February 14, 2018

COMPLIANCE REMINDERS FOR PRIVATE FUND ADVISERS - 2018

To Our Clients and Friends:

Private fund advisers are subject to a number of regulatory reporting requirements and other compliance obligations, many of which need to be completed on an annual basis. This Client Alert provides a brief overview.

1. Regulatory Filing Obligations under the Advisers Act

A private fund adviser that is either a registered investment adviser ("RIA") or an exempt reporting adviser ("ERA") under the U.S. Investment Advisers Act of 1940, as amended (the "Advisers Act"), must comply with a number of regulatory reporting obligations. Chief among these is the obligation to update the adviser's Form ADV and Form PF filings with the SEC on an annual basis. The following is a brief summary of those filing obligations and the applicable deadlines (assuming a fiscal year end of December 31, 2017):

a. *Form ADV Annual Update (3/31/2018 deadline)*. Each RIA and ERA has an ongoing obligation to update the information provided in its Form ADV no less frequently than annually. This annual update must be filed within 90 days of the end of the adviser's fiscal year. An RIA must update the information provided in both the "check the box" portion of its Form ADV (Part 1A) and in its "disclosure brochure" (Part 2A). An ERA is only required to update the information reported in its abbreviated Part 1A filing. This year, most private fund advisers will be filing for the first time on the amended Part 1A that went into effect on October 1, 2017.[1] We strongly recommend that each private fund adviser build extra time into its annual Form ADV updating process for this year in order to assess and address any changes to its reporting obligations.

All such updates must be filed with the SEC electronically through IARD. To avoid last minute delays, we recommend that each RIA and ERA check its IARD account early to ensure that its security access codes are up-to-date and that it has sufficient funds in its IARD account to cover all Federal and state filing fees.

Each RIA is also required to update the information provided in its "supplemental brochures" (Part 2B) no less frequently than annually.[2] Although an RIA is not required to publicly file its supplemental brochures with the SEC, up-to-date supplemental brochures must be kept on file at the RIA's offices.

b. *Disclosure Brochure Delivery (4/30/2018 deadline)*. An RIA is also required to deliver an updated version of its Part 2A disclosure brochure to all clients within 120 days of the end of its fiscal year.[3] An RIA may comply with this requirement either by mailing a complete copy of its updated brochure to its clients or by sending a letter providing a summary of any material changes that have been made to the brochure since its last annual update and offering to provide a complete copy of the updated brochure upon request free of charge.[4]

c. *Forms PF and CPO-PQR (4/30/2018 deadline)*. An RIA with regulatory assets under management attributable to private funds exceeding $150 million is required to provide a report on Form PF to the SEC regarding its private funds' investment activities. For most private fund advisers, the Form PF is required to be filed once a year within 120 days of the end of the RIA's fiscal year. However, a private fund adviser with assets under management exceeding certain thresholds may be required to file more frequently and/or on shorter deadlines.[5] In addition, the information that such a large private fund adviser must provide to the SEC is significantly more extensive.

An RIA that is also registered under the Commodity Exchange Act ("CEA") as a Commodity Pool Operator ("CPO") or Commodity Trading Adviser ("CTA") should consider its reporting obligations under Form CPO-PQR, a Commodity Futures Trading Commission ("CFTC") form that serves the same purpose as, and requires the reporting of similar types of information to, Form PF. In theory, a dual registrant may comply with its reporting obligations under both the Advisers Act and the CEA by filing a single Form PF. However, the CFTC still requires certain information to be provided in a Form CPO-PQR filing in order to take advantage of this feature.

2. Annual Compliance Program Review

Rule 206(4)-7 under the Advisers Act (the "Compliance Program Rule") requires an RIA (but not an ERA) to review no less frequently than annually the adequacy of its compliance policies and procedures and the effectiveness of their implementation. Although the Compliance Program Rule does not require that these reviews be in writing, the SEC's examination staff has a clear expectation that an RIA will document its review. SEC examiners routinely request copies of an RIA's annual compliance program review reports as part of the examination process.

Producing an annual compliance program review report need not be overly burdensome. Although an RIA may consider engaging a third party to conduct a comprehensive audit of the firm's compliance program from time to time, under normal circumstances an RIA can take a more risk-based approach to the process. For example, an RIA might build a review around the following three themes where potential compliance risks may be most acute:

a. Compliance policies and procedures that may be affected by changes in the RIA's business or business practices since the last review was conducted;

b. Any areas where SEC examiners have identified deficiencies or where the firm has experienced compliance challenges; and

c. Any changes in applicable law, regulation, interpretive guidance or regulatory priorities.

In addition, a CCO should document in the annual review report any incremental improvements that have been made to the firm's compliance program throughout the year, not just as part of a formal annual review process.

3. Notable Regulatory Developments

The following is a brief summary of the more notable regulatory developments for 2017 that a private fund adviser may want to consider when conducting its annual compliance program review:

a. *Fees and Expenses*. The SEC continues to focus on industry practices concerning the collection of non-investment advisory fees from portfolio companies and on the allocation of certain of the adviser's expenses to funds. This past year, in continuation of a line of enforcement actions against private fund advisers dating back to 2015, the SEC's Enforcement Division settled several enforcement actions against private equity firms in which violations of fiduciary duties were found with respect to the collection of non-advisory fees and/or the allocation of expenses.[6] Examples of the types of practices that could trigger SEC scrutiny (particularly if not the subject of clear prior disclosure and/or a contractual basis in the applicable fund governing documents) include:

i. re-characterizing non-investment advisory fee revenue in a manner intended to avoid triggering management fee offsets;

ii. charging accelerated monitoring or similar fees to portfolio companies;

iii. allocating expenses related to the adviser's overhead and/or back-office services to its funds;

iv. allocating broken deal expenses to funds without allocating a portion of those expenses to other potential co-investors (especially affiliated co-investors); and

v. negotiating discounts on service provider fees for work performed on behalf of the adviser without also making the benefit of those discounts available to the adviser's funds.

We continue to encourage private fund advisers to review their financial controls with respect to fee collection, management fee offsets and expense allocation to ensure that their practices are consistent with their funds' governing documents (including any disclosure documents) and in line with SEC expectations. We also encourage private fund advisers to periodically review their policies regarding fee collection and expense allocation practices to make sure that they are up-to-date and comprehensive.

b. *Cybersecurity*. The SEC continues to make cybersecurity a high priority for the entire financial services industry. In the past three years, OCIE has published five "Risk Alerts" relating to cybersecurity and identified cybersecurity as one of its examination priorities in 2015, 2016, 2017 and 2018.[7] In addition, the SEC's Division of Enforcement has formed a "CyberUnit" to focus on combatting cyber-related threats. In light of this regulatory focus, we recommend that each private fund adviser review its information security policies and practices thoroughly and implement enhancements to address any identified gaps promptly.

c. *Custody Rule*. One two occasions in February 2017, the staff of the SEC's Division of Investment Management issued interpretive guidance on Rule 206(4)-2 under the Advisers Act (the "Custody Rule").

   i. In a no-action letter, the staff was asked to affirm that an adviser did not have custody under the Custody Rule in circumstances where an investment adviser was authorized to instruct a custodian to transfer client funds to a designated third party account pursuant a standing letter of instruction from the client to both the adviser and the custodian. The staff refused, stating that "an investment adviser with power to dispose of client funds or securities for any purpose other than authorized trading" has access to the client's assets and is therefore subject to the Custody Rule. However, the staff did grant relief from the surprise audit requirements under the Custody Rule in circumstances where a standing letter of instruction meeting certain conditions is in place.[8]

   ii. In a separate "IM Guidance Update," the staff also cautioned investment advisers that, even in circumstances where the adviser's investment management agreement with a client prohibits the adviser from gaining access to the client's assets, the adviser may still "inadvertently" be subject to the requirements of the Custody Rule in circumstances where the client's custodian agreement purports to grant the adviser broader access to the client's assets.[9]

   Together, both interpretations demonstrate that the SEC continues to take a broad view of what constitutes "custody" under the Custody Rule. Advisers may wish to review their custody arrangements in view of this interpretive guidance to ensure that they are in strict compliance with the Custody Rule.

d. *OCIE "Frequent Findings" Reports*. OCIE issued two Risk Alerts in 2017 in which it summarized the most frequent findings from its compliance examinations of investment advisers. The first report focused on OCIE's exam findings generally and identified the following topics as the five most frequently cited deficiencies:

   i. failure to adopt or implement adequate compliance policies and procedures in accordance with Compliance Program Rule or to perform adequate annual reviews of such compliance policies and procedures;

ii. failure to submit accurate or timely regulatory filings;

iii. failure to comply with the Custody Rule;

iv. failure to comply with Rule 204-1 under the Advisers Act (the "Code of Ethics Rule"); and

v. failure to maintain proper books and records in compliance with Rule 204-2 under the Advisers Act (the "Books and Records Rule").[10]

The second report focused more specifically on OCIE's findings with respect to investment adviser advertising practices, and identified a number of topics as frequently cited deficiencies, including the use of misleading performance results, misleading one-on-one representations, misleading claims of compliance with voluntary performance standards, cherry-picked profitable stock selections, misleading selection of recommendations, and inadequate compliance policies and procedures. The staff also identified several common deficiencies as a result of its "touting initiative" focusing on the use of "accolades" in advertising materials, including the misleading use of third-party rankings or awards, and the misleading use of professional designations and testimonials.[11]

e. *Other Conflicts*. Finally, private fund advisers should remain vigilant for any other practices or circumstances that could present actual or potential conflicts of interest. Several recent enforcement actions serve to emphasize the SEC's view that the failure to properly address and disclose potential conflicts of interest is a breach of an investment adviser's fiduciary duties under the Advisers Act, even in the absence of clear harm to investors.[12]

4. Compliance Program Maintenance

Each private fund adviser should (and in some cases must) perform certain annual maintenance tasks with respect to its compliance program. The following is a list of mandatory and recommended tasks that should be completed:

a. *Code of Ethics Acknowledgements*. Each RIA is required under the Code of Ethics Rule to obtain a written acknowledgement from each of its "access persons" that such person has received a copy of the firm's Code of Ethics and any amendments thereto. As a matter of best practice, many RIAs request such acknowledgements on an annual basis. In addition, each access person must provide an annual "securities holdings report" at least once every 12 months and quarterly "securities transactions reports" within 30 days of the end of each calendar quarter. We recommend that each RIA review its records to ensure that each of its access persons has complied with these acknowledgement and personal securities reporting requirements, as the failure to maintain such documentation is a frequent deficiency identified by the SEC's examiners.[13]

b. *Custody Rule Audits*. Compliance with the Custody Rule generally requires a private fund adviser to prepare annual audited financial statements in accordance with US GAAP for each of its private funds and to deliver such financial statements to each fund's investors within 120 days of the fund's fiscal year end (180 days in the case of a fund-of-funds).

c. *Disclosure Documents/ Side Letter Certifications*. In addition to the updates to an RIA's disclosure and supplemental brochures on Form ADV Parts 2A and 2B discussed above, private fund advisers whose funds are continuously raising new capital (*e.g.,* hedge funds) should review the offering documents for their funds to ensure that the disclosure in these documents is up-to-date. A private fund adviser should also check to see that it has complied with all reporting, certification or other obligations it may have under its side letters with investors.

d. *Privacy Notice*. An investment adviser whose business is subject to the requirements of Regulation S-P (*e.g.,* because it maintains records containing "nonpublic personal information" with respect to "consumers") is required to send privacy notices to its "customers" on an annual basis. As a matter of best practice, most private fund advisers simply send privacy notices to all of their clients and investors, often at the same time they distribute the annual updates to their disclosure brochures on Form ADV (see above). We recommend that each adviser review its privacy notice for any updates to reflect changes in its business practices and for compliance with the applicable safe harbor provided in Regulation S-P.

e. *Political Contributions*. For a firm whose current or potential investor base includes state or local government entities (e.g., state or municipal employee retirement plans or public universities), we recommend that the political contributions of any of the firm's "covered associates" be reviewed for any potential compliance issues under Advisers Act Rule 206(4)-5 (the "Pay-to-Play" rule).

5. Other Potential Compliance Obligations

Depending on the scope and nature of a private fund adviser's business, numerous other regulatory reporting requirements and other compliance obligations may apply. For example:

a. *Rule 506(d) Bad Actor Questionnaires*. For a private fund adviser whose funds are either continuously raising capital (*e.g.,* hedge funds), or where the firm anticipates raising capital in the next twelve months, we recommend that the firm ensure that it has up-to-date "Bad Actor Questionnaires" under Regulation D Rule 506(d) on file for each of its directors, executive officers and any other personnel that are or may be involved in such capital raising efforts. Firms that are or are contemplating engaging in general solicitations under Rule 506(c) of Regulation D should also review their subscription procedures to ensure that they are in compliance with the enhanced accredited investor verification standards required under that Rule.

b. *ERISA*. Funds that are not intended to constitute ERISA "plan assets" (*e.g.,* because the fund is a "venture capital operating company" or because "benefit plan investors" own less than 25% of each class of equity of the fund) are typically required to certify non-plan asset status to their ERISA investors annually. Thus, a private fund adviser should confirm that its funds have continued to qualify for a plan asset exception and prepare the required certifications. In addition, investment advisers to funds that are ERISA plan assets sometimes agree to prepare an annual Form 5500 for the fund as a "direct filing entity." This approach allows underlying ERISA plan investors to rely on this Form 5500 with respect to the investment and have more limited auditing procedures for their own Forms 5500. If this approach is used, Form 5500 is due 9-1/2 months after year-end (*i.e.,* October 15 for calendar year filers). Alternatively, if the fund does not itself file a Form 5500, it will need to provide ERISA investors the information they need to complete their own Forms 5500.

c. *CFTC Considerations*. A private fund adviser that is registered as either a CPO or a CTA, or which relies on certain exemptions from registration as a CPO or CTA, is subject to certain annual updating and/or reaffirmation filing requirements under the CEA and the rules adopted by the CFTC thereunder.

i. *Exempt Advisers*. Many advisers and general partners of private funds that trade in a *de minimis* amount of commodity interests (*i.e.,* futures, options on futures, options on commodities, retail forex transaction, swaps) are not required to register under the CEA as a CPO, but need to qualify for, and rely on, an exemption from CPO registration. CFTC Regulation 4.13(a)(3) provides an exemption for advisers and general partners of private funds that engage in a *de minimis* amount of commodity interests (the "De Minimis Exemption") pursuant to a test found in that regulation. Other exemptions from registration as a CPO or a CTA may be available to advisers or general partners of private funds. An adviser or general partner must claim an exemption from CPO registration with respect to each fund that invests in commodity interests by filing an initial exemption through the National Futures Association ("NFA") website and must reaffirm its exemption filing within 60 days after the end of each calendar year or else the exemption will be deemed to be withdrawn.

ii. *Registered CPOs and CTAs*. If a private fund does not qualify for the De Minimis Exemption or another exemption, the adviser or general partner of that private fund may be required to register with the CFTC as a CPO or a CTA, resulting in annual fees, disclosure, recordkeeping and reporting requirements. Notably, a registered CPO must file an annual report with respect to each relevant commodity pool that it operates and update disclosures to investors (unless a limited exemption under CFTC Regulation 4.7 applies). A registered CPO should also consider reporting obligations under Form CPO-PQR, which would need to be filed with the NFA within 60 days of the end of each calendar quarter (depending on AUM). Similarly, registered CTAs must consider reporting obligations under Form CTA-PR, which

must be filed with the NFA within 45 days after the end of each calendar quarter. If a manager or general partner is dually-registered as both a CPO and a CTA, it must complete Form CTA-PR and Form CPO-PR with respect to the relevant private funds.

iii. *Other Considerations – Clearing, Trading and Uncleared Margin*. Regardless of whether an adviser or general partner claims an exemption from CPO registration with respect to a private fund, the simple fact that the private fund invests in commodity interests makes the private fund a "commodity pool" and the adviser and general partner CPOs (even if they are exempt from registration). The designation as a commodity pool has some practical implications for private funds as commodity pools are considered "financial entities" under Section 2(h)(7)(C)(i) of the CEA and are therefore subject to mandatory clearing, trade execution and margin requirements with respect to their swaps activities. Notably, rules requiring commodity pools to exchange variation margin for uncleared swaps came into force on March 1, 2017.

d. *Exchange Act Reporting Obligations*. A private fund adviser that invests in "NMS securities" (*i.e.,* exchange-listed securities and standardized options) is reminded that such holdings may trigger various reporting obligations under the Securities Exchange Act of 1934 (the "Exchange Act"). For example:

i. *Schedules 13D & 13G*. An investment adviser that exercises investment or voting power over more than 5% of any class of a public company's outstanding equity securities must file a holdings report on Schedule 13G if it qualifies as a passive institutional investor.[14] Schedule 13G filings must be made within 45 days of the end of the calendar year and within 10 days after the end of any calendar month in which the adviser's holdings in the applicable equity security exceeds 10%. A Schedule 13G filer is also required to file an amended report on Schedule 13G within 10 days after the end of any calendar month in which its holdings in an NMS security exceeded 10% and within 10 days after the end of any calendar month after that in which such holdings changes by more than 5%. An investment adviser that does not qualify as a passive institutional investor must file a report on Schedule 13D within 10 days of acquiring more than 5% of any class of an issuer's outstanding equity securities and "promptly" (typically within 24 hours) after any material change in the information provided in the Schedule 13D (including any change in such adviser's holdings of more than 1% or a change in the adviser's investment intent with respect to such holdings).

ii. *Form 13F*. An institutional investment adviser who exercises investment discretion over accounts holding publicly-traded equity securities[15] having an aggregate fair market value in excess of $100 million on the last trading day of any month in a calendar year must report such holdings to the SEC on Form 13F within 45 days

after the end of such calendar year and within 45 days after the end of each of the first three calendar quarters of the subsequent calendar year.

iii. *Form 13H*. A private fund adviser whose trading activity in NMS securities exceeds certain "large trader" thresholds[16] is required to file a report on Form 13H "promptly" (within 10 days) after exceeding the threshold. In addition, such filings must be amended within 45 days after the end of each calendar year and promptly after the end of each calendar quarter if any of the information in the Form 13H becomes inaccurate.

iv. *Section 16*. A private fund adviser that holds a greater than 10% voting position in a public company or whose personnel sit on the board of directors of a public company may also have reporting obligations under Section 16 of the Exchange Act and be subject to that Section's restrictions on "short swing profits."

e. *Regulation D and Blue Sky Renewal Filings*. A private fund that engages in a private offering lasting more than one year may be subject to annual renewal filing requirements under Regulation D and/or State blue sky laws.

f. *State Pay-to-Play and Lobbyist Registration Laws*. A private fund adviser that is soliciting state or local government entities for business may be subject to registration and reporting obligations under applicable lobbyist registration or similar state or municipal statutes in the jurisdictions where the adviser is engaged in such activities.

g. *Cross-Border Transaction Reporting Requirements*. A private fund adviser that engages in cross-border transactions or which has non-US investors in its funds may be subject to various reporting requirements under the Department of Treasury's International Capital System ("TIC") or the Bureau of Economic Analysis' ("BEA") direct investment survey program. In general, investments that take the form of investments in portfolio securities are subject to TIC reporting requirements, while investments that take the form of direct investments in operating companies are subject to the BEA's reporting requirements.

i. A direct investment is generally defined by the BEA as an investment that involves a greater than 10% voting interest in an operating company. For purposes of applying this definition, general partners are the only entities considered to have a voting interest in a limited partnership. Limited partner interests are not considered voting securities. The BEA's reporting requirements apply to any direct investment that exceeds $3 million in size (whether by a US investor overseas or by a non-US investor in the US), even if the BEA has not provided notice to the applicable investor that a reporting obligation applies. Which BEA Form applies, and the extent of the reporting person's reporting requirements, depends on the size and nature of the direct investment. This year, the BEA will conduct a 5-year "benchmarking survey" of all foreign direct investment into the United States. As of the date of this Client Alert, the BEA had not yet published the version of Form

BE-12 that it will use to conduct the survey, but a private fund adviser that is either domiciled outside the U.S. or that makes direct investments into the U.S. through offshore funds should keep track of developments in this area.

ii. In general, any cross-border investment (whether by an investor in a fund or by a fund in a portfolio security) that does not meet the BEA's definition of a direct investment is reportable under TIC. Again, the form to be used and the frequency and scope of the reporting obligation depends on the size and nature of the investment. In general, however, unless an investor receives written notice from the Federal Reserve Bank of New York to the contrary, an investor is only required to participate in the TIC's "benchmark surveys", which are conducted once every five years.[17] In addition, the reporting requirement generally falls on the first (or last) US financial institution in the chain of ownership at the US border, which means that in many cases for private fund advisers, the actual reporting obligations applies to the fund's custodian bank or prime broker, and not to the private fund adviser itself.

h. *European Regulatory Reporting Requirements*. Private fund advisers that are either registered as alternative investment fund managers ("AIFMs") or authorized to manage or market alternative investment funds ("AIFs") in the European Economic Area ("EEA") are required to regularly report information (referred to as transparency information) to the relevant regulator in each EEA jurisdiction in which they are so registered or authorized ("Annex IV Reports"). The process of registering to market an AIF is not consistent across jurisdictions. Registration of some type (which can range from mere notice to a formal filing-review-approval process lasting many months) is generally necessary before any marketing of the AIF may take place.

i. Once registered, the AIFM must begin making Annex IV Reports in each relevant jurisdiction. The transparency information required by the Annex IV Reports concerns the AIFM and the AIFs it is managing or marketing in the EEA. The AIFM must provide extensive details about the principal markets and instruments in which it trades on behalf of the AIFs it manages or markets in the EEA, as well as a thoughtful discussion of various risk profiles. Preparing Annex IV Reports, therefore, can be a challenging exercise. Further, while Annex IV Reports are conceptually analogous across jurisdictions, the precise reporting requirements imposed by each regulator differ.

ii. The reporting frequency will depend on the type and amount of assets under management of the AIFM, as well as the extent of leverage involved, but will be yearly, half-yearly, or quarterly. The reports must be filed within one month of the end of the annual (December 31st), half yearly (June 30th and December 31st) or quarterly (March 31st, June 30th, September 30th and December 31st) reporting periods, as applicable. Furthermore, AIFMD requires the AIF to prepare annual reports for its European investors, covering a range of specified information.

iii. We generally recommend that firms assess reporting requirements on an on-going basis in accordance with any changes to assets under management, and in consultation with reliable local counsel.

iv. As well as requiring the submission of Annex IV reports, AIFMD also imposes other requirements on AIFMs for information to be given to investors and regulators on an on-going basis (including in relation to the acquisition of control of EU companies by the AIF). Consequently, we have seen an increase in the number of firms choosing to adopt a "rent-an-AIFM" approach, effectively outsourcing the compliance function to a local service vendor. This removes the need to continually monitor shifts in local regulations, but not the need to do the internal collection and analysis of investment data required to complete the filings.

i. *EU General Data Protection Regulation*. The European Union General Data Protection Regulation ("GDPR") is a replacement for the current Data Protection Directive in the EU. Notably, the scope of the GDPR has been broadened and now extends to data controllers and processors outside the EU whose processing activities relate to the offering of goods or services (even if for free) to, or monitoring the behavior of, data subjects within the EU. Non-EU funds that are subject to the GDPR may be required to appoint an EU-based representative in connection with their GDPR obligations. The GDPR makes existing data protection obligations more onerous, and introduces a raft of new obligations. For example, the GDPR expands the information that must be provided to data subjects about how their data is processed, and introduces more stringent consent requirements. In addition, the GDPR places onerous accountability obligations on data controllers and data processors to demonstrate compliance with the GDPR. This includes requiring them to appoint data protection officers in certain instances and: (i) maintain and develop records of processing activities, (ii) conduct a data protection impact assessment (this applies only to data controllers), prior to data processing that is inherently "high risk" (e.g. a systematic monitoring of a publicly accessible area on a large scale), and (iii) implement data protection, including by not repurposing data (subject to limited exceptions, including consent) and through data minimization (which refers to the principle that personal data must be adequate, relevant and limited to what is necessary in relation to the purposes for which it is processed). Breaching the GDPR carries serious reputational and financial risk. A range of sanctions may be imposed for non-compliance, including fines of up to the greater of EUR 20,000,000 or 4% of total worldwide annual revenue for the preceding financial year, whichever is higher.[18]

j. *The Markets in Financial Instruments Directive II ("MiFID II")*. MiFID II came into force on January 3, 2018. The impact of MiFID II on a firm will depend upon the relevant firm's regulatory classification. The MiFID II framework will continue to apply directly to EU discretionary portfolio managers conducting MiFID activities ("MiFID AIFMs"), but has now been extended to apply directly to management companies of undertakings for the collective investment in transferable securities ("UCITS") and EU AIFMs which manage separate discretionary accounts. MiFID II also harmonizes the EU's regulatory approach

to non-EU investment firms by introducing a passport regime for the provision of services to eligible counterparties and professional clients in the EU. In order for a country to be eligible for a third country passport, the EU Commission will have to assess whether the relevant firm is subject to equivalent supervision in its home jurisdiction. A MiFID third country passport may offer UK firms currently passporting their services to other EU countries under MiFID access to EU markets post-Brexit.

MiFID AIFMs have needed to update their systems, controls, policies and procedures to address the following regulatory changes introduced by MiFID II:

i. *Best execution:* MiFID II has raised the best execution standard from an obligation to take "all reasonable steps" to an obligation to take "all sufficient steps consistently", to achieve the best possible result for the customer. In addition, firms are now subject to more onerous disclosure obligations regarding best execution (including a requirement to publish annually information relating to the firm's top five execution venues (including brokers, regulated markets, multi-lateral trading facilities and organized trading facilities) by volume, and on the execution quality provided by each (by reference to each different class of instrument).

ii. *Client Categorization:* As a result of mis-selling concerns connected to the sale of complex products to local government authorities, under MiFID II firms are no longer permitted to treat such investors as eligible counterparties or as *per se* professional clients. Under MiFID II, local authorities are now automatically deemed to be retail clients, with the ability to request an "opt-up" process in order to become elective professional clients. If local authorities are unable to satisfy the opt-up criteria, firms will need to assess whether their existing permissions allow them to continue providing services to such entities or if additional retail permissions are necessary.

iii. *Inducements and Investment Research:* MiFID II imposes additional restrictions affecting how discretionary investment managers may pay for research. Under MiFID II, firms carrying out MiFID business comprising portfolio management are restricted from how they may accept fees, commissions, or any monetary or non-monetary benefits paid or provided by a third party (e.g. research from an investment bank) in relation to the provision of services to clients. Such firms may, nonetheless, continue to receive third party research without contravening the inducements rules, provided that they pay for research either directly from their own resources or from a separate research payment account controlled by the firm but charged to its clients (the latter will need to satisfy a number of requirements, including as to transparency).

iv. *Product Governance:* A new regime has been introduced which imposes requirements on firms that manufacture and distribute financial instruments to act in the clients' best interests during the lifecycle of the relevant products (for PE

firms, the product is the fund itself). The granular rules include requirements to ensure the clear identification of a target market, the review of existing products and their suitability for the target market, and review the risks for new products.

v. *Scope of Transaction Reporting Rules:* Prior to MiFID II, MiFID's reporting rules applied to financial instruments admitted to trading on EU regulated markets and assets that derive their value from such investments (e.g. OTC derivatives). MiFID II extends the scope of the transaction reporting requirements to all financial instruments traded, or admitted to trading, on EU trading venues (this will expand the reporting regime to cover instruments traded on, inter alia, multi-lateral trading facilities and organized trading facilities). This is aimed at providing greater transparency and ensuring that the MiFID II reporting requirements mirror the scope of the Market Abuse Directive.

vi. *Telephone Recording:* Prior to MiFID II, the majority of private equity firms were exempt from the requirements to record calls and other electronic communications, under an exemption for discretionary managers. However, this exemption has now been removed and recording requirements under MiFID II apply to all communications that relate to activities such as arranging deals in investments, dealing in investments as agents, managing investments and in certain circumstances, managing AIFs. The requirements cover communications that were intended to result in a transaction, even if the communication does not, in fact, result in a transaction. Telephone recording is required to be carried out on a best endeavors basis and the recordings must be retained for 5 years.

vii. *UK Exemptions for Non-MiFID AIFMs.* In the UK the Financial Conduct Authority ("FCA") has granted a number of exemptions from the above requirements to AIFMs that are not MiFID AIFMs. For example:

1. the scope of the Telephone Recording obligations is limited to activities which involve financial instruments being traded on a trading venue or for which a request for admission has been made;

2. the Inducements and Investment Research obligations do not apply to an AIF or collective investment scheme, which generally invests in issuers or non-listed companies in order to acquire control over such companies; and

3. the Best Execution obligations do not apply, but AIFMs that are not MiFID AIFMs will nonetheless still need to comply with the best execution rules under the AIFMD Level 2 Regulations.

However, it is also worth noting that these exemptions will not be available if and when an AIFM is carrying on MiFID business. In practice, our experience has been that firms managing collective funds and segregated accounts have chosen

to apply common standards across their MiFID and non-MiFID business activities.

k. *Tax*. Depending on the structure and nature of a private fund adviser's investment activities and/or client base, certain tax filings or tax compliance procedures may need to be undertaken. Examples include:

i. Investments by U.S. persons in non-U.S. entities may need to be disclosed on IRS Form 5471 (ownership in non-U.S. corporation), IRS Form 8865 (ownership in non-U.S. partnership) and IRS Form 8858 (ownership in non-U.S. disregarded entity), which forms are required to be filed together with such U.S. persons' annual U.S. federal income tax returns.

ii. Investments by non-U.S. persons in U.S. entities may need to be disclosed on IRS Form 5472 (25% ownership in a U.S. corporation). For tax years beginning on or after January 1, 2017, a U.S. disregarded entity that is wholly owned by a non-U.S. person is treated as a U.S. corporation for purposes of determining any reporting obligations on IRS Form 5472.

iii. Transfer of property by a U.S. person to a foreign corporation may require the U.S. person to file an IRS Form 926.

iv. Ownership of interests in or signature authority over non-U.S. bank accounts and similar investments, may need to be disclosed under foreign bank and financial accounts reporting regime (FBAR) on Form FinCEN 114, the due date of which has been moved to April 15th for initial filings, with an automatic extension available to October 15th.

v. Managers may need to report the existence of certain accounts to the U.S. IRS or their local jurisdiction under FATCA or the OECD Standard for Automatic Exchange of Financial Account Information – Common Reporting Standard.

vi. Managers should be aware that IRS Forms W-8 provided by non-U.S. investors generally expire after three years from the execution date of the form and they may need to collect updated IRS Forms W-8 from their non-U.S. investors.

Clients are urged to speak to their Gibson Dunn contacts if they have any questions or concerns regarding these or any other regulatory requirements.

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[1] See *Significant Amendments to Form ADV go into Effect on October 1, 2017,* Gibson Dunn Client Alert (Sept. 25, 2017) https://www.gibsondunn.com/significant-amendments-to-form-adv-go-into-effect-on-october-1-2017/. The most significant changes to Form ADV include the formalization of the SEC's practice of permitting so-called umbrella registration of multiple private fund advisers operating

as a single firm and the expansion of reporting requirements for advisers of separately managed accounts.

[2] An RIA is required to prepare a supplemental brochure for each supervised person that (i) formulates investment advice for and has direct contact with a client, or (ii) has discretionary investment power over client assets (even if such person does not have direct client contact). As a practical matter, most private fund advisers prepare supplemental brochures for each member of their investment committees and/or each of their portfolio managers.

[3] As a technical matter, investors in a private fund are not considered "clients" of the fund's investment adviser. As a matter of best practice, however, most private fund advisers make updated copies of their disclosure brochures available to the investors in their funds.

[4] Such letters must also provide a website address (if available), e-mail address (if available) and telephone number by which a client may obtain a copy of the RIA's current disclosure brochure, as well as the website address through which a client may obtain information about the adviser through the SEC's Investment Adviser Public Disclosure (IAPD) system.

[5] In particular, a hedge fund adviser with more than $1.5 billion in regulatory assets under management attributable to its hedge funds is required to report on Form PF on a quarterly basis within 60 days of the end of each calendar quarter and to complete an additional section of the Form (Section 2). A private liquidity fund adviser with more than $1.0 billion in combined regulatory assets under management attributable to both registered money market funds and private liquidity funds is required to report on Form PF on a quarterly basis within 15 days of the end of each calendar quarter and to complete an additional section of the Form (Section 3). A private equity fund adviser with more than $2.0 billion in regulatory assets under management attributable to its private equity funds is only required to file on an annual basis within 120 days of the end of its fiscal year, but is required to complete an additional section of the Form (Section 4).

[6] See *TPG Capital Advisers*, Advisers Act Release No. 4830 (Dec. 21, 2017); and *Platinum Equity Advisers*, Advisers Act Release No. 4772 (Sept. 17, 2017). See also *Apollo Management V, L.P., et. al.*¸ Advisers Act Release No. 4493 (Aug. 23, 2016); *Blackstreet Capital Management, LLC, et. al.,* Exchange Act Release No. 77957, Advisers Act Release No. 4411 (Jun. 1, 2016); *Equinox Fund Management, LLC,* Securities Act Release No. 10004, Exchange Act Release No. 76927, Advisers Act Release No. 4315 (Jan. 19, 2016); *Cherokee Investment Partners, LLC, et. al.,* Advisers Act Release No. 4258 (Nov. 5, 2015); *Fenway Partners, LLC, et. al.,* Advisers Act Release No. 4253 (Nov. 3, 2015); *Blackstone Management Partners L.L.C., et. al.,* Advisers Act Release No. 4219 (Oct. 7, 2015); *Kohlberg, Kravis Roberts & Co.,* Advisers Act Release No. 4131 (Jun. 29, 2015); and *Alpha Titans, LLC, et al.,* Exchange Act Release No 74828, Advisers Act Release No. 4073, Investment Company Act Release No. 31586 (Apr. 29, 2015).

[7] See *OCIE Cybersecurity Initiative,* National Exam Program Risk Alert, Vol. IV, Issue 2 (Apr. 15, 2014); *Cybersecurity Examination Sweep Summary,* National Exam Program Risk Alert, Vol. IV, Issue 4 (Feb. 3, 2015); *OCIE's 2015 Cybersecurity Examination Initiative,* National Examination

Program Risk Alert, Vol. IV, Issue 8 (Sept. 15, 2015); *Cybersecurity: Ransomware Alert*, National Exam Program Risk Alert, Vol. VI, Issue 4 (May 17, 2017); and *Observations from Cybersecurity Examinations*, National Exam Program Risk Alert, Vol. VI, Issue 5 (Aug. 7, 2017). See also, *Examination Priorities for 2015,* National Exam Program, Office of Compliance Inspections and Examinations (Jan. 13, 2015); *Examination Priorities for 2016,* National Exam Program, Office of Compliance Inspections and Examinations (Jan. 11, 2016); *Examination Priorities for 2017,* National Exam Program, Office of Compliance Inspections and Examinations (Jan. 12, 2017); and *2018 National Exam Program Examination Priorities,* National Exam Program, Office of Compliance Inspections and Examinations (Feb. 7, 2018).

[8] *Investment Adviser Association*, SEC No-Action Letter (pub. avail. Feb. 21, 2017).

[9] *Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority*, IM Guidance Update No. 2017-01 (February 2017).

[10] *The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers*, National Exam Program Risk Alert, Vol. VI Issue 3 (Feb. 7, 2017).

[11] *The Most Frequent Advertising Rule Compliance Issues Identified in OCIE Examinations of Investment Advisers*, National Exam Program Risk Alert, Vol. VI Issue 6 (Sept. 14, 2017).

[12] See, e.g., *Centre Partners Management, LLC,* Advisers Act Release No. 4604 (Jan. 10, 2017) and *New Silk Road Advisors,* Advisers Act Release No. 4587 (Dec. 14, 2016).

[13] See Footnote 10 above and accompanying text.

[14] To qualify as a passive institutional investor, an investment adviser must be an RIA that purchased the securities in question "in the ordinary course of business and not with the purpose or effect of changing or influencing the control of the issuer nor in connection with or as a participant in any transaction having such purpose or effect."

[15] The SEC maintains a definitive list of securities subject to Form 13F reporting at http://www.sec.gov/divisions/investment/13flists.htm.

[16] A "Large Trader" is defined as any person that exercised investment discretion over transactions in Regulation NMS securities that equal or exceed (i) two million shares or $20 million during any single trading day, or (ii) 20 million shares or $200 million during any calendar month.

[17] The next 5-year benchmark survey will cover foreign investment in U.S. securities and is scheduled to be conducted in 2019.

[18] For a further discussion of the requirements of the GDPR, see *The General Data Protection Regulation: A Primer for U.S.-Based Organizations that Handle EU Personal Data,* Gibson Dunn Client Alert (Dec. 4, 2017) https://www.gibsondunn.com/the-general-data-protection-regulation-a-primer-for-u-s-based-organizations-that-handle-eu-personal-data/.

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Gibson, Dunn & Crutcher's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact any member of the Gibson Dunn team, the Gibson Dunn lawyer with whom you usually work, or any of the following leaders and members of the firm's Investment Funds practice group:

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