Market Trends 2017/18: Hedge Funds

A Lexis Practice Advisor® Practice Note by

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OVERVIEW

In 2017 hedge fund managers continued to adjust to an evolving global regulatory environment and changing marketplace. The year brought additional challenges from investor scrutiny of the asset class and the evolution of new financial products, particularly digital assets. There were also positive developments as many managers began to reverse a sustained stretch of poor performance, and some institutional and pension investors increased allocations.

Hedge fund managers continued to experience significant changes and expansion in regulation. Areas of substantial attention for hedge funds in 2017 included data protection and cybersecurity, allocation of opportunities/allocation of fees and expenses, and the impact of new tax reform legislation.

LEGAL AND REGULATORY TRENDS

Regulatory Developments on Cryptocurrency

Digital assets such as initial coin offerings (ICOs), cryptocurrencies (e.g., bitcoin), and various future agreements for token purchases, such as simple agreements for future tokens (SAFTs), became fairly mainstream investment assets in 2017. The market capitalization for this asset class rose from just under $20 billion at the beginning of 2017 to over half a trillion dollars by the end of the year. The tremendous market growth was largely attributable

to the proliferation of the ICO, a new and controversial method of raising venture funding. The Securities and Exchange Commission (SEC) had said little about the digital asset space until July 2017, when it issued a Report of Investigation which determined that the tokens sold in a particular ICO constituted securities under the federal securities laws. Shortly thereafter, the SEC created a Cyber Unit to enhance its enforcement capabilities with respect to digital assets and subsequently brought numerous enforcement actions related to ICOs. Moreover, Chairman Jay Clayton made a number of public statements during the second half of 2017 regarding the unique risks, potential for fraud, and other malfeasance in the ICO markets. In early 2018, the SEC issued dozens of subpoenas and requests for information related to digital assets, indicating that the SEC may just be getting started in its efforts to rein in activity in the space.

In contrast to the SEC, the Commodity Futures Trading Commission (CFTC) both asserted its role as a digital asset regulator earlier than the SEC and has been more accommodating toward developments in the digital asset space. In 2015, the CFTC first asserted that virtual currencies such as bitcoin were commodities. While the CFTC has had at least some role as a regulator of the digital asset markets over the past few years through enforcement actions targeting unlawful practices relating to virtual currency derivatives, as well as fraud and unlawful margin trading in the spot virtual currency markets, it has also taken a much more accommodating approach than the SEC with respect to developments in the space.

In July 2017, the CFTC granted registration status to LedgerX LLC as a swap execution facility and a derivatives clearing organization, allowing it to become the second U.S. federally regulated trading platform to list bitcoin derivatives, and the first to list and clear fully collateralized, physically settled bitcoin options. In December 2017, following months of dialogue, the CFTC permitted the Chicago Mercantile Exchange Inc. and the CBOE Futures Exchange to self-certify new contracts for bitcoin futures products, which launched later that month.

The SEC and the CFTC have recently made a concerted effort to coordinate their message regarding the digital asset markets, including through a joint opinion piece in the Wall Street Journal penned by SEC Chairman Jay Clayton and CFTC Chairman Christopher Giancarlo, as well as joint testimony by Chairmen Clayton and Giancarlo before the U.S. Senate Banking Committee. The common theme in these public statements has been the commissions' goal of policing the digital asset markets and protecting investors from bad actors and novel risks, while simultaneously embracing innovation and promising new technology.

A number of other federal and state regulators have some amount of jurisdiction over the markets for digital assets, and several regulatory bodies other than the SEC and CFTC have taken action to halt abuses in these markets. Notwithstanding that a number of different regulatory bodies are now paying close attention to developments in this space, reportedly 167 crypto-currency focused investment funds were launched in 2017. Only 39 such funds existed at the beginning of 2017. Given the speed with which the legal and regulatory environment is changing and a number of ambiguities and uncertainties in how to apply the law to this novel asset class, fund managers should proceed with caution when entering this space.

The DOL's Fiduciary Rule

The U.S. Department of Labor's twice-proposed regulation defining fiduciary, which was published in final form in April 2016, became applicable on June 9, 2017, and included several changes from the reproposed version, as well as several new and amended prohibited transaction class exemptions. Advisors and broker-dealers serving IRA and other plan clients originally had until January 1, 2018, to comply fully with the requirements of the new and amended exemptions in order to rely on the relief provided by those exemptions. In November 2017, the Department of Labor formally delayed that date until July 1, 2019. Until that time, advisors and broker-dealers can rely on the new exemptions, including the best interest contract exemption, by complying only with

the impartial conduct standards set forth in those exemptions. Those standards generally require the advisor or broker-dealer to (a) provide prudent advice that is in the IRA or other plan client's best interest, (b) charge no more than reasonable compensation, and (c) avoid materially misleading statements. On March 15, 2018, in a two-to-one decision, the Fifth Circuit vacated the Department of Labor's fiduciary rule and related exemptions in its entirety. The Fifth Circuit, in reversing the lower court's decision upholding the definition of fiduciary and related exemptions, stated that the Rule "conflicts with the plain text of the 'investment advice fiduciary' provision [in ERISA] ... and it is inconsistent with the entirety of ERISA's 'fiduciary' definition." As a result, DOL "lacked statutory authority to promulgate the Rule with its overreaching definition of 'investment advice fiduciary.'" Unless the Department of Labor requests a rehearing by the Fifth Circuit, the decision will become effective on May 7, 2018.

U.S. Tax Reform under the Tax Cuts and Jobs Act

On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act (the Tax Act), officially enacting into law the first comprehensive reform of the U.S. tax code since 1986. With few exceptions, the changes applicable to corporate, business-related, and international tax provisions are permanent, while the changes applicable to individuals are set to expire on December 31, 2025. The Tax Act will have substantial effects on taxpayers across all industries, including alternative investment funds and their managers and investors. Major provisions of interest to such funds and their managers and investors include the following:

- **Reduction of corporate tax rate.** The Tax Act reduces the corporate tax rate from a 35% rate to a 21% rate.
- **Reduction in individual tax rates and thresholds.** Under the Tax Act, ordinary income is subject to the following seven rate brackets: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. For joint returns, the thresholds are as follows: $19,050 (12%), $77,400 (22%), $165,000 (24%), $315,000 (32%), $400,000 (35%) and $600,000 (37%).
- **State and local taxes.** The Tax Act only allows up to $10,000 in aggregate deductions for state and local non-business income, property, or sales taxes, but allows unlimited deductions for state and local property and sales taxes attributable to a trade or business. Under old law, individuals could generally deduct their state and local taxes without any limitations.
- **Business interest deduction limitation.** With certain exceptions, the Tax Act limits the deduction in any taxable year for business interest (i.e., interest paid or accrued on indebtedness properly allocable to a trade or business) to the sum of (i) business interest income (interest income properly allocable to a trade or business) for that year; plus (ii) 30 percent of the adjusted taxable income (taxable income, computed without regard to certain items, including any net operating loss deduction and, in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization or depletion) for the year.
- ***Carried interest.*** Under the Tax Act, if a non-corporate taxpayer owns a partnership interest received in connection with the performance of services in an applicable trade or business (including the business of raising or returning capital or investing in or developing certain assets), any capital gain allocable to such taxpayer in respect of specified assets (e.g., stocks, bonds, or real estate) held by the partnership for more than one year (that would have otherwise been treated as long-term capital gain) will be converted into short-term capital gain, unless the assets are held by the partnership for more than three years.
- ***Tax on gain on sale of a partnership interest by foreign persons.*** Under the Tax Act, gain recognized by a foreign person on the sale of an interest in a partnership is treated as effectively connected with a U.S. trade or business if the partnership is engaged in a U.S. trade or business. Accordingly, such sales are fully taxable in the United States. A new 10% withholding tax is also imposed on the sale unless a non-foreign affidavit is provided by the seller.
- **Excess business loss limitation.** Under the Tax Act, for any taxable year, an individual's excess business loss (i.e., the excess of the aggregate deductions attributable to the taxpayer's trades or businesses over

the sum of the aggregate gross income or gain of such taxpayer attributable to such trades or businesses) is disallowed to the extent such net loss exceeds $250,000 ($500,000 in the case of a joint return) and treated as a net operating loss carryover. Thus, individuals will have a limited ability to use losses from businesses in which they are actively involved to offset certain types of non-business income.

- **Pass-through deduction**. The Tax Act allows for a 20% deduction that will reduce the effective tax rate for non-corporate taxpayers on qualified income from certain types of businesses owned in pass-through form (e.g., a sole proprietorship, partnership or S corporation). However, certain specified trades or business are excluded (such as investing, investment management, securities trading, and a variety of service businesses). In addition, the deduction does not apply to investment income (capital gains, dividends, and most interest income), and the deduction is capped based on the taxpayer's share of the W-2 wages and unadjusted basis in qualified property with respect to the business. Accordingly, the applicability of the pass-through deduction in the alternative investment funds sphere is uncertain and likely to be limited.
- **Elimination of miscellaneous itemized deductions**. The Tax Act eliminates the individual deduction for miscellaneous itemized deductions, meaning that investors can no longer deduct certain investment expenses such as management fees, loan servicing fees, and fees to other third-party service providers.

The provisions of the Tax Act are very complex and will require a significant amount of guidance from the Internal Revenue Service and U.S. Department of Treasury. It is also likely that Congress will need to pass a technical corrections bill. However, there may be substantial delays before such guidance is issued or a technical corrections bill is proposed and enacted.

Risk Retention Judicial Victory for Managers of Open Market CLOs

On February 9, 2018, the Court of Appeals for the D.C. Circuit ruled in favor of the Loan Syndications and Trading Association (LSTA) in connection with the LSTA's challenge to the application of U.S. risk retention requirements to managers of open market collateralized loan obligations (CLOs). Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) directed the SEC and the three primary federal banking regulators (the Board of Governors of the Federal Reserve, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation) to issue regulations that would require any securitizer to retain an economic interest in a portion of the credit risk of the securitized assets. When the agencies had finalized their regulations at the end of 2014, they had concluded—over the objections of the LSTA and others—that managers of open market CLOs were securitizers for this purpose and thus were subject to the risk retention requirements. In its 2018 decision, the Court rejected the agencies' construction of Section 941, holding that the statute does not authorize the agencies to subject open market CLO managers to risk retention regulation, because those managers are not securitizers. To be a securitizer for purposes of Section 941, the Court concluded, a "party must actually be a transferor, relinquishing ownership or control of assets to an issuer" of the securitization assets. Because managers of open market CLOs do not own or control assets that are transferred to a CLO issuer and do not otherwise transfer assets to the issuer, they are not securitizers for purposes of the statute. In its decision, the Court acknowledged that its reasoning may apply to managers in connection with other types of securitizations. Thus, for example, if a fund forms a subsidiary to issue asset-backed securities for the purpose of levering a portion of the fund's portfolio, the decision should support a conclusion that the manager of the fund is not itself required to retain risk (though the fund may be required to do so). The government had until March 26, 2018 to seek review of the Court's decision before the full D.C. Circuit, but did not do so. The government has until May 10, 2018 to petition the Supreme Court to review the decision.

AIFMD Review but No Third-Country Passport In sight

The European Commission is conducting a comprehensive study on how the Alternative Investment Fund Managers Directive (AIFMD) has worked in practice so far. Phase 1 of the study includes an online survey open to

all market participants and stakeholders. It was available to complete until March 29, 2018. The review will assess how well AIFMD has achieved its objectives.

Owing, it seems at least in part, to political complications arising from the United Kingdom's decision to exit the European Union (EU) (Brexit), the AIFMD third country marketing passport (i.e., the ability for non-EU firms to market across borders in the EU) has still not been activated, despite the United States (along with other countries) having been assessed positively by the European Securities and Markets Authority (EMSA) for purposes of the passport extension. In any event, U.S. managers are unlikely to use the marketing passport in any significant numbers because: (i) using the passport means having to register with an EU member's state regulator and to comply fully with requirements of the AIFMD (not only those relating to marketing) as though the U.S. manager were established in the EU itself; and (ii) the Cayman Islands have yet to be assessed positively by ESMA, so U.S. managers would not be able to market Cayman funds to EU investors under the third country marketing passport.

MiFID II Goes Live

On January 3, 2018, the second EU Markets in Financial Instruments Directive and the Markets in Financial Instruments Regulation (together, MiFID II) came into effect across the EU. MiFID II represents a major overhaul of the regulatory and compliance obligations of investment firms in the EU, as well as significantly changes market structure and the trading of swaps and futures. Most of the changes introduced by MiFID II will only affect EU-based investment managers (including EU sub-advisors/affiliates of U.S. managers). However, non-EU investment advisors, even if they do not have any direct EU presence, may find that they are directly or indirectly affected. For example, U.S. managers which access EU markets by direct electronic access (DEA) arrangements with EU broker-dealers are likely to face significant new requirements because the EU broker-dealers will be required to ensure their DEA clients comply with the MiFID II requirements. U.S. investment advisors will already have received new documentation from their EU brokers. More broadly, some of the changes introduced by MiFID II could have an impact on U.S. domestic markets as U.S. institutional investors attempt to obtain for themselves by contract, the protections given to EU investors by MiFID II (e.g., research unbundling).

New Rules for Retail Investors Apply Widely

On January 1, 2018, new rules relating to the promotion of investment products to retail investors in the EU came into force. The EU Packaged Retail and Insurance-based Investment Products (PRIIPs) requires that manufacturers of PRIIPs produce a key information document (KID) when they make their product available to retail investors. The rules also apply to non-EU manufacturers of PRIIPs. U.S. hedge fund managers are therefore in scope if they allow their products to be made available to retail investors (even if as a result of a reverse solicitation). Non-EU investment advisors are having to assess whether the time and costs associated with producing a KID make it unviable to promote their investment products to retail investors in the EU. If so, such firms will need to take steps to ensure that their products are not distributed to retail investors.

Further Implementation of the Organization for Economic Co-operation and Development's (OECD's) Base Erosion Profit Shifting (BEPS) Recommendations in the United Kingdom and EU

Since the release of the OECD's final BEPS recommendations in 2015 many jurisdictions have taken steps to enshrine such recommendations in law. One aspect of the BEPS process of particular note to fund managers is its focus on the ability of special purpose vehicles to benefit from double tax treaties. The recently signed multilateral instrument, which seeks to implement the OECD's BEPS recommendations, includes provisions which are aimed at preventing persons from obtaining the benefits of a tax treaty in circumstances where they are perceived to be engaging in so-called treaty shopping.

The proposed multilateral instrument targets such persons by modifying tax treaties so as to include one of the following three provisions: (A) a principle-purpose test (PPT); (B) a limitation-of-benefits provision (LOB), which denies access to treaty benefits unless a person is a qualifying person; or (C) a combination of the PPT and a simplified version of the LOB.

In Europe, the majority of jurisdictions (including the United Kingdom, Ireland, the Netherlands, and Luxembourg) have opted to include the PPT provision in their tax treaties. Broadly, the PPT denies treaty benefits where (i) one of the principal purposes behind an arrangement is to obtain such treaty benefits and (ii) granting such treaty benefits would not be in accordance with the object and purpose of the relevant tax treaty.

The main concern for fund managers is that the PPT is subjective in nature, leaving an element of uncertainty as to how tax authorities might apply it. OECD commentary does, however, provide examples of how the PPT might operate in practice, with one such example suggesting that, where there are clear non-tax reasons for an arrangement, the existence of tax motives should not cause the arrangements to fall foul of the PPT.

Separately, many EU member states have either taken, or are beginning to take, steps to implement the requirements set out in the EU's Anti-Tax Avoidance Directive (ATAD). The ATAD is broadly based on the OECD recommendations and requires EU member states to implement legislation relating to:

- Restricting the deductibility of interest payments
- Imposing an exit tax on transfers of assets, permanent establishments, or corporate residence from the member state of origin
- Introducing a general anti-avoidance rule
- Introducing rules that attribute the income of a controlled foreign company to its controlling company
- Introducing rules countering hybrid mismatches (e.g., arrangements that give rise to a double deduction or deduction without a corresponding recognition of taxable income)

EU member states must generally implement these measures by January 1, 2019, but may do so before. The United Kingdom has, in many regards, led the way in implementation of the OECD's recommendations, and has already (in concept) implemented many of the ATAD rules, including equivalent hybrid mismatch rules, controlled foreign corporation rules, interest deductibility restrictions, and a general anti-abuse rule.

The EU's List of Non-Cooperative Tax Jurisdictions (the EU Blacklist)

The recently published EU Blacklist is intended to promote good governance in worldwide taxation and to maximize efforts to prevent tax avoidance, tax fraud, and tax evasion. The list currently includes nine jurisdictions. Importantly, and of note to fund managers, 55 jurisdictions were placed on the so-called graylist, representing those jurisdictions that avoided being included on the EU Blacklist due to commitments to either: (i) improve transparency; (ii) improve fair taxation; (iii) improve substance requirements; and/or (iv) commit to apply certain of the OECD's BEPS minimum standards.

Gray-listed jurisdictions include Bermuda, Guernsey, the Isle of Man, Jersey, the Cayman Islands, and Switzerland. Gray-listed jurisdictions have until the end of 2018 to follow through on their commitments before being reconsidered for inclusion on the EU Blacklist. As a result, fund managers should monitor any legislative changes proposed by gray-listed jurisdictions to which they (or their managed funds) have links.

Inclusion on the EU Blacklist carries sanctions that could affect not just the jurisdiction itself, but also entities based in such jurisdiction and entities that are doing business with or otherwise linked with such jurisdiction. The

precise sanctions have not yet been finalized but those currently being considered include increased audits and enquiries from tax authorities on such entities, as well as the imposition of withholding taxes on payments made to such entities.

GDPR and Hedge Funds

The General Data Protection Regulation (GDPR) entered into force in May 2016. Businesses, including hedge fund firms, now only have until May 25, 2018 to meet the new requirements under the GDPR. The GDPR aims to harmonize data protection legislation across the European Economic Area (EEA). However, in order to achieve this, the GDPR introduces a number of new requirements that will have a significant impact on businesses, including hedge fund firms. The GDPR is also likely to still be relevant to hedge fund firms based in the United Kingdom despite Brexit, as the GDPR will become law in May 2018, which is before the United Kingdom withdraws from the EU in 2019. Some of the key provisions of the GDPR that are of particular relevance for hedge fund firms are summarized below.

The GDPR introduces an aggressive enforcement regime with administrative fines of up to 4% of a company's annual worldwide turnover (gross revenue) or €20 million, whichever is higher. In addition, Data Protection Authorities (DPAs) will also have significant investigative and corrective powers, such as the ability to impose a temporary or definitive ban on processing personal data, or to issue reprimands to controllers and processors (see below) for infringing the provisions of the GDPR.

The GDPR applies to businesses established in the EU but also extends to businesses based outside the EEA that process personal data of individuals in the EEA, where the processing is related to: (i) the offering of goods or services to individuals in the EEA; or (ii) the monitoring of their behavior.

The GDPR has increased the thresholds for obtaining valid consent to process personal data. Consent must now be freely-given, informed, clear, and affirmative, rather than implicit and tacit. In addition, individuals, whether EU employees or investors, need to be given data privacy notices that include new information requirements as set out in the GDPR.

The GDPR includes enhanced accountability principles to demonstrate compliance with the GDPR, including the requirement for organizations to implement data protection policies, to maintain a detailed record of processing activities, to conduct privacy impact assessments, and to implement data protection by design and by default. A business will be required to conduct a privacy impact assessment where data processing uses new technologies and is likely to result in a high risk for individuals.

All organizations must implement appropriate technical and organizational security measures, particularly if sensitive personal data is processed (e.g., health data, racial or ethnic origin data, or criminal data). Furthermore, after becoming aware of a security breach, depending on the level of risk, businesses will be required to notify both their national DPA and the individuals adversely affected by the security breach, without undue delay and, where feasible, not later than 72 hours after becoming aware of the security breach. Businesses must also amend contracts with vendors that have access to their personal data subject to the GDPR including, for example, fund administrators, to include GDPR required processing provisions.

One of the more controversial rights introduced under the GDPR includes the right to be forgotten (or the right to erasure). The right to be forgotten allows individuals to ask for their personal data to be deleted in certain circumstances, such as when the processing is no longer necessary or the individual withdraws consent. Businesses must comply with such requests unless certain exemptions apply.

The GDPR maintains the current restriction on transferring personal data to countries outside the EEA that are not considered to have an adequate level of protection, such as the United States. It also retains existing data transfer solutions, such as EU data transfer agreements (also referred to as Model Contracts), the use of Binding Corporate Rules, and the recently adopted EU-US. Privacy Shield. It is clear that the GDPR will significantly impact the way in which hedge fund firms process personal data whether in relation to their EU employees or investors. It is important for hedge fund firms to understand their obligations under the GDPR and start making the requisite policy, procedural, technological, or other changes to ensure compliance. Failure to do so could result in significant sanctions and liabilities.

INCREASED ENFORCEMENT AND AUDIT

The SEC has ramped up inspection and enforcement efforts aimed specifically at registered investment advisors (RIAs or advisors), which increased from 1,447 in fiscal year 2016 to 2,000 in fiscal year 2017. In fiscal year 2017, there were 754 total enforcement actions, which resulted in $1.07 billion in penalties and fines. Hot topics include: improper allocation of fees and expenses; so-called cherry-picking profitable trades for personal account; failure to implement adequate policies and procedures to prevent the misuse of material nonpublic information (MNPI); advisors not entitled to rely on exemption from SEC registration; custody rule and compliance rule violations; failure to properly oversee third-party pricing vendor; improper share class selection; and insider trading. In 2017, several of these hot topics resulted in noteworthy enforcement actions, such as the following:

- **Trades for personal accounts.** The SEC settled charges against two investment advisors for allegedly engaging in separate fraudulent trade allocation schemes. Through data analysis, the SEC found that the principals of the two firms each cherry-picked profitable trades for their personal accounts to the detriment of client accounts.
- **Misuse of MNPI.** The SEC found that an RIA violated Section 204A (15 U.S.C.S. § 80b-4a) of the Investment Advisers Act of 1940. On behalf of its advisory clients, the advisor engaged in extensive research regarding the healthcare industry. These efforts encompassed hiring third-party experts, expert networks, and research firms (including research firms that specialized in providing political intelligence regarding upcoming regulatory and legislative decisions).
- **Custody rule and compliance rule.** The SEC settled one enforcement action involving multiple charges that reflect several current SEC compliance concerns. Two affiliated advisors advised two private funds with regulatory assets under management of less than $150 million. Although one of the affiliates was registered with the SEC, the other affiliated advisor filed separately with the SEC as an exempt reporting advisor relying on the private fund advisor exemption. The SEC found that the affiliated advisor was not entitled to rely on the exemption because the two advisors were under common control, operationally integrated (sharing the same principal office, place of business, and technology systems) and collectively managed more than $150 million. The two funds were both owned by the same entity, shared the same employees, operated in the same office, shared the same technology systems, and failed to maintain policies and procedures addressing registration or exemption from registration as an investment advisor.
- **Allocation of fees and expenses.** The SEC settled an enforcement action involving the improper allocation by an RIA of fees and expenses to two private equity fund clients. The SEC found that the advisor had improperly used the assets of a fund client to pay for services provided by the advisor's affiliates to a portfolio company of the fund. The SEC also settled an enforcement action alleging improper allocation of broken deal expenses by an RIA that manages private equity funds.
- **Third-party pricing vendor.** The SEC settled charges that an RIA materially misstated the value of assets in five private funds, resulting in the funds' paying excessive management fees and incorrectly calculating redemptions from the funds. The RIA used a third-party pricing service to value municipal bonds held in

the funds. However, during the pertinent period, the methodology used by the pricing service violated the advisor's own valuation policy and was not accurately represented in the advisor's disclosure documents.

- **Insider trading.** The SEC continues to focus on insider trading. The SEC uncovered an insider trading scheme by a former information technology employee at a bank who misused his access and tipped four individuals to trade on market-moving information. The SEC press release noted that the SEC's Data Analysis Tool assisted in detection of the suspicious patterns of the trades.

Increased inspection and enforcement also have led to record levels of whistle blowing (and fear thereof) and internal investigations at private fund managers. The SEC enforcement staff has also made it clear that corrective actions without follow-up verification may expose chief compliance officers to sanction. For additional information on whistle blowing, see Whistleblowing, Whistleblower Protections under Dodd-Frank and Sarbanes-Oxley (SOX), Market Trends 2016/17: Whistleblower Protections, and Dodd-Frank Whistleblower Award Provisions.

However, the U.S. Supreme Court recently held in Digital Realty Trust, Inc. v. Somers (Slip Op. No. 16-1276, February 21, 2018) that whistleblower protections under Dodd-Frank only apply to individuals who have reported alleged violations of securities laws to the SEC, and not to employees who have only reported alleged violations internally to their employers. The court held that individuals who report such allegations only internally are not whistleblowers based on the plain meaning of Dodd-Frank's statutory text and therefore are not entitled to the statute's whistleblower protections. Accordingly, the court's holding in this case eliminates companies' exposure under Dodd-Frank's whistleblower protections with respect to employees who did not report to the SEC prior to any alleged retaliatory adverse actions.

Because due diligence requests and side letters with investors routinely require production of or discussion relating to examination deficiency letters, private fund managers must be prepared to promptly respond to SEC examinations as a routine cost of doing business (e.g., by investing in compliance and technology and confirming that insurance is both available by its terms and sufficient in amount to pay the often substantial legal and accounting costs involved in responding to document and other informational requests). For the same reasons, non-routine exams or the identification of deficiencies during an exam may require additional attention and external resources in an effort to stave off referral to enforcement or to blunt the enthusiasm of the enforcement staff should a referral occur.

CFTC Enforcement

The CFTC under Republican Chairman Christopher Giancarlo and the recently appointed Director of Enforcement, James McDonald, has not been soft on violations of the Commodity Exchange Act and CFTC rules. To the contrary, although the CFTC's enforcement focus has shifted, it has been no less intense in 2017 than it had been under the previous administration. The CFTC is taking a back-to-basics approach to enforcement, focusing on fraud, market manipulation, and disruptive trading practices, and particularly bringing a number of cases for spoofing. Spoofing occurs when a trader bids or offers on a registered futures exchange or swap execution facility with the intent to cancel before execution. The CFTC staff believes the practice of spoofing is both pernicious and widespread and has aggressively pursued alleged spoofing activity in the markets they
oversee. Possible instances of spoofing have become easier for the CFTC to detect, as the CFTC has increased its reliance on big data to automate the search for potential illicit activity. However, many traders believe the CFTC's focus on spoofing discourages common, and arguably beneficial, market activity. Monitoring for possible spoofing within a firm is therefore both increasingly vital to avoiding a visit from the CFTC enforcement staff, and difficult for firms that are engaged in automated and/or high-frequency trading. The CFTC's focus on bad behavior among traders is expected to continue and potentially even intensify in 2018.

MARKET TRENDS

Cryptocurrency and ICOs. A number of new hedge funds have launched in the last 12-18 months that have been focused on investments in cryptocurrency, initial coin offerings, future tokens, functional tokens, and similar assets. Another set of funds has launched that focuses on venture and private equity investments in companies developing blockchain and distributed ledger technology. The regulatory status of the underlying instruments continues to be uncertain, and U.S. federal and state regulators are taking an increasingly aggressive enforcement position against key market participants. Fund managers and advisors wishing to actively participate in this space should consult with legal counsel on the possible legal and regulatory implications (e.g., registration) of their investments, disclosure of risks to investors, fiduciary duties, and a range of other matters before entering the space.

Transparency. Managers continue to face increased demands for transparency and more granular due diligence inquiries focused on managers, service providers, and counterparties. Managers are increasingly being asked to provide position-level data to third-party risk aggregators. Transparency raises difficult preferential treatment issues across products and investors, as well as the need to protect a manager's confidential intellectual property.

Increased Institutionalization. There has been an increased focus in investors' due diligence on internal operations and compliance policies; increased negotiations of side letters or renegotiations of fund terms; lower or tailored fees; more investor-friendly terms; enhanced governance; increased transparency; more ERISA plan asset funds; and greater allocations to large, established managers with longer track records and significant infrastructure. The increased diligence standards and negotiation of institutional investors, together with increased regulatory requirements, have increased the burden on new launches.

Managed Account Platforms. Various allocators (including sovereign wealth funds, state pension funds, large family offices, and fund of funds managers) have established managed account platforms to access the strategies of underlying managers. Certain platforms are also designed to permit investors, through the use of increased leverage and trading/volatility exposures, to make more efficient use of their capital. Many fund of funds that utilize managed account platforms leverage those platforms to provide greater investor customization as well as feeder fund access.

Fund of Funds Manager Non-Advisory Services. In addition to or instead of traditional advisory services, fund of funds managers are increasingly asked to provide administration or platform-related services such as manager diligence, service provider diligence, middle/back office operations, guideline monitoring, and tailored reporting. These services can also include a substantial educational and training component for certain large asset allocators and are part of the convergence between the services that fund of fund managers traditionally provide and the services that consultants traditionally provide (as some consultants have launched commingled fund of funds or other products).

Single-Investor/Single-Relationship Hedge Funds. In addition to the increased prevalence of managed accounts, the number of single-investor hedge funds and hedge funds for groups of affiliated or commonly advised investors continues to grow. These funds may allow for increased transparency, tailored fees, tailored liquidity, and tailored investment guidelines. Operating flagship funds and single investor funds side-by-side may raise allocation issues (especially if investment guidelines have been tailored) and conflict issues (broadly depending on the transparency and liquidity terms of each product).

Limited Use of General Solicitation. Although now permitted under both SEC Rule 506(c) (17 C.F.R. § 230.506) and CFTC Rule 4.7 or 4.13(a)(3) exemptions, relatively few managers are using general solicitation to market

their hedge funds. Deterrents include increased investor verification requirements; compliance with advertising rules; inability to fall back on the Section 4(a)(2) (15 U.S.C.S. § 77d) private offering exemption if the issuer fails to comply with Rule 506(c); need to have a six-month cooling off period if an issuer decides to convert back to Rule 506(b); proposed filing requirements for marketing materials; and proposed additional Form D filing requirements (both of which are still unclear). Reliance on Rule 506(c) is an all-or-nothing proposition, so careful consideration must be made before deviating from traditional private offering practices. The use of Rule 506(c) has generally been limited to managers who want to maintain a more robust public profile, not necessarily managers that want to use Rule 506(c) to market particular funds.

Seeded Manager Launches. The demand for seed capital continues to exceed supply. However, a number of new seed funds and seed capital providers have begun to expand their efforts in this area. There has also been an increase in co-seeding where multiple seeders team up to seed a new manager. As a result, 2018 is projected to be a year of increased seeded manager launches and increasing complexity in requests by seeders. Seed capital deals often include significant revenue sharing, lock-ups of up to three years, significant noncompetition obligations for principals, exit rights for the seed capital providers (self-executing or otherwise), and call rights for the seeded managers. Founders' classes (i.e., share classes with special benefits for early investors in a fund) continue to be popular for new launches and often incorporate some of the economic benefits of seed deals, often with fewer constraints.

Continued Use of Registered Funds. There is a continuing appetite for liquid alternatives and, consequently, expanded opportunities for hedge fund managers to advise or sub-advise registered funds. This allows managers to reach retail investors, avoid plan assets status, and, for closed-end funds, create permanent capital vehicles. Challenges for such funds include allocation of investments; conflicts of interest; operational and compliance hurdles; fee, investment, and leverage restrictions; tax requirements; and enhanced governance.

Focus on Trading Documentation and Dealer/Counterparty Credit Risk. Fund managers continue to place high priority on negotiating favorable terms in their counterparty trading agreements. In addition to traditional concerns like managing default and liquidity risk, managers and regulators alike have in recent years focused on managing counterparty credit risk. Throughout 2017, most managers amended their existing swaps documentation to accommodate a new regulatory mandate requiring daily, bilateral posting of variation margin for all uncleared swap transactions. In 2018, managers will continue to amend trading agreements to take into account other regulations that establish resolution procedures for insolvent financial institutions throughout the globe. We expect these trends to continue throughout 2018. In addition, in 2018 many managers will begin to prepare for the transition from London Interbank Offered Rate (LIBOR) and other interbank offered rates to newly established risk free reference rates that are expected to be introduced in April 2018.

Robust Secondary Market Sales. The secondary market in hedge fund interests has become more robust, including the development of numerous funds designed exclusively to purchase side pockets, gated interests, and other fund interests.

Reduced Prevalence of Certain Side Letter Terms. While side letters remain common and institutional investors demand a wide variety of special terms, concerns regarding regulatory scrutiny of side letters have led to an increased reluctance of managers to grant in a side letter any terms that may materially adversely impact other investors, such as preferential liquidity or portfolio transparency. Some managers have abrogated their side letters and either adopted a "no substantive side letter" policy, incorporated key side letter terms into fund offering/governing documents to benefit all investors, or developed their own standard form of side letters which standardized the terms for common requests.

Co-Investments. Certain hedge fund managers have sought to use co-investment vehicles to handle excess deal capacity or to manage investments that do not fit into a commingled fund's liquidity profile. These may be structured as single investor vehicles or commingled vehicles. Furthermore, hedge fund managers have increasingly used co-investment vehicle structures to offer investors exposure to high conviction investment ideas, including positions in publicly traded equities or other liquid investments.

Continued Pressure on Fees. The hedge fund industry is continuing to see pressure on fees. Recently launched hedge funds are routinely offering a founders' share class with a 25% to 50% discount to standard hedge fund fees as an incentive to invest in their fund. In addition, managers increasingly offer fee reductions as a means of asset retention after periods of poor performance. Fund of funds managers have continued to face downward pressure on fees as the industry is experiencing a period of contraction and consolidation.

Specialized/Customized Fee Structures. In addition to fee pressure generally, the hedge fund industry has seen an increase in the types of fee structures utilized. This includes an increase in the use of benchmarks, multi-year incentive fees, tiered management fees based on increases in fund assets under management, and "1 or 30" fee structures.

Family Office Conversion as the Succession Plan. In lieu of seeking to transfer an investment manager business to other principals or addressing the regulatory burdens associated with managing third-party capital, some managers have recently converted their operations into family offices. This trend has only accelerated over time. However, complying with the SEC's Family Office Rule (17 C.F.R. § 275.202(a)(11)(G)-1) can pose challenges, and returning capital to outside investors while retaining positions for the principal raises conflict issues.

Blurring of the Lines Between Hedge Funds and Private Equity Funds. Certain hedge funds have recently incorporated terms that are akin to private-equity style funds in order to capitalize on advantageous trading opportunities in less liquid strategies. This is resulting in longer lock-ups, longer redemption notice periods, investor-level gates (sometimes in combination with fund-level gates), and committed capital structures for illiquid strategies. Single-investor and/or single-relationship funds are also increasingly adopting private equity-like terms with limited or no liquidity.

Increased Attraction of U.K. Corporate Structure for U.K. Management Arrangements. U.S. fund managers setting up operations in the United Kingdom have historically favored the use of a U.K. limited liability partnership (LLP) over a U.K. limited company (LTD). This was generally due to the greater commercial and legal flexibility and reduced tax burden afforded by the LLP structure. Recent developments, however, have led to increased consideration of the LTD structure, both for new and existing managers. In particular, the United Kingdom's salaried members rules deem certain individual members of LLPs to be employees for U.K. tax purposes, resulting in an effective tax rate of up to 47% for the relevant individual member and an additional 13.8% in employer social security obligations for the LLP itself. Further, LLPs with both individual and corporate members are now subject to new rules that limit the amount of the LLPs' income that can be allocated to any corporate member, limiting the ability to retain U.K. profits through the corporate member of the LLP. Finally, the U.K. corporation tax rate applied to the taxable profits of an LTD is currently at its lowest rate for years–19%–with the government committing to further reduce such rate to 17% by 2020.

Daniel F. Spies
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DAN SPIES is a partner in the Investment Funds, Advisers and Derivatives practice. His practice focuses on securities and futures-related funds and corporate transactions, including related regulatory matters. He regularly advises and represents clients regarding domestic and international offerings of investment funds as well as compliance with the Investment Advisers Act of 1940 and the Commodity Exchange Act.

Representative funds/investment products include:

- Domestic and offshore hedge funds, private equity funds and hybrid funds;
- Public and private commodity pools;
- Funds of funds;
- Seed capital arrangements (including seed capital funds and seeding transactions representing both seeders and recipients of seed funding); and
- Managed accounts and single investor funds.

Dan is a leader in the firm's recruiting efforts. He is a co-chair of the firm's Summer Committee in Chicago, which oversees the firm's summer associate program each year. He also is actively involved in the firm's on-campus recruiting efforts.

Bradley D. Howard
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BRAD HOWARD advises alternative asset managers with respect to hedge funds, fund of hedge funds, managed accounts, private equity funds and various related structures. He also advises clients on managed account platforms, fund-related derivatives, special opportunity funds, co-investments and commodity pools. His advice often focuses on structuring, regulatory and compliance issues for these products.

Brad advises asset manager clients on credit facilities and financing/leverage-related derivative instruments. He also advises on the Investment Advisers Act, the Commodity Exchange Act, Regulation D and Dodd-Frank related compliance issues. Brad has advised clients on seed deals, joint ventures, manager restructurings and other manager-related transactions.

Kara J. Brown
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KARA BROWN advises hedge funds and private equity funds, as well as advisers offering separately managed accounts and sub-advisers to registered funds, regarding SEC registration and the development, implementation and enhancement of compliance programs. Prior to joining Sidley, she held various legal and compliance positions with investment advisers, including serving as chief compliance officer. Kara has extensive experience pertaining to the Investment Advisers Act of 1940 and other regulations applicable to investment advisers. She also advises clients with respect to SEC examinations and regulatory filing obligations. She is admitted in New York and Massachusetts and has held the Series 7 license.

Christian Brause
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CHRISTIAN BRAUSE, a tax partner in the New York office, focuses on advising U.S. and non-U.S. clients on U.S. tax aspects of domestic and international mergers and acquisitions and other major domestic and international transactions, including spinoffs, corporate restructurings, joint ventures, debt financings and IPOs. Christian also spends a significant amount of his time on advising clients in respect of the structuring of alternative investments and the formation of alternative investment vehicles, including hedge funds, private equity funds and real estate funds. He focuses in particular on REITs, including mortgage REITs. Christian is recommended in Domestic Tax: East Coast and International Tax in *The Legal 500 US* 2013, Investment Fund Formation and Management: Private Equity Funds, Real Estate and Construction: Real Estate Investment Trusts (REITs) (2015–2016) and in Tax: International Tax (2016) in The Legal 500 US and is recognized in the *Tax Directors Handbook* 2014.

Christian is the co-author of the Tax Management Portfolio, “Hedge Funds,” a treatise that discusses U.S. tax issues in connection with the structuring and operation of hedge funds. He is also the author of “Federal Income Tax Aspects of REITs,” which is published annually by the Practising Law Institute.

Christian was a scholar of the German Merit Foundation (*Studienstiftung des Deutschen Volkes*), and he is a senior member of St. Hugh’s College of Oxford University.

Nathan Howell
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NATE HOWELL’S practice focuses on futures and derivatives regulation, transactions and compliance, with a core focus on Commodity Exchange Act, Commodity Futures Trading Commission (CFTC) and Dodd-Frank Act matters. He also frequently advises clients on issues related to cryptocurrency, blockchain and distributed ledger technology, and tokenized assets. He understands the complexities of the current legislative and regulatory environment in the United States in light of the disruption caused by technology. Nate’s clients rely on him to understand all of this complexity, while providing practical and straightforward solutions.

Leonard Ng
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LEONARD NG is co-head of the EU Financial Services Regulatory group and a member of the firm’s Investment Funds, Advisers and Derivatives and Banking and Financial Services practices. Based in Sidley’s London office, Leonard advises a wide range of financial institutions on UK and EU financial services regulatory issues and has particular experience in advising investment fund managers and other clients on operating under the post-financial crisis regulatory framework. Leonard is a member of the UK Financial Conduct Authority’s (FCA) Legal Experts Group on the AIFM Directive. He is also a past member of the Board of the Managed Funds Association (MFA), the global trade association for hedge funds and is a frequent speaker at industry conferences.

In addition to UK and EU regulatory matters, Leonard has extensive experience in advising international clients on the Basel regulatory capital framework, as well as assisting EU-based clients assess the implications of U.S. legislation such as the Dodd Frank Act, in conjunction with colleagues in Sidley’s U.S. offices.

Leonard has received acknowledgement from numerous industry ranking guides, including *Chambers UK* 2017, *IFLR1000* 2017, *The Legal 500 UK* 2016, *Best Lawyers* 2017 and *Who’s Who Legal* 2017.

Leonard has also been interviewed widely for his thought leadership, including in such national publications as the *Financial Times*, *Wall Street Journal* and *New York Times’ Dealbook*. He has also been featured in numerous industry outlets, including *Bloomberg Briefs*, *HFMWeek*, *Financial News*, *Private Equity News*, *Institutional Investor Magazine* and *Global Risk Regulator*.

Will Smith
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WILL SMITH is a transactional and advisory lawyer who focuses on the direct and indirect aspects of a range of international and UK tax matters. Whilst having a particular emphasis on representing a wide range of investment funds and investment advisers, Will has extensive experience in the tax aspects of cross-border investment and structuring, structured and cross border finance (including CLOs), real estate structuring and transactions, corporate transactions and reorganizations and complex incentive arrangements (including carry).

William Shirley
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WILLIAM SHIRLEY is counsel in the firm’s New York office. His practice encompasses a wide range of legal matters related to the financial services industry, particularly those associated with Dodd-Frank and other regulatory initiatives that followed in the wake of the financial crisis. He works closely with colleagues in several of the firm’s practice groups, including the Investment Funds, Advisers and Derivatives group, the Banking and Financial Services group, and the Global Finance group, who practice in several of the firm’s offices, including New York, Chicago, Washington, D.C. and London.

Bill served for 17 years as a senior lawyer at AIG Financial Products Corp., including as its General Counsel for four years prior to leaving in 2011. Subsequently Bill was a visiting assistant professor of law at Hofstra Law School, where he taught banking and financial

institution law during the spring of 2012. Previously Bill had a varied capital markets and M&A practice at another large international law firm, where he was initially based in New York before spending three years resident in Paris followed by two years in London.

William Long
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WILLIAM LONG is a global co-leader of Sidley's highly ranked Privacy and Cybersecurity practice and also leads the EU data protection practice at Sidley. William advises international clients on a wide variety of GDPR, data protection, privacy, information security, social media, e-commerce and other regulatory matters.

William has been a member of the European Advisory Board of the International Association of Privacy Professionals (IAPP) and on the DataGuidance panel of data protection lawyers. He is also on the editorial board of e-Health Law & Policy and also assists with dplegal ("data privacy" legal), a networking group of in-house lawyers in life sciences companies examining international data protection issues.

Beth J. Dickstein
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BETH J. DICKSTEIN regularly advises pension plan investors, as well as investment managers, regarding legal issues relating to various investment products, including the product's fee arrangements and related party transactions. This has involved significant analysis of the fiduciary duty and prohibited transaction provisions of ERISA. Beth focuses on assisting investment managers, insurance companies and other financial institutions with structuring different types of alternative investment vehicles to be offered to ERISA plans, including hedge funds, private equity funds, real estate funds and bank collective investment trusts. Beth has prepared ERISA compliance procedures for investment managers, has performed "mock" Department of Labor fiduciary audits and has trained investment managers and plan investment committees regarding their fiduciary responsibilities under ERISA. She has advised clients regarding the structuring of administrative and investment committees of pension, 401(k) and 403(b) plans and regularly assists pension investment staff and pension investment committees with legal review of proposed investments and the drafting and negotiation of investment management agreements, consulting agreements, recordkeeping agreements and other service provider contracts. In addition, Beth provides support to the firm's litigators in ERISA fiduciary duty and 401(k) fee lawsuits.

Beth represents numerous companies in the establishment and administration of pension, profit sharing and 401(k) plans. She also advises clients with respect to multiemployer plan matters generally and in connection with plant shutdowns and audit requests. Her practice also focuses on employee benefit issues arising in connection with mergers, acquisitions and financings.

Michele Navazio
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MICHELE (MIKI) NAVAZIO is a member of Sidley's Derivatives Industry group, advising buy-side clients in negotiating derivatives transactions and trading documentation, and with respect to regulatory issues and developments that affect derivatives market participants. His clients include a significant number of the world's largest hedge funds and asset managers, as well as private equity firms, funds of funds, mutual funds and corporate end-users. Miki's derivatives practice encompasses the Dodd-Frank Act and regulations related to both systemic and counterparty risk, swap margin, central clearing and execution of OTC derivatives, collateral segregation, reporting and compliance.

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