments and, along with current interest rates, have provided a boost for the credit funds market in Brazil.

State Regulation / Blue-Sky

Compliance with Rule 506 is very important in connection with state securities or “blue sky” laws, since, under Section 18 of the Securities Act, the states are pre-empted from regulating offerings that comply with Rule 506. Without such compliance with Rule 506, there is no pre-emption and, unless an applicable self-executing state exemption is available, a state where an investor purchases the issuer’s securities can require a pre-sale filing and regulate the required disclosure for the offering as well as other aspects of the offering. If a filing is incomplete or late or a state finds any other issue with it, they may require that the issuer make a rescission offer to the investors and possibly pay fines.

Provided that an offering is made in compliance with Rule 506, the blue sky laws of many states currently require that a hard copy of Form D be filed with the relevant state authority within 15 days following the initial sale of securities in that state, along with the state’s required filing fee. In addition, some states’ blue sky laws require that copies of amended SEC filings also be filed with the state. A handful of states require annual renewal filings and, in a couple of cases, the payment of annual renewal fees for ongoing offerings. Please note that all but three states now have a central electronic filing system for Rule 506 offerings, “The NASAA Electronic Filing Depository” usually referred to as the “EFD,” which is currently required to be used for filings in 18 states, and possibly will be mandatory for all or most states in the not-too-distant future. EFD filings have become much more prevalent since the start of the pandemic.

Private funds should be aware of requirements that may be triggered when sales of securities are made to investors in states where sales have not been made in the past, and sales in states in which a Form D has not yet been filed. The penalties for failing to make timely filings can be significant. Some states may require payment of a fine, or even demand that an issuer offer rescission to each investor in a state, or the administrator may issue a consent order.

Although Section 18 of the Securities Act states that covered securities, such as securities offered pursuant to Rule 506 of Regulation D, are not subject to state regulation, an increasing number of states use their authority under broker-dealer and investment adviser regulation and anti-fraud statutes to review and comment on Form Ds filed in connection with Rule 506 offerings. Questions regarding whether a related party listed under item 3 of the Form D is required to be registered as an investment adviser in the state are not unusual. A handful of states also occasionally request to see copies of the offering materials provided in connection with the offering.

Annual and Other Periodic Filing Requirements

Below is a summary of certain key filing requirements applicable to advisers to private funds. We note that this list of filings discussed below is not intended to be exhaustive. In addition to the requirements discussed in this Annual Review, advisers should examine the nature of their business and operations and determine whether any other filings or other actions will be required pursuant to applicable federal, state, and/or non U.S. laws and/or regulations.

We further note that the SEC has made a number of rule proposals that, if enacted, will result in material changes to certain forms, including Form ADV, Form PF and Schedules 13D and 13G. Please see "SEC Policy and Rulemaking Updates" for a discussion on the rule proposals.

Form ADV

RIAs must file an updated Form ADV Part 1 and Part 2A with the SEC within 90 days after the investment adviser's fiscal year-end (e.g., by March 31, 2023 for advisers with a December 31 fiscal year-end). RIAs must deliver the updated Form ADV Part 2A, or a summary of the material changes made, to clients within 120 days following the adviser's fiscal year-end (e.g., by April 30, 2023 for advisers with a December 31 fiscal year-end). Although underlying investors of private funds managed by an adviser are not "clients" of the adviser under the Advisers Act, it is generally considered best practice to deliver the updated Form ADV Part 2A to these investors on an annual basis. Part 2B of Form ADV is called the "brochure supplement." RIAs must give a client a brochure supplement for each individual that it supervises who: (1) formulates investment advice for that client and has direct client contact; or (2) makes discretionary investment decisions for that client's assets, even if the supervised individual has no direct client contact.

In addition to the annual amendments, Form ADV Part 1 must be promptly amended where certain types of information reported, such as the disciplinary history of the adviser and/or its personnel, becomes inaccurate or, in certain cases, materially inaccurate. Form ADV Part 2A must be amended promptly whenever information reported becomes materially inaccurate. If the change relates to a disciplinary event, then the updated Form ADV Part 2A and/or Part 2B, as applicable, also must be delivered to clients. While Form ADV Part 2B is not required to be filed with the SEC, advisers must maintain copies in their records, and the Exams Division does ask for Part 2B when they undertake exams.

ERAs are subject to similar reporting requirements with respect to sections in Form ADV Part 1 that apply to them. If the ERA is exempt from SEC registration under the "private fund adviser" exemption, the ERA must register with the SEC once it reports in its annual amendment to Form ADV that its RAUM attributable to private funds have reached $150 million (or, in the case of an adviser based outside of the

U.S., if the RAUM attributable to private fund assets managed from a place of business in the U.S. have reached $150 million). The ERA must apply for registration within 90 days of filing the amendment. If the ERA is exempt from SEC registration under the "venture capital fund adviser" exemption, the ERA must register with the SEC *prior* to the time it may no longer rely on such exemption.

Certain states impose "notice filing" requirements, requiring advisers to file their Form ADV with the relevant state securities authorities. Advisers may also be subject to additional state requirements, where, for example, the adviser has a place of business in the state and/or has over five non-exempt clients in that state. Advisers may also be subject to certain blue sky requirements, as discussed below. An adviser should review its business on a periodic basis to determine whether any additional state requirements have been triggered.

Form PF

A RIA that advises one or more private funds and has at least $150 million in RAUM attributable to private funds is required to file Form PF with the SEC to report certain information regarding the private funds under its management. The frequency of the reporting obligation and the amount of information that must be reported on Form PF will vary depending on the size of the adviser and the type of private funds managed by it.

In general, a registered adviser that has at least $150 million in RAUM attributable to private funds is required to file Form PF within 120 days after the end of the adviser's fiscal year (e.g., by April 30, 2023 for advisers with a December 31 fiscal year-end). However, the reporting requirements for advisers with larger RAUMs will be more frequent and/or more extensive. In particular:

> *Large Hedge Fund Advisers*. An adviser with at least $1.5 billion in RAUM attributable to hedge funds as of any month-end during the preceding fiscal quarter is subject to more comprehensive quarterly reporting requirements with respect to hedge funds under its management. In addition, a Large Hedge Fund Adviser is required to provide fund-specific information with respect to any "qualifying hedge funds" (i.e., hedge funds with more than $500 million in net asset value). A Large Hedge Fund Adviser must file Form PF within 60 days of each quarter-end (by March 1, 2023 for the quarter ending December 31, 2022).

> *Large Private Equity Fund Advisers*. An adviser with at least $2.0 billion in RAUM attributable to private equity funds as of the end of the most recent fiscal year will be subject to more comprehensive annual reporting requirements with respect to private equity funds under its management. Large Private Equity Fund Advisers must file Form PF within 120 days of fiscal year-end (by April 30, 2023 for investment advisers with a December 31 fiscal year-end).

> *Large Liquidity Fund Advisers*. An adviser with at least $1.0 billion in RAUM attributable to private liquidity funds and registered money market funds as of any month-end during the preceding fiscal quarter will be subject to more comprehensive quarterly reporting requirements with respect to private liquidity funds and registered money market funds under its management. Large Liquidity Fund Advisers must file Form PF within 15 days of each quarter-end (by January 15, 2023 for the quarter ending December 31, 2022).

For purposes of determining whether an adviser meets any of the applicable large adviser classifications above, the adviser may disregard a private fund's equity investments in other private funds.

ERAs are not required to file Form PF.

Form D and Blue Sky Filings

Form D. A private fund conducting an offering under Rule 506 must file a Form D with the SEC on its filer management system, EDGAR, within 15 days of the initial sale of securities in such offering (*i.e.*, the date on which the first investor is irrevocably contractually committed to invest). For any ongoing offering for which a Form D was filed after March 16, 2009, Form D must be amended annually on or before the first anniversary of the last notice filed. Form D must also be amended as soon as practicable to correct a material mistake of fact or error or to reflect a change in the information provided in the previously filed notice. For certain specified types of changes in information, however, such as a change in the amount of securities sold in the offering or the number of investors who have invested in the offering, the private fund is not required to amend Form D until the next annual filing (if any) is due (but may choose to do so at any time).

Blue Sky Filings. Compliance with Rule 506 is very important for compliance with blue sky laws, since, under Section 18 of the Securities Act, the states are preempted from regulating offerings that comply with Rule 506. Without such compliance, unless an applicable self-executing state exemption is available, a state where an investor purchases the issuer's securities can require a pre-sale filing and regulate the required disclosure and other aspects of the offering.

Provided that an offering is made in compliance with Rule 506, the blue sky laws of many states currently require that a hard copy of Form D be filed with the relevant state authority within 15 days following the initial sale of securities in that state, along with the state's required filing fee. In addition, some states' blue sky laws require that copies of amended SEC filings also be filed with the state. A handful of states require annual renewal filings and, in a couple of cases, the payment of annual renewal fees for ongoing offerings. Please note that the states now have a central electronic filing system for Rule 506 offerings, which is currently required to be used for filings in a few states, and possibly will be mandatory for all or most states in the not-too-distant future.

Advisers should be aware of requirements that may be triggered when sales of securities are made to investors in states where sales have not been made in the past, and sales in states in which a Form D has not yet been filed. The penalties for failing to make timely filings can be significant. Some states may require payment of a fine, or even demand that an issuer offer rescission to each investor in a state, or the administrator may issue a consent order.

Although Section 18 of the Securities Act states that covered securities, such as securities offered pursuant to Rule 506 of Regulation D, are not subject to state regulation, an increasing number of states have nevertheless used their authority under broker-dealer and investment adviser regulation and anti-fraud statutes to review and comment on Form Ds filed in connection with Rule 506 offerings. Questions regarding whether a related party listed under item 3 of the Form D is required to be registered as an investment adviser in the state are not unusual. Some states have also requested to see copies of the offering materials to be provided.

Form 13F

An adviser is required to file a Form 13F with the SEC if it exercises investment discretion over $100 million or more in Section 13(f) securities as of the last trading day of any month in any calendar year. In general, Section 13(f) securities include U.S.-listed equity securities, certain equity options and warrants, shares of closed-end investment companies and certain convertible debt securities. The SEC publishes an official list of Section 13(f) securities at the end of every quarter.

An adviser must file a Form 13F for the last quarter of the calendar year during which the reporting threshold is met. In addition, it must file a Form 13F for the first three quarters in the subsequent calendar year, even if its holding level has dropped below $100 million. In each case, Form 13F will be due within 45 days of quarter-end.

For advisers that exceeded the reporting threshold for the first time in 2022, the first Form 13F filing deadline in 2023 will be February 14, 2023 (for the quarter ending December 31, 2022).

Schedules 13D and 13G

A person that has direct or indirect beneficial ownership of more than 5% of a class of outstanding voting equity securities of a U.S. public company is required to file Schedule 13D, or Schedule 13G, if eligible, with the SEC. "Beneficial ownership" is defined to include the direct or indirect power to (i) vote the securities; or (ii) exercise investment authority over the securities, including the right to acquire the securities within 60 days (such as through the exercise of an option or a convertible security). Under this definition, "beneficial owners" may include a private fund, its investment adviser and/or certain controlling persons and/or parent companies of the adviser.

Schedule 13D. Schedule 13D must be filed within 10 days after crossing the 5% threshold and must be amended promptly following: (i) a material increase or decrease in the filer's holding; or (ii) a material change in the Schedule 13D. An increase or decrease is deemed "material" if it equals at least 1% of the outstanding securities and may, depending on the facts and circumstances, be deemed "material" even if it is less than 1%.

Schedule 13G. A beneficial owner otherwise required to file Schedule 13D may file Schedule 13G if it acquired the securities in the ordinary course of its business and not with the purpose or effect of changing or influencing the control of the issuer.

> If the beneficial owner falls within any of the specified categories of "Qualified Institutional Investors" (QII), which includes SEC-registered investment advisers, it must file Schedule 13G within 45 days after the end of a calendar year if its holding crossed the 5% threshold during the year and is at least 5% as of year-end (by February 14, 2023 for 2022). Schedule 13G must be amended within 10 days of a month-end if the holding exceeds 10% of the class of equity securities as of such month-end and if it thereafter increases or decreases by more than 5% of the class of equity securities.

> A beneficial owner that does not qualify as a QII may still use Schedule 13G as a "passive investor," so long as its holding is below 20% of the class of securities. A passive investor must file Schedule 13G within 10 days of crossing the 5% threshold. Schedule 13G must be amended promptly once the holdings exceed 10% of the class of equity securities and if it thereafter increases or decreases by more than 5% of the class of equity securities.

Schedule 13G is also available to a beneficial owner that crossed the 5% threshold as of calendar year-end but is exempt from filing a Schedule 13D due to exemptions under Section 13(d) of the Exchange Act or otherwise. This may include, for example, a beneficial owner that met the 5% threshold at the time the issuer went public and continues to meet the 5% threshold at the end of the relevant calendar year-end, if other conditions are met. Each such exempt filer is required to file a Schedule 13G within 45 days after the end of a calendar year (by February 14, 2023 for 2022).

QII, passive investor and exempt investor filers must amend Schedule 13G within 45 days of each calendar year end to report any changes in the information previously reported, provided that no amendment will be required if the only change relates to the filer's percentage holding and is solely due to a change in the underlying aggregate number of outstanding shares in the class. The filing deadline for 2022 amendments will be February 14, 2023.

Forms 3, 4 and 5

Form 3. A person, including an adviser or other affiliate, depending on various factors, is required to file Form 3 with the SEC within 10 days of: (i) acquiring beneficial ownership of more than 10% of a class of equity securities of a U.S. public company (including, among other things, puts, calls, options, warrants, convertible securities, or other rights or obligations to buy or sell securities exercisable within 60 days); and/or (ii) becoming an officer or director of a U.S. public company. "Beneficial ownership" is defined in the same way as in the Schedule 13D and 13G context. With respect to an issuer undergoing an IPO, the initial Form 3 filing is due on the effective date of the registration of the securities under the Exchange Act.

Form 4. If a director, officer, or 10% beneficial owner effects a transaction which changes the beneficial ownership of securities previously reported on Form 3, such director, officer, or beneficial owner must file a Form 4 with the SEC within 2 business days of the transaction.

Form 5. Form 5 must be filed with the SEC within 45 days following the issuer's fiscal year end to report any exempt or other insider transactions not previously reported on Form 4 (by February 14, 2023 if the issuer has a fiscal year-end of December 31).

Form 13H

Large traders of Regulation NMS securities (generally defined to be exchange-listed securities, including options) are required to file Form 13H with the SEC. A "large trader" is any person that exercises investment discretion over transactions in Regulation NMS securities that equal or exceed: (i) two million shares or $20 million during any day; or (ii) 20 million shares or $200 million during any month. Large traders must file Form 13H with the SEC when the thresholds above are met. The initial Form 13H filing must be made "promptly" after reaching the threshold (generally within 10 days). Thereafter, an annual 13H filing must be submitted within 45 days of the end of the calendar year (by February 14, 2023 for 2022). Amendments to Form 13H must be filed promptly following the end of a calendar quarter, if any information on the Form 13H becomes inaccurate. For example, the addition or removal of brokers would need to be reported at the end of a calendar quarter.

CFTC Annual Reaffirmations and Periodic Reports

CPO and CTA Exemption Reaffirmations. Each Commodity Pool Operator ("CPO") exempt from CPO registration under CFTC Rule 4.5, 4.13(a)(1), 4.13(a)(2), 4.13(a)(3), or 4.13(a)(5) and each Commodity Trading Advisor ("CTA") exempt from CTA registration under CFTC Rule 4.14(a)(8) must submit an annual affirmation of its exemption via the NFA's Electronic Exemption System within 60 days of calendar year-end (by March 1, 2023 for 2022).

Annual Reports and Account Statement Requirements. Each registered CPO, including a CPO relying on CFTC Rule 4.7, must file financial statements of each commodity pool it operates with the NFA within 90 days after each such commodity pool's fiscal year-end (by March 31, 2023, if the fiscal year ends on December 31).

In addition, each registered CPO must distribute monthly account statements to participants of the commodity pool within 30 days of month-end for commodity pools with a net asset value greater than $500,000. For commodity pools with a net asset value of $500,000 or less, or operated under CFTC

Rule 4.7, the CPO is instead required to distribute quarterly account statements to pool participants within 30 days of the quarter-end.

CFTC Form CPO-PQR and NFA Form PQR. Each registered CPO is required to report certain information to the CFTC on CFTC Form CPO-PQR. CFTC Form CPO-PQR contains three sections: Schedule A, Schedule B, and Schedule C. The frequency that a CPO must file CFTC Form CPO-PQR and the sections that it must complete will depend on the CPO's amount of assets under management (AUM) and its SEC reporting obligations (if a dual-registrant).

Each registered CPO that is an NFA member is also required to file NFA Form PQR quarterly with the NFA. NFA Form PQR consists of certain questions from Schedule A and Schedule B of CFTC Form CPO-PQR.

Both CFTC Form CPO-PQR and NFA Form PQR are filed on the NFA's EasyFile system. As NFA Form PQR is incorporated into CFTC Form CPO-PQR, there are no separate filings for the CFTC and the NFA. A CPO will satisfy its NFA Form PQR reporting obligations to the extent it is already responding to the same items on its CFTC Form CPO PQR for that reporting period.

In addition, CPOs that are registered as investment advisers with the SEC may satisfy certain of their CFTC Form CPO-PQR filing obligations by filing Form PF with the SEC.

Filing Requirements				
CPO Size	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Large CPO (CPO with AUM of at least $1.5 billion)	CFTC Form CPO-PQR Schedules A, B, and C (within 60 days of quarter-end)	CFTC Form CPO-PQR Schedules A, B, and C (within 60 days of quarter-end)	CFTC Form CPO-PQR Schedules A, B, and C (within 60 days of quarter-end)	CFTC Form CPO-PQR Schedules A, B, and C (within 60 days of quarter-end)
Mid-Sized CPO (CPO with AUM of at least $150 million but less than $1.5 billion)	NFA Form PQR (within 60 days of quarter-end)	NFA Form PQR (within 60 days of quarter-end)	NFA Form PQR (within 60 days of quarter-end)	CFTC Form CPO-PQR Schedules A and B (within 90 days of year-end)
Small CPO (CPO with AUM of less than $150 million)	NFA Form PQR (within 60 days of quarter-end)	NFA Form PQR (within 60 days of quarter-end)	NFA Form PQR (within 60 days of quarter-end)	CFTC Form CPO-PQR Schedule A and NFA Form PQR (within 90 days of year-end)

Dual-Registered CPO (CPO that is an SEC-registered investment adviser and files Form PF with the SEC)	NFA Form PQR (within 60 days of quarter-end)	NFA Form PQR (within 60 days of quarter-end)	NFA Form PQR (within 60 days of quarter-end)	CFTC Form CPO-PQR Schedule A and NFA Form PQR (within 60 or 90 days of quarter-end, depending on AUM)

The upcoming filing deadlines for the period ending on December 31, 2022 will be March 1, 2023 for Large CPOs and March 31, 2023 for Mid-Sized and Small CPOs.

CFTC Form CTA-PR and NFA Form PR. All registered CTAs, regardless of size and dual registration, must file CFTC Form CTA-PR annually within 45 days of the end of the fiscal year. CFTC Form CTA-PR covers certain identifying information about the CTA as well as performance information. In addition, each CTA that is an NFA member must file NFA Form CTA-PR within 45 days of each quarter-end. As the same form is used for CFTC Form CTA-PR and NFA Form PR, a CTA will satisfy its NFA Form PR obligation for the quarter ending on December 31 by filing its annual CFTC Form CTA-PR. Both CFTC Form CTA-PR and NFA Form PR are filed on the NFA's EasyFile system.

The deadline for the period ending December 31, 2022 will be February 14, 2023.

The CFTC has published a series of FAQs on CFTC Forms CPO-PQR and CTA-PR.

TIC Form B

A U.S. adviser (on behalf of itself and any U.S. or non-U.S. funds that it manages) and U.S. resident funds managed by a non-U.S. resident adviser are required to report cross-border claims, liabilities and short-term securities holdings on TIC B Forms with the Federal Reserve Bank of New York in each case if the reporting person is owed "reportable claims" or owes "reportable liabilities" in excess of certain monetary thresholds, as discussed below.

The TIC B Forms require reporting of current obligations (including loans, regardless of their maturity) and short term securities:

- that are owed by a U.S. resident entity to a non-U.S. resident, or by a non-U.S. resident entity to a U.S. resident;
- that are not held by a U.S. custodian or sub-custodian; and
- that are in excess of the relevant reporting thresholds (determined on an aggregated basis for the top-tier U.S. entity in an affiliated group, and separately for all of the funds that they manage).

TIC B Forms consist of a series of monthly and quarterly forms. Monthly TIC B filings (Forms BC, BL-1, and BL-2) are due no later than 15 days following the end of a month. Quarterly TIC B filings (Forms BQ-1, BQ-2 (Part 1), BQ-2 (Part 2), and BQ-3) are due no later than 20 days following the end of a quarter. If the due date of a report falls on a weekend or federal holiday, the due date is the following business day. Any financial institutions with "reportable claims" or "reportable liabilities" (as described below) exceeding the monetary thresholds and required to file for a reporting period are also required to file for all subsequent reporting periods in that year, regardless of whether the thresholds are exceeded in the subsequent periods. The reporting threshold for each TIC B Form (except Form BQ-3) is $50 million total ($25 million in any one foreign country). The reporting threshold for Form BQ-3 is $4 billion total (no country limit). A reporter is only required to file the applicable TIC B Forms for which its reportable claims and/or liabilities exceed the relevant threshold.

“Reportable claims” generally include all claims not held by a U.S. resident custodian or sub-custodian, including deposit balances due from banks, negotiable certificates of deposit of any maturity, brokerage balances, customer overdrawn accounts, loans and loan participations, resale agreements and similar financing agreements, short term (original maturity of one year or less) negotiable and non-negotiable securities, money-market instruments, reinsurance recoverables, and accrued interest receivables.

“Reportable liabilities” generally include all liabilities not held by a U.S. resident custodian or sub-custodian, including non-negotiable deposits of any maturity, brokerage balances, overdrawn deposit accounts, loans of any maturity, short-term (original maturity of one year or less) non-negotiable securities, repurchase agreements and similar financing agreements, insurance technical reserves, and accrued interest payables.

“Reportable claims” and “reportable liabilities” do not include long-term securities (including equities and any long-term notes, bonds and debentures), derivatives, credit commitments, contingent liabilities and securities borrowing or lending agreements in which one security is borrowed or lent in return for another. For purposes of the TIC B Forms, a feeder fund’s investment into a master fund is considered a non-reportable long-term security and is not a reportable claim.

Representatives of the government agencies responsible for the TIC B Forms have indicated that any claims or liabilities held by a U.S. resident custodian or sub-custodian (such as a bank) or otherwise reportable by another U.S. financial institution (such as an administrative agent) should not be reported by investment advisers or funds, or be used to calculate whether the threshold limits have been exceeded.

A U.S. resident investment adviser reporting on behalf of itself and the entities in its organization should generally file Forms BC, BL-1, BQ-2 (Part 1), and/or BQ-3, as applicable. A U.S. resident investment adviser should generally file consolidated reports on behalf of the funds it manages, including reportable claims and liabilities of non-U.S. resident funds, on Forms BL-2, BQ-1, and BQ-2 (Part 2). Non-U.S. investment advisers do not have a reporting obligation, but any U.S. resident fund they manage may be required to make a TIC B filing.

TIC Form S

The U.S. Department of Treasury recently announced that it will be discontinuing TIC Form S in the near future. However, as an exact date of discontinuation has not been announced, below follows a discussion on TIC Form S and its current requirements.

A U.S. resident entity, including a U.S. investment adviser, is required to file TIC Form S with the Federal Reserve Bank of New York if its transactions (e.g., purchases, sales, redemptions and new issues) in long-term securities with foreign residents exceed $350 million in the aggregate during a month. Long-term securities are securities without a stated maturity date (such as equities) or with an original term-to-maturity of over a year.

Reportable transactions include, among other things, purchases and sales of newly-issued securities, purchases and sales of existing securities from other investors, and transactions resulting from sinking fund redemptions, or called or maturing securities. Long-term securities received or delivered to settle derivative contracts are also reportable as purchases or sales by foreign residents. For U.S. investment advisers, reportable transactions include, among other things:

- purchases and sales they make for the accounts of their U.S. resident funds and other clients that are conducted directly with a foreign resident or placed through a foreign-resident broker, dealer or underwriter;
- purchases and sales made for the accounts of their foreign-resident funds and other clients that are placed through U.S. resident brokers, dealers or underwriters, if the identity of the underlying account holder had not been fully disclosed to such brokers, dealers or underwriters;
- redemptions from the accounts of their U.S. resident funds and other clients that are presented to a foreign resident intermediary (e.g., a foreign-paying agent, foreign-resident broker, foreign-resident dealer or foreign-resident issuer) without the use of a U.S. resident custodian; and
- purchases and sales of interests in a foreign master fund by a U.S. resident feeder fund or in a U.S. resident master fund by a foreign feeder fund.

U.S. investment advisers meeting the reporting threshold in any given month must file TIC Form S no later than 15 calendar days following the last business day of the month. If the due date of the report falls on a weekend or federal holiday, TIC Form S is due the following business day. U.S. investment advisers must continue to file TIC Form S monthly for the remainder of the calendar year, regardless of the level of transactions in the subsequent months.

TIC Form SLT

U.S. resident custodians (including U.S. resident banks), U.S. resident issuers (including U.S. private funds) and U.S. resident end-investors (including U.S. investment advisers, whether or not registered) are required to file TIC Form SLT with the Federal Reserve Bank of New York to report their cross-border ownership of reportable long-term securities if the fair market value of their reportable holdings and issuances equals at least $1 billion as of the last business day of any month.

Most equity securities and debt securities with a maturity of greater than one year are considered reportable long term securities for purposes of Form SLT. Certain types of securities are excluded, such as, among other things, short-term securities (original maturity of one year or less), bankers' acceptances and trade acceptances, derivative contracts (including forward contracts to deliver securities), loans and loan participation certificates, letters of credit, bank deposits and annuities.

U.S. advisers with aggregate holdings of reportable long-term securities with a fair market value of at least $1 billion by the adviser and its clients are likely to be subject to Form SLT reporting. An adviser that is subject to the reporting requirement will file one consolidated report for all U.S. resident parts of its organization and all U.S. resident entities that it advises. Funds organized under the laws of any U.S. state are included in the "U.S. resident" portion of a reporting adviser's organization, which will subject securities issued by non-U.S. master funds that are held by U.S. feeder funds and holdings of U.S. master fund securities by non-U.S. feeder funds to reporting. For U.S. resident holdings of non-U.S. securities, the reporting party would be required to disclose:

- the residence of the non-U.S. issuer; and

- the fair market value and type of non-U.S. security.

For non-U.S. resident holdings of U.S. securities, the reporting party would be required to disclose:

- the non-U.S. holder's residence;
- the fair market value and type of U.S. security; and
- whether the non-U.S. holder is a "foreign official institution" (including national governments, international and regional organizations and sovereign wealth funds).

The U.S. Department of Treasury has recently adopted an amendment to Form SLT to elicit more detailed data from reporting parties. Effective for all Form SLT reports that are due in December 2022, each reporting party should expect to be required to disclose the above in more detail than they were required to previously.

Form SLT must be filed monthly by the 23rd day following the end of each month (e.g., by January 23, 2023 for December 2022). If the due date of the report falls on a weekend or federal holiday, the TIC Form SLT report should be submitted the following business day. If the $1 billion threshold is crossed as of the end of any month, the reporting person must file Form SLT for all remaining months in that calendar year regardless of the subsequent amount of its reportable holdings.

BE-13

BE-13 collects data on new foreign direct investment in the U.S. from U.S. persons that meet the reporting requirements, even if such U.S. person has not been contacted by the BEA.

A U.S. entity is required to make a BE-13A filing if a non-U.S. person acquires direct or indirect ownership or control of 10% or more of the voting securities of such U.S. entity. A U.S. entity that crosses the 10% reporting threshold must file a Form BE-13A if the cost of acquiring or establishing such interest exceeds $3 million. However, U.S. private funds will not have to report on BE-13 unless a foreign person acquires 10% or more of the voting interests in an operating company indirectly through the U.S. private fund.

A different BE-13 form is required depending on the type of event that has occurred (e.g., formation, acquisition, merger or expansion). If the 10% reporting threshold is crossed but the cost of the transaction does not exceed $3 million, a U.S. entity must file a BE-13 Claim for Exemption. The BE-13 forms are due no later than 45 calendar days after an acquisition is completed, a new U.S. business enterprise is established, or the expansion is begun.

The discussion above focuses on the regulatory obligations applicable to investment advisers to private funds. The filing obligations applicable to other types of investment advisers (particularly investment advisers to separately management accounts or retail investors, banks, bank holding companies and non-financial entities) may be different.

Annual U.S. Tax Elections and Filings

This section briefly summarizes certain U.S. tax filings and elections (and related deadlines) relevant to private funds, their investors and related persons.

Form 8832 Filings. If an entity filed an IRS Form 8832 (an entity classification election) with respect to 2022, that entity must attach a copy of the Form 8832 with its U.S. federal income tax return. If that entity is not required to file a U.S. return, all direct or indirect owners of that entity generally must attach a copy with their U.S. federal income tax returns, if they are otherwise required to file U.S. returns. The deadline will be the due date (including any applicable extensions) of the filer's 2022 U.S. federal income tax return.

"Qualified Electing Fund" (QEF) Election. If a private fund has invested in a non-U.S. portfolio company that is (or may be) a "passive foreign investment company" (PFIC), the first U.S. person in the PFIC's ownership chain (e.g., the fund itself, if a U.S. fund, or each U.S. investor, if a non-U.S. fund) may wish to file a QEF election with respect to that PFIC. The QEF election must be filed with that U.S. person's U.S. federal income tax return for the first year in which the fund invested in the PFIC. The deadline for PFICs acquired in 2022 will be the due date (including any applicable extensions) of that U.S. person's 2022 U.S. federal income tax return.

"Electing Investment Partnership" (EIP) Election. Private funds that satisfy certain requirements may opt out of otherwise mandatory tax basis adjustments (including those that may result from transfers of interests in a fund) by filing an EIP election. The EIP election must be filed with the private fund's U.S. federal income tax return for the first year in which the election is intended to apply. For funds wishing to be treated as EIPs with respect to 2022 (and subsequent years), the deadline will be the due date (including any applicable extensions) of the private fund's 2022 U.S. federal income tax return.

CbCR Reporting. A U.S. tax resident parent entity of a multinational enterprise (MNE) group that has revenues of $850 million or more during the taxable year must file IRS Form 8975 by the due date (including any applicable extensions) of its 2022 U.S. federal income tax return.

Certain U.S. Tax Filings with Respect to Non-U.S. Entities. U.S. private funds and their U.S. investors may be required to make certain filings with respect to non-U.S. entities owned by the private fund. These filings may include, without limitation:

- IRS Form 5471 (with respect to certain non-U.S. corporations, including "controlled foreign corporations," owned by the private fund);
- IRS Form 926 (with respect to certain contributions of property to a non-U.S. corporation);
- IRS Form 8621 (with respect to certain non-U.S. corporations that are PFICs; however, such reporting generally is not required of U.S. tax-exempt investors);
- IRS Form 8865 (with respect to certain non-U.S. partnerships);
- IRS Form 8858 (with respect to certain non-U.S. disregarded entities);
- IRS Form 8938 (with respect to certain non-U.S. financial assets); and
- IRS Form 8992 (with respect to certain U.S. shareholders of controlled foreign corporations to calculate their share of "global intangible low-taxed income" (GILTI)).

Generally, the deadline will be the due date (including any applicable extensions) of the U.S. person's 2022 U.S. federal income tax return.

Other Annual Requirements and Considerations

Audited Financial Statements Delivery

The Custody Rule requires registered advisers with custody of client assets to implement certain safeguards designed to protect client assets against the risk of loss, misuse or misappropriation. Among other things, it requires assets of an adviser's clients to be held by a qualified custodian and to be subject to surprise annual examinations by an independent public accountant that is registered with and subject to inspection by the PCAOB. With respect to private fund clients, however, an adviser, rather than complying with the surprise audit requirement, may comply with the Custody Rule by relying on the Audit Provision under part (b)(4) of the Custody Rule. To rely on the Audit Provision, the adviser must have an independent public accountant that is registered with and subject to inspection by the PCAOB conduct an annual audit of each private fund client and deliver audited financial statements to all of its private fund investors. The audited financial statements must be delivered:

- within 120 days of the private fund's fiscal year-end (by April 30, 2023, if the fiscal year ends on December 31); or
- within 180 days of the private fund's fiscal year-end, if the private fund is a fund-of-funds (by June 29, 2023, if the fiscal year ends on December 31).

Currently, only auditors to public companies are subject to regular inspection by the PCAOB. However, on December 11, 2019, the staff of the SEC's Investment Adviser Regulation Office in the Division of Investment Management issued a no-action letter that affirmed continuing relief that the SEC would not recommend enforcement action against an adviser engaging an auditor that is not subject to inspection by the PCAOB to audit the financial statements of a pooled investment vehicle in connection with the annual audit provision, on the condition that such auditor was (i) registered with the PCAOB, and (ii) engaged to audit the financial statements of a broker or a dealer as of the commencement of the professional engagement period and as of each calendar-year end. This relief was permitted by the SEC through the date the SEC would approve a PCAOB-adopted permanent program for the inspection of broker and dealer auditors.

Privacy Policy Delivery

Following changes to the Gramm-Leach-Bliley Act contained in Section 75001 of the Fixing America's Surface Transportation Act of 2015 (the FAST Act), and subsequent 2019 conforming rulemaking from the CFTC, 2018 rule amendments from the U.S. Bureau of Consumer Financial Protection and 2019 staff guidance from the Division of Examinations, delivery of annual privacy notices is now required only if a financial institution's privacy policies and practices have changed since the last distribution of a privacy notice. Specifically, if there has been any change to the privacy policy that would permit non-public client information to be disclosed to non-affiliated third parties, and the new disclosure is not covered in the existing notice, the financial institution must deliver an updated notice to clients and provide them a reasonable opportunity to opt out of the new disclosure.

Schedule K-1 Delivery

Under IRS rules, partnerships are required to deliver certain information on Schedule K-1 to their partners on or before the day on which the return for the relevant taxable year is required to be filed. As required by IRS rules issued in 2012, a partnership must obtain a partner's affirmative consent for the partnership to validly deliver Schedule K-1 to the partner electronically (e.g., via email or by posting the Schedule K-1 on a web portal). For the consent to be valid, it must be obtained from a partner in the same electronic manner in which the partnership will deliver the Schedule K-1 to the partner. The applicable IRS rules also prescribe certain other requirements for electronic delivery of Schedule K-1s, including certain disclosures, which must be provided to partners regarding electronic delivery of Schedule K-1s. In addition to these IRS rules, states or other jurisdictions may impose security requirements for maintenance and transmission of sensitive personal information (such as individual Social Security numbers), which a partnership may need to comply with when delivering Schedule K-1s to its partners.

New Issues Investor Reaffirmations

If a private fund intends to invest in "new issues," the adviser will often obtain annual reaffirmations from each investor relating to its eligibility to participate in profits and losses from "new issues." Reaffirmation may be obtained by sending out notices asking each investor to notify the adviser if the investor's new issues status has changed or by including a representation in the investor's subscription agreement whereby the investor agrees to notify the adviser of any subsequent change in its new issues status.

ERISA/VCOC Annual Certifications and Compliance

Many private funds that accept investments from investors subject to ERISA are operated in such a manner so that the assets of such private funds do not constitute the "plan assets" of ERISA investors for purposes of ERISA. Typically, such a fund will either be operated as a "venture capital operating company" ("VCOC"), a "real estate operating company" ("REOC") or so that "benefit plan investor" equity participation is not "significant" (i.e., under the ERISA 25% limit), and the sponsor of such a private fund often will contractually agree with its ERISA investors to deliver an annual certification as to the private fund's continued compliance with the VCOC/REOC requirements and/or the 25% benefit plan investor limit. Private funds that accept investments from ERISA investors should conduct the VCOC/REOC or 25% benefit plan investor limit analysis as applicable, whether or not they are required to annually certify compliance with respect thereto, and should be prepared to deliver any required or requested certifications in a timely manner.

Private funds that are designed to hold "plan assets" and that actually are holding "plan assets" of ERISA investors may need to provide the ERISA investors prior to their admission to the private fund with certain information (sometimes referred to as "408(b)(2) disclosures," by reference to the relevant section of ERISA) relating to any changes to the fees or expenses paid by the fund and/or certain other information relating to the private fund adviser's compensation that is requested by any ERISA investor and required for any ERISA investor's compliance with its reporting and disclosure obligations under ERISA.

California Financing Law Requirements

The California Financing Law generally requires lenders (including private funds) "engaged in the business of a finance lender" in California to obtain a license, although there is an exemption for a person making no more than five loans per year, so long as the loans are incidental to the business of the person relying on the exemption (e.g., bridge loans to a portfolio company) and the person is not engaged in the business of making loans. The licensing process is cumbersome and time-consuming, but willful violation of the law can result in civil and criminal penalties. A license holder is subject to certain inspection and reporting obligations.

Lobbyist Registration

Under a California law that became effective January 1, 2011, "placement agents" hired or engaged to solicit California state plans (e.g., CalSTRS, CalPERS and the University of California pension system) are required to register as lobbyists. Under existing law, lobbyists are restricted in their ability to provide gifts and make campaign contributions and are prohibited from accepting fees contingent upon the success of their lobbying efforts. Under the 2011 law, certain employees of a fund sponsor may be subject to the lobbyist registration requirements and the gift and campaign contribution limits, and sponsors that retain placement agents may have filing and recordkeeping obligations as "lobbyist employers." Any party contemplating retention of a placement agent or any solicitation of CalSTRS, CalPERS or the University of California pension system can contact a member of their Proskauer team for more information.

In addition, under New York City's Lobbying Law and based on regulatory guidance issued in 2010-2012, placement agents and/or employees of investment advisers may be required to register with New York City in connection with the offering of fund interests to any of the New York City pension funds (including New York City Employees' Retirement System, the New York City Police Pension Fund, the New York Fire Department Pension Fund, the New York City Teachers' Retirement System, and the New York City Board of Education Retirement System). Although the Lobbying Law had been in effect for 20 years, it had not been previously interpreted to apply to the marketing activities of investment funds and their agents.

As a reminder, other state and local plans have their own regulations and policies on the use of placement agents (including disclosure requirements or placement agent bans in some circumstances), and lobbyist registration may be relevant for marketing to other state or local plans.

Liability Insurance

Investment advisers should consider purchasing management liability insurance depending on their level of exposure and the extent to which their business and operations warrant such coverage. Given the heightened regulatory scrutiny of the private funds industry, investment advisers may benefit from protection against officer and director liability, fiduciary liability, error and omission liability and employment practice liability.

2022 - 2023 Federal Filings and Other Document Delivery Calendar[36]

Filing / Delivery	**Who Must File**	**Deadline**
December 2022		
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country)	December 15 (for November 2022)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding $350 million as of any month	December 15 (for November 2022)
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding $1 billion as of the last day of any calendar month	December 23 (for November 2022)

[36] Any deadlines for filings to be made with the SEC that fall on a federal holiday, Saturday or Sunday may be filed on the first business day following such date.

Filing / Delivery	**Who Must File**	**Deadline**
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below $500,000)	December 30 (for November 2022)
January 2023		
Form PF	Large Liquidity Fund Advisers	January 15 (for the quarter ending December 31, 2022)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding $350 million as of any month	January 16 (for December 2022) Note: Usually filed 15 calendar days following the last business day of the month, but if the 15th day is a federal holiday, Saturday or Sunday, the filing deadline is extended until the next business day.
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country)	January 16 (for December 2022) Note: Usually filed on the 15th calendar day of the following month, but if the 15th day is a federal holiday, Saturday or Sunday, the filing deadline is extended until the next business day.
TIC Form BQ-1, BQ-2 and BQ-3	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country) (Form BQ-1 and BQ-2 Part 1), in excess of $50 million (no country limit) (Form BQ-2 Part 2) or in excess of $4 billion (no country limit) (Form BQ-3)	January 20 (for the quarter ending December 31, 2022)
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding $1 billion as of the last day of any calendar month	January 23 (for December 2022)

Filing / Delivery	Who Must File	Deadline
Delivery of Quarterly Account Statements to Pool Participants	Registered CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below $500,000	January 30 (for the quarter ending December 31, 2022)
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below $500,000)	January 30 (for December 2022)
February 2023		
Schedule 13G Annual Amendment	Beneficial owners of at least 5% of a class of outstanding equity securities of a U.S. public company eligible to file Schedule 13G (e.g., Qualified Institutional Investors and/or passive investors)	February 14 (for 2022)
Form 13H Annual Update	Large traders of Regulation NMS securities	February 14 (for 2022)
Form 5	Insiders required to report any exempt or other insider transactions not previously reported on Form 4	February 14 (if the issuer has a December 31 fiscal year-end)
CFTC Form CTA-PR	Registered CTAs	February 14 (for the quarter ending December 31, 2022)
Form 13F	Investment managers that exercise investment discretion over $100 million or more in Section 13(f) securities	February 14 (for the quarter ending December 31, 2022)
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country)	February 15 (for January 2023)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding $350 million as of any month	February 15 (for January 2023)
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding $1 billion as of the last day of any calendar month	February 23 (for January 2023)

Filing / Delivery	**Who Must File**	**Deadline**
March 2023		
Form PF	Large Hedge Fund Advisers	March 1 (for the quarter ending December 31, 2022)
CFTC Form CPO-PQR	Large CPOs	March 1 (for the quarter ending December 31, 2022)
CFTC Registration Exemption Reaffirmations	CPOs exempt from CPO registration under CFTC Rule 4.5, 4.13(a)(1), 4.13(a)(2), 4.13(a)(3) or 4.13(a)(5) and CTAs exempt from CTA registration under CFTC Rule 4.14(a)(8)	March 1 (for 2022)
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below $500,000)	March 2 (for January 2022)
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country)	March 15 (for February 2023)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding $350 million as of any month	March 15 (for February 2023)
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding $1 billion as of the last day of any calendar month	March 23 (for February 2023)
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below $500,000)	March 30 (for February 2022)
CRS Information Reports	Financial institutions in “Participating Jurisdictions” (which currently do not include the US)	Consult local advisers for timing
Form ADV Annual Update	Registered investment advisers and ERAs	March 31 (for an investment adviser with a December 31 fiscal year-end)

Filing / Delivery	**Who Must File**	**Deadline**
NFA Commodity Pool Annual Financial Statements Filing	Registered CPOs	March 31 (for a pool with a December 31 fiscal year-end)
FATCA Information Report	Participating FFIs (except for FFIs in Model 1 IGA jurisdictions) FFIs in Model 1 IGA jurisdictions	Consult local advisers for timing
April 2023		
FBAR	Hedge funds and private equity funds, and their investment advisers, if they have non-U.S. bank or other financial accounts	April 15 (with a six-month extension available)
Form PF	Large Liquidity Fund Advisers	April 15 (for the quarter ending March 31, 2023)
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country)	April 17 (for March 2023) Note: Usually filed on the 15th calendar day of the following month, but if the 15th day is a federal holiday, Saturday or Sunday, the filing deadline is extended until the next business day.
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding $350 million as of any month	April 17 (for March 2023) Note: Usually filed 15 calendar days following the last business day of the month, but if the 15th day is a federal holiday, Saturday or Sunday, the filing deadline is extended until the next business day.
TIC Form BQ-1, BQ-2 and BQ-3	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country) (Form BQ-1 and BQ-2 Part 1), in excess of $50 million (no country limit) (Form BQ-2 Part 2), or in excess of $4 billion (no country-limit) (Form BQ-3)	April 20 (for the quarter ending March 31, 2023)

Filing / Delivery	Who Must File	Deadline
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding $1 billion as of the last day of any calendar month	April 24 (for March 2023) Note: Usually filed on the 23rd calendar day of the following month, but if the 23rd day is a federal holiday, Saturday or Sunday, the filing deadline is extended until the next business day.
Form PF	Registered investment advisers with at least $150 million in RAUM attributable to private funds, including Large Private Equity Fund Advisers	April 30 (for an investment adviser with a December 31 fiscal year-end)
Delivery of Annual Audited Financial Statements to Private Fund Investors	Registered investment advisers (except with respect to fund-of-funds)	April 30 (for private fund with a December 31 fiscal year-end)
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below $500,000)	April 30 (for March 2022)
Delivery of Quarterly Account Statements to Pool Participants	Registered CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below $500,000	April 30 (for March 2022)
Delivery of Updated Form ADV Part 2A to Clients	Registered investment advisers	April 30 (for an investment adviser with a December 31 fiscal year end)
Form PF	Registered investment advisers with at least $150 million in RAUM attributable to private funds, including Large Private Equity Fund Advisers	April 30 (for an investment adviser with a December 31 fiscal year-end) Note: Usually filed on the 120th calendar day of the following year, but if the 120th day is a federal holiday, Saturday or Sunday, the filing deadline is extended until the next business day.
May 2023		
NFA Form PR	All registered CTAs	May 15 (for the quarter ending March 31, 2023)

Filing / Delivery	Who Must File	Deadline
Form 13F	Investment managers that exercise investment discretion over $100 million or more in Section 13(f) securities	May 15 (for the quarter ending March 31, 2023)
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country)	May 15 (for April 2023)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding $350 million as of any month	May 15 (for April 2023) Note: Usually filed 15 calendar days following the last business day of the month, but if the 15th day is a federal holiday, Saturday or Sunday, the filing deadline is extended until the next business day.
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding $1 billion as of the last day of any calendar month	May 23 (for April 2023)
Form PF	Large Hedge Fund Advisers	May 30 (for the quarter ending March 31, 2023)
CFTC Form CPO-PQR	Large CPOs	May 30 (for the quarter ending March 31, 2023)
NFA Form CPO-PQR	All registered CPOs, except Large CPOs	May 30 (for the quarter ending March 31, 2023)
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below $500,000)	May 30 (for April 2022)
June 2023		
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country)	June 15 (for May 2023)

Filing / Delivery	**Who Must File**	**Deadline**
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding $350 million as of any month	June 15 (for May 2023)
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding $1 billion as of the last day of any calendar month	June 23 (for May 2023)
Delivery of Annual Audited Financial Statements to Private Fund Investors	Registered investment advisers (with respect to fund-of-funds)	June 29 (for a fund-of-funds with a December 31 fiscal year-end)
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below $500,000)	June 30 (for May 2022)
July 2023		
Form PF	Large Liquidity Fund Advisers	July 15 (for the quarter ending June 30, 2023)
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country)	July 17 (for June 2023) Note: Usually filed on the 15th calendar day of the following month, but if the 15th day is a federal holiday, Saturday or Sunday, the filing deadline is extended until the next business day
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding $350 million as of any month	July 17 (for June 2023) Note: Usually filed 15 calendar days following the last business day of the month, but if the 15th day is a federal holiday, Saturday or Sunday, the filing deadline is extended until the next business day.

Filing / Delivery	Who Must File	Deadline
TIC Form BQ-1, BQ-2 and BQ-3	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country) (Form BQ-1 and BQ-2 Part 1), in excess of $50 million (no country-limit) (Form BQ-2 Part 2), or in excess of $4 billion (no country-limit) (Form BQ-3)	July 20 (for the quarter ending June 30, 2023)
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding $1 billion as of the last day of any calendar month	July 24 (for June 2022) Note: Usually filed on the 23rd calendar day of the following month, but if the 23rd day is a federal holiday, Saturday or Sunday, the filing deadline is extended until the next business day.
Delivery of Quarterly Account Statements to Pool Participants	Registered CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below $500,000	July 30 (for the quarter ending June 30, 2022)
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below $500,000)	July 30 (for June 2022)
August 2023		
NFA Form PR	All registered CTAs	August 14 (for the quarter ending June 30, 2023)
Form 13F	Investment managers that exercise investment discretion over $100 million or more in Section 13(f) securities	August 14 (for the quarter ending June 30, 2023)
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country)	August 15 (for July 2023)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding $350 million as of any month	August 15 (for July 2023)

Filing / Delivery	**Who Must File**	**Deadline**
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding $1 billion as of the last day of any calendar month	August 23 (for July 2023)
Form PF	Large Hedge Fund Advisers	August 29 (for the quarter ending June 30, 2023)
CFTC Form CPO-PQR	Large CPOs	August 29 (for the quarter ending June 30, 2023)
NFA Form CPO-PQR	All registered CPOs, except Large CPOs	August 29 (for the quarter ending June 30, 2023)
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below $500,000)	August 30 (for July 2022)
September 2023		
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country)	September 15 (for August 2023).
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding $350 million as of any month	September 15 (for August 2023)
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding $1 billion as of the last day of any calendar month	September 25 (for August 2023) Note: Usually filed on the 23rd calendar day of the following month, but if the 23rd day is a federal holiday, Saturday or Sunday, the filing deadline is extended until the next business day.
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below $500,000)	September 30 (for August 2022)
October 2023		

Filing / Delivery	Who Must File	Deadline
Form PF	Large Liquidity Fund Advisers	October 15 (for the quarter ending September 30, 2023)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding $350 million as of any month	October 16 (for September 2023) Note: Usually filed 15 calendar days following the last business day of the month, but if the 15th day is a federal holiday, Saturday or Sunday, the filing deadline is extended until the next business day.
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country)	October 16 (for September 2023) Note: Usually filed 15 days after previous month end, but if the day is a federal holiday, Saturday or Sunday, the filing deadline is extended until the next business day.
TIC Form BQ-1, BQ-2 and BQ-3	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country) (Form BQ-1 and BQ-2 Part 1), in excess of $50 million (no country limit) (Form BQ-2 Part 2), or in excess of $4 billion (no country limit) (Form BQ-3)	October 20 (for the quarter ending September 30, 2023)
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding $1 billion as of the last day of any calendar month	October 23 (for September 2023)
Delivery of Quarterly Account Statements to Pool Participants	Registered CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below $500,000	October 30 (for the quarter ending September 30, 2022)

Filing / Delivery	**Who Must File**	**Deadline**
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below $500,000)	October 30 (for September 2022)
November 2023		
NFA Form PR	All registered CTAs	November 14 (for the quarter ending September 30, 2023)
Form 13F	Investment managers that exercise investment discretion over $100 million or more in Section 13(f) securities	November 14 (for the quarter ending September 30, 2023)
TIC Form BC, BL-1 and BL-2	U.S. residents with reportable cross-border claims or liabilities in excess of $50 million (or $25 million with respect to an individual country)	November 15 (for October 2023)
TIC Form S	U.S. resident entities conducting cross-border reportable transactions exceeding $350 million as of any month	November 15 (for October 2023)
TIC Form SLT	U.S. resident custodian, issuer or end-investor having cross-border ownership of reportable long-term securities exceeding $1 billion as of the last day of any calendar month	November 23 (for October 2023)
Form PF	Large Hedge Fund Advisers	November 29 (for the quarter ending September 30, 2023)
CFTC Form CPO-PQR	Large CPOs	November 29 (for the quarter ending September 30, 2023)
NFA Form CPO-PQR	All registered CPOs, except Large CPOs	November 30 (for the quarter ending September 30, 2023)
Delivery of Monthly Account Statements to Pool Participants	Registered CPOs (except for CPOs exempt under CFTC Reg. 4.7 or with respect to commodity pools with NAV below $500,000)	November 30 (for October 2022)

Filing / Delivery	**Who Must File**	**Deadline**
Other Floating Deadlines		
Form D	Private funds conducting an offering under Regulation D	Initial Filing: Within 15 days of the initial sale of securities Annual Amendment: Anniversary date of the previous Form D filing, if the offering is still ongoing Interim Amendment: As soon as practicable to correct material mistakes or errors after certain changes in information Note: Additional state blue sky filing requirements may apply
Schedule 13D	Beneficial owners of at least 5% of a class of outstanding equity securities of a U.S. public company	Initial Filing: Within 10 days of crossing the 5% threshold Amendment: Promptly after any material change in beneficial ownership percentage
Schedule 13G	Beneficial owners of at least 5% of a class of outstanding equity securities of a U.S. public company eligible to file Schedule 13G (*i.e.*, Qualified Institutional Investors and/or passive investors)	Initial Filing: Generally, within 45 days of year-end (if a QII or passive investor) or within 10 days of crossing the 5% threshold (if a passive investor) Annual Amendment: Within 45 days of year-end (see above) Interim Amendment: Within 10 days of month-end (if a QII) or promptly (if a passive investor) if holding exceeds 10% or if it thereafter increases or decreases by over 5%

Filing / Delivery	**Who Must File**	**Deadline**
Form 13H	Large traders of Regulation NMS securities	Initial Filing: Promptly (usually 10 days) after reaching reporting threshold Annual Amendment: Within 45 days of year-end (see above) Interim Amendment: Promptly after quarter-end if there is any change in information
Form 3	Beneficial owners of more than 10% of a class of equity securities of a U.S. public company, or officers or directors of a U.S. public company	Within 10 days of becoming a 10% beneficial owner, officer or director For an IPO, on the effective date of registration of the securities under the Exchange Act
Form 4	Beneficial owners of more than 10% of a class of equity securities of a U.S. public company or officers or directors of a U.S. public company that effect a transaction changing the beneficial ownership of securities previously reported on Form 3	Within 2 business days of the transaction
Hart-Scott-Rodino Filings	Persons contemplating a business transaction which is not "solely for the purpose of investment" and relates to either: (i) the acquisition of voting securities valued in excess of $84.4 million (adjusted annually); or (ii) the acquisition of a majority of interests in certain unincorporated entities (such as certain partnerships or LLCs). The passive investor exemption is available only for holdings not exceeding 10% of an issuer's voting stock	Prior to completion of the proposed business transaction Note: Filers are generally subject to a 30-day waiting period after submitting their HSR notice filing

Filing / Delivery	**Who Must File**	**Deadline**
Form BE-13A or BE-13 Claim for Exemption	U.S. advisers to private funds in which a non-U.S. person acquires direct or indirect ownership or control of 10% or more of the voting securities If the cost of the transaction exceeds $3 million, then the U.S. entity should file Form BE-13A If the cost of the transaction does not exceed $3 million, then the U.S. entity should file a BE-13 Claim for Exemption	Within 45 days after a reportable transaction
New Issues Affirmations	Private funds that invest in new issues	Annually
Delivery of Privacy Policy Notice to Clients	Financial institutions who have changed their privacy policies and practices since the last distribution of a privacy notice (see above)	Annually
Delivery of ERISA/VCOC/REOC Annual Certification to ERISA Investors	Private funds operating as a VCOC/REOC or pursuant to the 25% cap	As per fund documents and/or other contractual agreements with ERISA investors (typically no more frequently than annually)
Delivery of Schedule K-1	Private funds that are partnerships for tax purposes	Due date (including any applicable extension) of the partnership's U.S. federal income tax return
Form 8832 Filing	Entities that filed an IRS Form 8832 with respect to 2022	Due date (including any applicable extension) of that entity's 2022 U.S. federal income tax return
QEF Election	In the case of a private fund that has invested in a non-U.S. portfolio company that is (or may be) a PFIC, the first U.S. person in the PFIC's ownership chain (e.g., the fund itself if a U.S. fund, or each U.S. investor if a non-U.S. fund)	Due date (including any applicable extensions) of that U.S. person's 2022 U.S. federal income tax return

Filing / Delivery	**Who Must File**	**Deadline**
EIP Election	Eligible private funds wishing to opt out of mandatory tax basis adjustments	Due date (including any applicable extensions) of that private fund's 2022 U.S. federal income tax return
CbCR – Form 8975	U.S. tax resident parent entity of a MNE that has revenues of $850 million or more during the taxable year	Due date (including any applicable extension) of that entity's 2022 U.S. federal income tax return
Certain U.S. Tax Filings with Respect to Non-U.S. Entities	Private funds and their U.S. investors may be required to make certain filings with respect to non-U.S. entities owned by the private fund, including, without limitation: IRS Form 5471 IRS Form 926 IRS Form 8621 IRS Form 8865 IRS Form 8858 IRS Form 8938 IRS Form 8992	Generally, due date (including any applicable extensions) of the U.S. person's 2022 U.S. federal income tax return

Contacts

This Annual Review was prepared by the contributors listed below. For additional information on matters discussed in the Annual Review, please refer further below for a complete list of contacts:

HEDGE FUNDS

Caryn J. Greenspan
+1.212.969.3281
cgreenspan@proskauer.com

Robert G. Leonard
+1.212.969.3355
rleonard@proskauer.com

Michael F. Mavrides
+1.212.969.3670
mmavrides@proskauer.com

Kelli L. Moll
+1.212.969.3520
kmoll@proskauer.com

Christopher M. Wells
+1.212.969.3600
cwells@proskauer.com

PRIVATE INVESTMENT FUNDS

Warren Allan
+44.20.7280.2234
wallan@proskauer.com

Monica Arora
+1.212.969.3003
marora@proskauer.com

Howard J. Beber
+1.617.526.9754
hbeber@proskauer.com

Bruno Bertrand-Delfau
+44.20.7280.2126
bbertrand-delfau@proskauer.com

Ryan M. Carpenter
+1.617.526.9607
rcarpenter@proskauer.com

Sarah K. Cherry
+1.617.526.9769
scherry@proskauer.com

Niamh A. Curry
+1.212.969.3474
ncurry@proskauer.com

Camille Higonnet
+1.617.526.9738
chigonnet@proskauer.com

Jordan Hurwitz
+44.20.7280.2083
jhurwitz@proskauer.com

David T. Jones
+1.617.526.9751
djones@proskauer.com

Joseph E. Kasegian
+1.617.526.9449
jkasegian@proskauer.com

Kirsten Lapham
+44.20.7280.2031
klapham@proskauer.com

Edward Lee
+44.20.7280.2057
etlee@proskauer.com

Galen R. Lewis
+1.617.526.9405
glewis@proskauer.com

Stephen T. Mears
+1.617.526.9775
smears@proskauer.com

Don B. Melamed
+1.310.284.5621
dmelamed@proskauer.com

Nicholas C. Noon
+1.617.526.9490
nnoon@proskauer.com

Peter J. Olds
+44.20.7280.2270
polds@proskauer.com

Robin A. Painter
+1.617.526.9790
rpainter@proskauer.com

Charles (Chip) Parsons
+1.212.969.3254
cparsons@proskauer.com

Marc A. Persily
+1.212.969.3403
mpersily@proskauer.com

Aranpreet Randhawa
+44.20.7280.2235
arandhawa@proskauer.com

Yong Ren
+86.10.8572.1899
yren@proskauer.com

Christopher C. Robinson
+1.212.969.3676
ccrobinson@proskauer.com

Bradley A. Schecter
+1.617.526.9619
bschecter@proskauer.com

Brian S. Schwartz
+1.617.526.9785
bschwartz@proskauer.com

Kerry F. Shriver
+1.617.526.9413
kshriver@proskauer.com

Michael R. Suppappola
+1.617.526.9821
msuppappola@proskauer.com

Robert H. Sutton
+1.212.969.3480
rsutton@proskauer.com

David W. Tegeler
+1.617.526.9795
dtegeler@proskauer.com

Nigel van Zyl
+44.20.7280.2070
nvanzyl@proskauer.com

John Verwey
+44.20.7280.2033
jverwey@proskauer.com

Fabio A. Yamada
+55.11.3045.1250
fyamada@proskauer.com

REGISTERED FUNDS

Stuart H. Coleman
+1.212.969.3350
scoleman@proskauer.com

Robert E. Plaze
+1.202.416.6692
rplaze@proskauer.com

David Stephens
+1.212.969.3357
dstephens@proskauer.com

TAX

Ira G. Bogner
+1.212.969.3947
ibogner@proskauer.com

Richard M. Corn
+1.212.969.3553
rcorn@proskauer.com

Michael Fernhoff
+1.310.284.5671
mfernhoff@proskauer.com

Robert E. Gaut
+44.20.7280.2064
rgaut@proskauer.com

Martin T. Hamilton
+1.212.969.3964
mhamilton@proskauer.com

Collen Hart
+1.310.284.4519
chart@proskauer.com

Scott S. Jones
+1.617.526.9772
sjones@proskauer.com

Mary B. Kuusisto
+44.20.7280.2159
mkuusisto@proskauer.com

Arnold P. May
+1.617.526.9757
amay@proskauer.com

David S. Miller
+1.212.969.3006
dmiller@proskauer.com

Ekaterina (Kate) Napalkova
+1.212.969.3215
enapalkova@proskauer.com

Jeremy M. Naylor
+1.617.526.9441
jnaylor@proskauer.com

Amanda H. Nussbaum
+1.212.969.3642
anussbaum@proskauer.com

Janicelynn Asamoto Park
+1.212.969.3152
jpark@proskauer.com

Daniel J. Paulos
+1.212.969.3420
dpaulos@proskauer.com

Stephen Pevsner
+44.20.7280.2041
spevsner@proskauer.com

Jamiel E. Poindexter
+1.617.526.9773
jpoindexter@proskauer.com

Catherine Sear
+44.20.7280.2061
csear@proskauer.com

Stephen Severo
+1.617.526.9640
ssevero@proskauer.com

PRIVATE EQUITY AND HEDGE FUND LITIGATION

Peter Duffy Doyle
+1.212.969.3688
pdoyle@proskauer.com

Michael R. Hackett
+1.617.526.9723
mhackett@proskauer.com

Timothy W. Mungovan
+1.617.526.9412
tmungovan@proskauer.com

Kevin J. Perra
+1.212.969.3454
kperra@proskauer.com

Seetha Ramachandran
+1.212.969.3455
sramachandran@proskauer.com

Hadassa R. Waxman
+1.212.969.3040
hwaxman@proskauer.com

Jonathan M. Weiss
+1.310.284.4524
jweiss@proskauer.com

SEC ENFORCEMENT

Robert J. Cleary
+1.212.969.3340
rjcleary@proskauer.com

Joshua M. Newville
+1.212.969.3336
jnewville@proskauer.com

Jonathan E. Richman
+1.212.969.3448
jerichman@proskauer.com

BROKER-DEALER

Benjamin J. Catalano
+1.212.969.3980
bcatalano@proskauer.com

REGULATORY/COMPLIANCE

Kirsten E. Lapham
+44.20.7280.2031
klapham@proskauer.com

Robert E. Plaze
+1.202.416.6692
rplaze@proskauer.com

Robert H. Sutton
+1.212.969.3480
rsutton@proskauer.com

John Verwey
+44.20.7280.2033
jverwey@proskauer.com

MARKETS AND TRADING/REGULATION

Frank Zarb
+1.202.416.5870
fzarb@proskauer.com

ERISA

Ira G. Bogner
+1.212.969.3947
ibogner@proskauer.com

Adam W. Scoll
+1.617.526.9486
ascoll@proskauer.com

EXECUTIVE COMPENSATION
Michael J. Album
+1.212.969.3650
malbum@proskauer.com

Seth J. Safra
+1.202.416.5840
ssafra@proskauer.com

David B. Teigman
+1.212.969.3440
dteigman@proskauer.com

EMPLOYMENT
Allan S. Bloom
+1.212.969.3880
abloom@proskauer.com

Keisha-Ann G. Gray
+1.212.969.3855
kgray@proskauer.com

INSURANCE
John E. Failla
+1.212.969.3141
jfailla@proskauer.com

Nathan R. Lander
+1.212.969.3566
nlander@proskauer.com

ALTERNATIVE DATA
Robert G. Leonard
+1.212.969.3355
rleonard@proskauer.com

Joshua M. Newville
+1.212.969.3336
jnewville@proskauer.com

Jeffrey D. Neuburger
+1.212.969.3075
jneuburger@proskauer.com

ANTITRUST/HART-SCOTT-RODINO ACT
John R. Ingrassia
+1.202.416.6869
jingrassia@proskauer.com

TRADING DOCUMENTS
Elanit Snow
+1.212.969.3283
esnow@proskauer.com

WHISTLEBLOWER
Lloyd B. Chinn
+1.212.969.3341
lchinn@proskauer.com

TRUSTS AND ESTATES
Stephanie E. Heilborn
+1.212.969.3679
sheilborn@proskauer.com

Henry J. Leibowitz
+1.212.969.3602
hleibowitz@proskauer.com

David Pratt
+1.561.995.4777
dpratt@proskauer.com

Jay D. Waxenberg
+1.212.969.3606
jwaxenberg@proskauer.com

BANKRUPTCY AND RESTRUCTURING
Martin J. Bienenstock
+1.212.969.4530
mbienenstock@proskauer.com

David M. Hillman
+1.212.969.3740
dhillman@proskauer.com

Vincent Indelicato
+1.212.969.4248
vindelicato@proskauer.com

Jeff J. Marwil
+1.312.962.3540
jmarwil@proskauer.com

CYBERSECURITY/ INTELLECTUAL PROPERTY AND TECHNOLOGY
Ryan P. Blaney
+1.202.416.6815
rblaney@proskauer.com

Wai L. Choy
+1.212.969.3118
wchoy@proskauer.com

Daryn A. Grossman
+1.212.969.3665
dgrossman@proskauer.com

Jeffrey D. Neuburger
+1.212.969.3075
jneuburger@proskauer.com

PRIVATE CREDIT

Peter J. Antoszyk
+1.617.526.9749
pantoszyk@proskauer.com

Stephen A. Boyko
+1.617.526.9770
sboyko@proskauer.com

Gary J. Creem
+1.617.526.9637
gcreem@proskauer.com

Steven M. Ellis
+1.617.526.9660
sellis@proskauer.com

CAPITAL MARKETS

Peter Castellon
+44.20.7280.2091
pcastellon@proskauer.com

Jeremy C. Leifer
+852.3410.8048
jleifer@proskauer.com

Fabio A. Yamada
+55.11.3045.1250
fyamada@proskauer.com

FCPA/OFAC/ANTI-MONEY LAUNDERING

Seetha Ramachandran
+1.212.969.3455
sramachandran@proskauer.com

MERGERS & ACQUISITIONS

Joshua A. Apfelroth
+1.212.969.3438
japfelroth@proskauer.com

Lauren K. Boglivi
+1.212.969.3082
lboglivi@proskauer.com

Will S. Chuchawat
+1.310.284.4550
wchuchawat@proskauer.com

Steven Davis
+44.20.7280.2049
sdavis@proskauer.com

Daniel I. Ganitsky
+1.212.969.3186
dganitsky@proskauer.com

Proskauer.com