The Private Investment Fund Accounting, Operations, & Compliance Forum

Ensuring a Compliant and Cost-Efficient Culture Within your Fund

July 29-30, 2015 | NYC
Thank you for attending the conference!

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# Financial Research Associates Presents

## The Private Investment Fund Accounting, Operations and Compliance Forum

**July 29th and 30th, 2015**  
**New York City**

### DAY ONE: Wednesday, July 29th, 2015 NYC

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<tr>
<td>8:00 – 8:45</td>
<td>Breakfast sponsored by</td>
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<tr>
<td>8:50 – 9:00</td>
<td>Chair’s Welcome</td>
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<td></td>
<td>Karl Jordan, CPA, GCMA, <em>Domestic and International Principal</em></td>
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<td><em>ELLIOTT DAVIS DECOSIMO</em></td>
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<tr>
<td>9:00 – 10:00</td>
<td>2015 Private Investment Fund Accounting Update</td>
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<td>Matt Maulbeck, <em>Partner</em></td>
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<td><em>EISNERAMPER LLP</em></td>
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<td>Frank Boutillette</td>
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<td><em>WITHUM SMITH+BROWN, PC</em></td>
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<td>Renee Ford, <em>Shareholder</em></td>
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<td><em>ELLIOTT DAVIS DECOSIMO</em></td>
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<td>10:00 – 11:00</td>
<td>Tales from an SEC Audits - Lessons Learned and Moving Forward</td>
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<td>Gerald Esposito, <em>Managing Director, CFO, CCO</em></td>
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<td><em>NEWBURY PARTNERS</em></td>
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<td>Mark Schein, <em>Managing Director, CCO</em></td>
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<td><em>YORK CAPITAL</em></td>
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<td>Michael Cohn, <em>Chief Compliance Officer and Deputy General Counsel</em></td>
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<td><em>FORTRESS INVESTMENT GROUP</em></td>
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</table>
11:00 – 11:10  Refreshment break

11:10 – 12:00  Effectively Addressing the Risks of Cybersecurity

Ashley Gimbel, Senior Vice President
DYAL CAPITAL PARTNERS

Chris Gimbel, Manager of Information Systems & Infrastructure
ABBOTT CAPITAL MANAGEMENT

Adam L. Menkes, Director
CREDIT SUISSE

Michael Koffler, Partner
SUTHERLAND, ASBILL, & BRENNAN

12:00 – 1:00  Luncheon sponsored by

1:00 – 2:15  Tackling Key Regulatory and Compliance Issues that Private Investment Funds are Facing

Moderator:
Dianne Mattioli, Principal
REGULATORY COMPLIANCE SOLUTIONS INC.

Panelists:
Jason Ment, Partner, General Counsel, CCO
STEPSTONE

Moshe Luchins, Deputy General Counsel and Compliance Officer
ZWEIG-DIMENNA ASSOCIATES

2:15 – 2:30  Refreshment break
At this point, the conference breaks out into two tracks – one that’s focused on specific private equity issues and the other that’s focused on specific hedge fund issues. These tracks will continue through until right before lunch on the second day.

**Track A Chair:**
Karl Jordan, CPA, GCMA, *Domestic and International Principal*
ELLIOTT DAVIS DECOSIMO

**Track B Chair:**
Anthony Tuths, Partner
WITHUM SMITH+BROWN, PC

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<th>Track B – Hedge Fund</th>
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<tr>
<td>2:30 – 3:20</td>
<td>Private Equity Tax Outlook 2015</td>
<td>Successfully Addressing Key Valuation Issues for Hedge Funds</td>
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<td><strong>Moderator:</strong> Joshua Cherry-Seto, Chief Financial Officer</td>
<td>Hillel Kamionski, CPA, Controller</td>
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<td><strong>BLUE WOLF CAPITAL PARTNERS</strong></td>
<td><strong>ALJ CAPITAL MANAGEMENT</strong></td>
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<td><strong>Panelists:</strong> Jeffrey Hecht, Partner ERNST &amp; YOUNG LLP</td>
<td>Mark Shayne, Managing Director</td>
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<td>Anthony Tuths, Partner WITHUM SMITH+BROWN, PC</td>
<td><strong>EMPIRE VALUATION CONSULTANTS</strong></td>
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<td>Neil Datta, <em>Director, Risk Management</em> OPTIMA FUND MANAGEMENT</td>
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<td>Marni Pankin, Partner MARCUM</td>
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<tr>
<td>3:20 – 4:10</td>
<td>Successfully Addressing Key Valuation Issues for Private Equity Funds</td>
<td>Hedge Fund Tax Outlook 2015</td>
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<td><strong>Keith Smith, Managing Director</strong> EMPIRE VALUATION CONSULTANTS</td>
<td>Lucy Gates, Manager ELLIOTT DAVIS DECOSIMO</td>
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<td>Craig Ter Boss, <em>Director</em> EISNERAMPER LLP</td>
<td>Steve Yardumian, Partner WITHUM SMITH+BROWN, PC</td>
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<td>4:10 – 5:00</td>
<td>Portfolio Company Due Diligence and Optimization – Value-Add Tactics for Your Fund’s Investments</td>
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</table>
|       | James M. Haluszczak, Managing Partner  
|       | STEELBRIDGE CONSULTING  
|       | Joshua Cherry-Seto, Chief Financial Officer  
|       | BLUE WOLF CAPITAL PARTNERS |
|       | The Next Phase of FATCA Compliance - Working out the Kinks and Ensuring that Your Fund is Doing Everything Right |
|       | Vic DeMaise, Manager  
|       | ELLIOTT DAVIS DECosimo  
|       | Justin Rindos, Vice President, Structuring Services  
|       | PARTNERS GROUP |

5:00 Day One Sessions Adjourn; Cocktail Reception sponsored by:

![Sponsor Logo]
### 8:00 – 9:00  Continental breakfast

### 9:00 – 9:10  Chair’s Welcome

**Track A Chair:**
Karl Jordan, CPA, GCMA, Domestic and International Principal
ELLIOTT DAVIS DEocosimo

**Track B Chair:**
Anthony Tuths, Partner
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<td>9:10 – 10:00</td>
<td>Private Investment Fundraising and Beyond: Marketing, Due Diligence and Investor Relations</td>
<td>State of the Derivatives Market and its Impact on Your Fund’s Operations</td>
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<td>- Adam Nadborny, General Counsel &amp; Chief Compliance Officer</td>
<td>- Joel Telpner, Partner JONES DAY</td>
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<td>- ATALAYA CAPITAL MANAGEMENT</td>
<td>- Stephen Humenik, Of Counsel COVINGTON &amp; BURLING LLP</td>
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<td>- Harsh Jadhav, Chief of Internal Audit</td>
<td>- Joshua Sterling, Partner MORGAN, LEWIS &amp; BOCKIUS LLP</td>
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<td>- ALAMEDA COUNTY EMPLOYEES RETIREMENT ASSOCIATION</td>
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<td>- Justin Rindos, Vice President, Structuring Services PARTNERS GROUP</td>
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<td>10:00 – 10:50</td>
<td>LP Terms and Conditions – Being Creative and Providing Win/Win Opportunities</td>
<td>Operating an Alternative Fund in the ’40 Act Space</td>
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<td>Michael Elio, Partner STEPSTONE</td>
<td>Larry Chiarello, Portfolio Manager &amp; Partner BPV CAPITAL MANAGEMENT</td>
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<td>Kristine O’Connor, Partner FRANKLIN PARK</td>
<td>Nadine K. Haidar, Managing Director, Head of Liquid Alternatives Platform Management RAMIUS LLC</td>
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<td>Paul Landi, Director STEELBRIDGE CONSULTING</td>
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10:50 – 11:15 Refreshment break

Breakout sessions end and general conference resumes

11:15 – 12:30 Promoting Efficiency: Fund Operation Strategies that Do More with Less

James Rankin, Director of Investment Operations PACIFIC ALTERNATIVE ASSET MANAGEMENT COMPANY

Marc Baum, General Counsel, Chief Administrative Officer SERENGETI ASSET MANAGEMENT

Lance Taylor, Chief Financial Officer HGGC

Neal Coxworth, Vice President SETTLEMENT RECOVERY GROUP

12:30 – 1:30 Luncheon sponsored by

[Empire Valuation Consultants, LLC logo]
1:30 – 2:20  Vendor Oversight and Due Diligence – Ensuring That You’re Getting the Services that You’re Supposed to be Getting

Marshall Terry, Managing Director, COO and CCO
ROTATION CAPITAL MANAGEMENT LP

Tim Cheu, Principal Consultant
ACA APONIX

2:20 – 3:10  Managing Funds that are Winding Down

Greg Levy, Partner
KAUFMAN ROSSIN

Michael Belsley, Partner
KIRKLAND & ELLIS

3:10  Conference Adjourns
Dear Conference Participant:

On behalf of Financial Research Associates, LLC, I would like to cordially welcome you to this industry event.

We have developed this event based on extensive industry research, structuring the topics and gathering together the speaker faculty based on feedback from numerous industry participants. Our goal is to provide you with the most up-to-date industry information possible, along with top-notch networking opportunities. Every effort has been made on our part to obtain the speakers’ presentations to be included in the PDF link that you have received via email. If a speaker’s presentation is not included in the PDF link, we ask that you contact the speaker directly. If we have failed to meet your expectations in any way, please let us know by completing the evaluation form provided at this event. Of course, we would like to hear positive feedback as well!

We appreciate that you have chosen to spend your time and training dollars with us, and we’re committed to satisfying your informational needs. Again, welcome to this event and thank you for your participation – we truly value your business.

Sincerely,

Lori Medlen, President
Financial Research Associates, LLC
If you have any additional questions or requests for information beyond what is in this document book, please feel free to contact us at any time. A link with final speaker presentations will be forwarded via email approximately 2 weeks after the conference.

Denise Lateefuddin
Financial Research Associates, LLC
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Charlotte NC 28277

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Dentists and Dental Practices
Emerging Business
Entertainment
Family Office

Government
Healthcare
Hedge Funds
Hospitality and Restaurant
Manufacturing and Distribution
Not-for-Profit
Private Equity Groups and Portfolio Companies
Professional Services
Real Estate
Technology and Life Sciences
It takes more than luck to be a winner in business today.

It takes the right team to keep a deal on track. Elliott Davis Decosimo provides audit and tax services as well as invaluable transaction due diligence and valuation services to private equity firms and portfolio companies. Let us help you meet your long-term business objectives.
Today's landscape can be both trying and fortuitous for investment companies. Whether you are a hedge fund or private equity group, you need the right team with the right experience to help you step up to opportunity and conquer challenges. Our high-performance team provides everything from audit and tax solutions to specialized advisory services for a variety of funds. Let us guide your business through unpredictable terrain.

With a 360° approach, we are with you at every turn.
At Empire Valuation Consultants, we have the good fortune of working with many of the world’s top hedge funds and alternative investment managers. We have over 25 years’ experience delivering accurate, transparent and dependable valuations of illiquid equity, real estate and debt securities. Take advantage of our breadth of expertise to introduce valuation best practices into your fund.
WithumSmith+Brown’s Financial Services Group provides audit, tax and consulting services to the asset management industry including hedge funds, private equity funds, venture capital funds and family offices. Withum services managers in the start-up arena as well as proven market leaders. Our client base includes unregistered funds, registered funds, commodity pools, future merchants and other financial services type entities. With alternative investment expertise across our U.S. and Cayman offices, Withum is able to bring unparalleled client service to every manager. With over 40 years of experience in the asset management field, WithumSmith+Brown can help your fund **BE IN A POSITION OF STRENGTH**.
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Did your firm trade FOREX any time from 2003 to the present?
You may be eligible for a significant refund from the FOREX Benchmark Rates Anti-Trust Settlement.

**SETTLEMENT OVERVIEW**

Plaintiffs allege that the Defendants conspired to fix prices in the foreign exchange (“FX”). A settlement has been reached with several defendants, and these defendants have agreed to pay $812.5 million into a Settlement Fund. This fund is expected to grow much larger as more defendants settle.

Any refund applies to any entity that traded FOREX with one of 12 major banks (defendants) that act as dealers in the FOREX market.

**INTERESTED?**

See Neal Coxworth or stop by the SRG booth for more details.

SRG handles all aspects of class action claims filing including administration, monitoring, tracking and modeling of claims for maximum recovery on a contingency basis.

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Neal Coxworth - Settlement Recovery Group
Ph: 201-222-4309   Cell: 917-678-2279
ean.coxworth@srgllc.com · srgllc.com

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Financial Research Associates, LLC
Proudly Presents

The Private Investment Fund Accounting, Operations, & Compliance Forum

July 29-30, 2015
The Princeton Club, New York
Chair’s Welcome

Karl Jordan, CPA, GCMA, *Domestic and International Principal*

ELLIOTT DAVIS DECOSIMO
Karl Jordan, CPA, CGMA
Shareholder

Services: Business Advisory | Industries/Specializations: Investment Partnerships, Private Equity, Hedge Funds, Banking & Financial Services, Family Office, Captive Insurance, Real Estate

Professional Overview

Karl has over 35 years of experience in tax, auditing and corporate finance consulting services. He provides services to financial institutions, private investment partnerships, alternative investment groups, hedge funds, broker/dealers, real estate companies, captive insurance, investment companies, family offices and high-net-worth individuals.

Karl’s family office operations services include merger and acquisition consultation, financial planning and estate considerations. He also assists clients with investment partnerships, including initial setup, accounting systems and procedures consultations, regulatory assistance and other related management planning and consultation. He has actively worked with the Federal Deposit Insurance Corporation and the Resolution Trust Corporation in closing numerous financial institutions, as well as with the Securities and Exchange Commission and other governmental regulatory authorities. He is a recognized national speaker, leading seminars and discussion groups on investment fund formations, fund operations and regulatory issues.

Education, Credentials and Special Training
Certified Public Accountant
Chartered Global Management Accountant
Master of Business Administration, University of Tennessee System
A.S., Accounting, Chowan College
B.S., Accounting, East Tennessee State University

Professional Affiliations
American Institute of Certified Public Accountants
Tennessee Society of Certified Public Accountants
Georgia Society of Certified Public Accountants
Cayman Islands Society of Professional Accountants

Civic and Community Activities
Grant Committee, Hedge Funds Cares Southeast
Chairman, Board of Accountancy, East Tennessee State University College of Business & Technology
Treasurer, Peach State PETS (President Elect Training Seminar)
2015 Private Investment Fund Accounting Update

Matt Maulbeck, Partner
EISNERAMPER LLP

Frank Boutillette
WITHUM SMITH+BROWN, PC

Renee Ford, Shareholder
ELLIOTT DAVIS DECOISMO
Matthew Maulbeck is a Partner in the firm’s Professional Practice Group. Matt has more than ten years of technical accounting, financial reporting and auditing experience with both public and private companies in the financial services, real estate, retail and pharmaceutical industries. He also has substantial experience with SEC rules and regulations and reviewing SEC filings. Matt’s current focus is technical accounting reviews and consultations for audit clients in the financial services industry, including primarily hedge funds, private equity funds, investment advisors, broker-dealers and mutual funds.

Prior to joining the firm, Matt worked as a reviewer in the Division of Corporation Finance at the U.S. Securities and Exchange Commission and at a Big 4 accounting firm. Matt graduated from Loyola University with a B.B.A. in Accounting and from the University of Texas with a master’s degree in Professional Accounting. He is a member of the American Institute of Certified Public Accountants (AICPA) and New Jersey Society of Certified Public Accountants (NJSCPA). Matt has served on ad hoc committees for the Center for Audit Quality, contributed to the AICPA’s Audit and Accounting Guide for Investment Companies and is a co-author of "Auditing a Private Equity Fund," published in Private Equity International’s The US Private Equity Fund Compliance Companion.
Frank R. Boutillette, CPA/ABV, CGMA  
Partner, WithumSmith+Brown, PC

Frank is a partner based in WS+B’s New York office and has over 25 years of accounting and auditing experience. He is a licensed certified public accountant in the states of New York and New Jersey and specializes in accounting and auditing and business valuation services. Frank is the practice leader of WS+B’s Financial Services & Investment Group and has a great deal of experience working with investment companies (hedge funds, mutual funds and ETFs), broker-dealers, private equity and venture capital funds, registered investment advisors and closely-held businesses. He also performs peer and quality reviews of CPA firms.

A graduate of Rutgers University, Newark, Frank received his BA degree in accounting. He is a member of the American Institute of Certified Public Accountants (AICPA) and the New Jersey Society of Certified Public Accountants (NJCPA), where he currently serves as president of the organization. Frank is also a member of the NJCPA Peer Review Executive Committee, which administers peer reviews on behalf of the AICPA in New Jersey. He is past chair of both the NJCPA Accounting and Auditing Standards Interest Group and the NJCPA Accounting and Auditing Resource Group. Frank is a former member of the Audit Committee for the NJCPA and past treasurer of both the NJCPA and the Middlesex/Somerset Chapter of the NJCPA. He recently completed a three-year term on the AICPA Peer Review Board. The Peer Review Board is responsible for maintaining, furthering and governing the activities of the Peer Review Program, including the issuance of peer review standards and peer review guidance, while being mindful of the profession’s covenant to serve the public interest with integrity and objectivity. Frank is a frequent lecturer on accounting and auditing topics to professional and business groups. He has been quoted in several publications and is the coauthor of three books on accounting. Frank resides in Ocean County, NJ.
Renee Ford, CPA
Shareholder

Services: Assurance | Industries: Investment Companies, Healthcare, Captive Insurance

Professional Overview
Renee has over 25 years’ experience in public accounting in both assurance and taxation. She is a member of the Elliott Davis Decosimo Executive Committee and serves as the firm’s Investment Company Specialty Practice Group leader. She practices primarily in the area of financial statement audits under both U.S. and international audit and accounting standards with emphasis on investment entities, healthcare and captive insurance.

Renee holds has a certification in International Financial Reporting Standards (IFRS), and as part of the firm’s Investment Companies Practice, she serves domestic and international funds. She has advised and assisted many clients in successfully transitioning and maintaining compliance with the complex rules and disclosure requirements of the fair-value accounting standards. Renee is a frequent speaker on accounting and advisory topics impacting hedge funds and alternative investment advisors at seminars hosted by Financial Research Associates LLC in New York.

Renee has over a decade of experience serving clients in the healthcare industry. She works with one of the nation’s largest long-term care chains comprising more than 250 nursing, assisted and independent-living facilities, as well as six other independently owned facilities.

Renee also has experience assisting captive insurance companies and has served captives and captive managers ranging in size from $100,000 to over $500 million in total assets.

Education, Credentials and Special Training
Certified Public Accountant - Tennessee, Georgia and South Carolina
B.S., Accounting, cum laude, University of Tennessee at Chattanooga
ACCA Certification in IFRS

Professional Affiliations
American Institute of Certified Public Accountants
Tennessee Society of Certified Public Accountants
Past President - Tennessee Society of Certified Public Accountants, Chattanooga Chapter

Civic and Community Activities
Board of Directors, Chattanooga Area Chamber of Commerce
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Chattanooga Ronald McDonald House, Volunteer Hall of Fame Inductee

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2015 PRIVATE INVESTMENT FUND ACCOUNTING UPDATE

- Renee Ford, Shareholder – Elliott Davis Decosimo
- Matthew Maulbeck, Partner – EisnerAmper
- Frank Boutillette, Partner – WithumSmith+Brown, PC

Private Investment Fund Accounting, Operations and Compliance Forum
July 29, 2015

INVESTMENT COMPANY DEFINITION
Investment Company Definition

- Financial Services – Investment Companies (Topic 946)
- ASU 2013-08 Amendments to the Scope, Measurement and Disclosure Requirements
- Effective for years beginning after December 31, 2013
- Earlier Adoption is PROHIBITED

ASU 2013-08 does the following

- Changes the approach to the investment company assessment
- Clarifies the characteristics of an investment company
- Provides comprehensive guidance for assessing whether an entity is an investment company
- Requires investment company to measure non-controlling interest investments in other investment companies at fair value rather than equity method
- Requires additional disclosures”
  - Fact that the entity is an investment company and is applying guidance in Topic 946
  - Information about changes in an entity’s status as an investment company
  - Information about financial support provided or contractually required to be provided by an investment company to any of its investees
What is an Investment Company?

• Any entity regulated under the Investment Company Act of 1940
• An entity that has the following fundamental characteristics
  - Obtains funds from one or more investors and provides investment management services
  - Commits to investors that its business purpose and only substantive activities are investing the funds solely for returns from capital appreciation, investment income or both
  - The entity or its affiliates do not obtain or have the objective of obtaining returns or benefits from an investee or its affiliates that are not normally attributable to ownership interests that are other than capital appreciation or investment income

Typical Characteristics

Has more than one investment
Has more than one investor
Has investors that are not related parties of the parent or the investment manager
Has ownership interests in the form of equity or partnership interests
Manages substantially all of its investments on a fair value basis
Implementation Guidance

Business Purpose and Substantive Activities

- No substantive purpose other than investing
- No significant assets or liabilities other than those related to investing
- Exit strategy for how it plans to realize capital appreciation of its investments – need not be specific
- May provide investing-related services to other entities as long as not substantive

Recognition

Initial determination is made upon formation of the entity.

Reassessment occurs if there has been a change in the purpose and design of the entity or if the entity is no longer regulated under the ‘40 Act.

An entity that subsequently becomes an investment company as a result of the reassessment shall account for the effect of the change as cumulative-effect adjustment to net assets at the date of the change.

The adjustment to net assets includes:
- Difference between FV and carrying amount of the entity’s investees
- Any amounts previously recognized in Accumulated OCI
Examples of Inconsistent Characteristics

• Acquisition, use, exchange or exploit the processes, assets or technology of an investee
• Arrangements with investees to jointly develop, produce, market, or provide products or services
• Providing financial guarantees or assets as collateral to investee with objective of providing returns other than capital appreciation or investment income
• Affiliate holding an option to purchase investee from an entity at other than fair value
• Transactions with investee are not at arms-length

Investments in Operating Companies

• Retains current GAAP requirement that investment company should report its investment in an operating company at fair value even if:
  - It can exercise control or significant influence
  - Owns a controlling interest
  - Example
    • Private equity fund holds a majority interest in a portfolio company
## Special situations

### Master-Feeder Structure

A feeder fund qualifies as an investment company and is required to report its investment in the master feeder at fair value.

### Non-Investment Company Parent

Investment in an investment company shall retain specialized accounting used by investment company subsidiary in its consolidated financial statements.

Example – noninvestment company general partner consolidates its investment funds it manages – shall retain the FUND's specialized accounting guidance (ie fair value)

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## CONSOLIDATION
Consolidation – ASU 2015-02

Pre-ASU 2015-02 consolidation model:

1. Determine whether a reporting entity holds any “variable interests” in an investee entity:
   a) If yes, move to 2
   b) If no, the reporting entity does not consolidate

2. Determine whether the investee entity is a variable interest entity.
   a) If yes, move to 3
   b) If no, the investee entity is a voting interest entity, move to 4

Consolidation – ASU 2015-02

Pre-ASU 2015-02 consolidation model (continued):

3. Variable interest entities: determine whether the reporting entity is the “primary beneficiary” of the investee entity
   a) If yes, consolidate
   b) If no, do not consolidate

4. Voting interest entities: determine whether the reporting entity has a “controlling financial interest” in the investee entity
   a) If yes, consolidate
   b) If no, do not consolidate
Consolidation – ASU 2015-02

- ASU 2015-02 did not change the basic framework for making a consolidation determination

- What changed significantly under the standard is how to apply the basic concepts, variable interests, variable interest entities, primary beneficiary, etc.

- The new standard will likely result in more investment funds being considered variable interest entities, but it is less likely that the GP or managing member will be the primary beneficiary and have to consolidate

Consolidation – ASU 2015-02

Variable Interests

- Eliminated certain criteria, focus now on:
  a) whether the fees are commensurate with the level of effort required for the services provided;
  b) whether the reporting entity has any direct or indirect interests that absorb more than an insignificant amount of the entity’s variability; and
  c) whether the arrangement includes customary terms only

- Fees paid to a decision maker less likely to be considered variable interests
Consolidation – ASU 2015-02

VIE Determination: LPs or similar entities
- An LP is a VIE unless a simple majority or lower threshold of unrelated LPs have substantive kick-out rights.
  * Includes participating or liquidation rights

- Generally speaking, GPs will not consolidate limited partnerships that are not VIEs

Consolidation – ASU 2015-02

VIE Determination: Entities other than LPs
- Two step analysis:
  * Step 1 – Evaluate whether the equity holders have power over the most significant activities of the entity through equity interests, if no, move to Step 2
  * Step 2 – Focus on whether a single equity holder (including RPs) has substantive kick-out or participating rights over the decision maker (assuming the decision maker holds a variable interest). If no such rights exist, entity is a VIE
Primary Beneficiary Determination
- An entity is considered the primary beneficiary of a VIE if it has both:
  1. The power to direct the activities of the VIE that most significantly affect performance and
     a) GP has power unless a single unrelated investor has kickout rights (this did not change from prior standard)
  2. the obligation to absorb losses of and the right to receive benefits from a VIE that could potentially be significant to the VIE
- ASU 2015-02 excludes from the analysis of (2) above fees that are both customary and commensurate with the level of effort required for the services provided.

The FASB explicitly excluded any bright line guidance in its final standard in assessing “significance” under (2) above.

In the basis for conclusions (BC 56-59) the FASB stressed that this is a “qualitative assessment based on all facts and circumstances…”
Consolidation – ASU 2015-02

• Related parties and VIEs
  - Each party in a RP group must first determine whether it has the characteristics of a controlling financial interest
  - If power is shared and the group as a whole has control, the related-party tiebreaker test must be performed
  - If power is not shared, RP tiebreaker test is only performed amongst parties under common control
  - If a RP group, not under common control holds control and substantially all of the VIE’s activities are conducted on behalf on a single entity, that entity is the primary beneficiary

Consolidation – ASU 2015-02

• Other notable changes:
  - ASC 810-20 (Formerly EITF 04-5) related to control of partnerships is eliminated
  - ASU 2010-10, “FAS 167 Deferral” is eliminated
Consolidation – ASU 2015-02

Transition:
• Effective for public business entities for annual periods, and for interim periods within those annual periods, beginning after December 15, 2015. For all other entities, it is effective for fiscal years beginning after December 15, 2016. Early adoption is permitted.
• Upon adoption, a reporting entity is required to reevaluate all previous consolidation decisions under the revised consolidation model.
• An entity may apply the amendments in ASU 2015-02 using a modified retrospective approach by recording a cumulative-effect adjustment to equity as of the beginning of the fiscal year of adoption or may apply the amendments retrospectively.

Consolidation – SEC IM Update (2014-11)

In October 2014, the SEC issued guidance related to investment funds and various consolidation matters
• Master/Feeder Structures:
  - Most meaningful presentation is unconsolidated provided that the feeder attaches the FS of the master
  - However, consultation is encouraged in cases where, by design, a master is wholly owned by a feeder
• Funds of Funds:
  - Most meaningful presentation is unconsolidated
  - Consider master-feeder type presentation in cases where a single investment is significant
• Wholly owned subsidiaries:
  - If purpose is to facilitate investment in a portfolio company, consolidate
FV Practical Expedient – ASU 2015-07

• Reporting entities are permitted to use Net Asset Value or “NAV” as a practical expedient to measure fair value of an investment provided that:
  1. The investment does not have a readily determinable FV, and
  2. The investment meets the definition of “investment company” under ASC 946
• Prior to ASU 2015-07, such investments were categorized in either level 2 or level 3 of the FV hierarchy depending on its redemption attributes (e.g. monthly, quarterly, annually)
• Diversity in practice
**FV Practical Expedient – ASU 2015-07**

- ASU 2015-07 **removes** the requirement to categorize investments for which the practical expedient is elected within the fair value hierarchy.
- Investments which are eligible for the practical expedient, but is not elected, would continue to be categorized within the FB hierarchy.
- ASU 2015-07 requires disclosure of investments measured at NAV to allow reconciliation with investments classified with the FV hierarchy.

**FV Practical Expedient – ASU 2015-07**

- Conforming amendments:
  - Statement of cash flows exemption for certain investment companies: redeemable in the “near term”
  - Pension plans: clarification that pension plan investments may be valued using the practical expedient
- Transition:
  - Effective date for public business entities is fiscal years beginning after December 15, 2015, and interim periods within those years. The effective date for all other entities is fiscal years beginning after December 15, 2016, and interim periods within those years. Early adoption is permitted.
Update on SEC Custody Rule

Recap of main Custody Rule provisions affecting pooled investment vehicles –
- RIAs having “custody” of client funds must maintain them with qualified custodian in segregated accounts.
- RIAs that advise pooled investment vehicles can comply with custody rule requirements by delivering audited FS of the fund to investors within 120/180 days.
**Update on SEC Custody Rule**

June 2014 SEC Release
- Provides guidance to advisers of pooled investment vehicles who use SPVs (special purpose vehicles)
- Provides guidance to advisers to pooled investment vehicles holding escrow accounts

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**Update on SEC Custody Rule**

Guidance to investment advisers who use SPVs (special purpose vehicles) on complying with the Custody Rule.
- New guidance arose out of inquiries from advisers and issues identified in examinations.
- Applies to advisers to pooled investment vehicles who use SPVs to facilitate investments in certain securities by one or more pooled investment vehicles that adviser manages.
Update on SEC Custody Rule

Main provisions
- Two treatment options available for the SPV as it pertain to the Custody Rule
  • Treat SPV as separate client
  • Treat SPV’s assets as assets of the pooled investment vehicle(s) that are invested in it.
- Separate client option
  • The SPV will have separate annual audited financial statements
  • Such statements should be distributed to all “beneficial owners” (i.e. investors in the pooled investment vehicle)

Main provisions (continued)
- Assets of SPV are treated as assets of the pooled investment vehicle
  • Assets of the SPV are included within the scope of the audit of the financial statements of the pooled investment vehicle.
  • Only allowed if the SPV and the pooled investment vehicle(s) are all owned by the adviser and its related group.
Update on SEC Custody Rule

Adviser -> Pooled Investment Vehicle

Pooled Investment Vehicle -> SPV

SPV

10% GP

90% LP

Update on SEC Custody Rule

Adviser

Pooled Investment Vehicle

Pooled Investment Vehicle

10% GP

45% LP

45% LP

SPV
Update on SEC Custody Rule

Guidance to advisers to pooled investment vehicles holding escrow accounts:

- Specifically addresses escrows held in connection with the sale of a portfolio company of a private equity fund.
- Addresses Custody Rule requirement that funds be placed with a qualified custodian in a special account for each client
  - Issue is whether or not creating multiple escrow accounts in this case is required (onerous and costly)
Update on SEC Custody Rule

Advisers may utilize a single escrow account for this purpose if all of the following criteria are met:

- Fund is a pooled investment vehicle that uses the audited financial statement provision to meet the custody rule requirements.
- The escrow is included in the fund’s audited financial statements.
- The escrow contains an amount agreed upon as part of a sale negotiation for an agreed upon period of time.
- The escrow is held by a qualified custodian.
- The seller (fund) is contractually obligated to promptly distribute the funds remaining at the end of the escrow period on a pre-determined formula to the pooled investment vehicle investors.

AUDITOR INDEPENDENCE WHAT THEY CAN AND CAN’T DO
Auditor Independence Rules

- Funds requiring audits subject to SEC Independence rules
- Audit client includes affiliates
  - Entity has control over the audit client or over which the audit client has control or which is under common control with the audit client (more than 50%)
  - Entity over which audit client has significant influence, unless not material to the audit client (20% to 50% interest or board rights)
  - Entity has significant influence over audit client unless audit client is not material to the entity
  - Each entity in the investment company complex when the audit client is an entity that is part of an investment company complex

Principles of Independence

Auditor cannot:

- **Audit its own work**
  - such as design of a financial reporting system or Enterprise Resource Planning (ERP) system, maintaining the accounting records of a significant foreign subsidiary, or performing actuarial services for the post-retirement benefit plan that covers substantially all of the company’s employees.
- **Function as a part of management or as an employee of the audit client**
  - such as recruiting, hiring or designing compensation packages for executives or designing and implementing internal accounting and risk management controls;
- **Act as an advocate of its audit client**
  - such as legal or expert services to defend an audit client in judicial or regulatory matter, expert witness testimony in a utility rate setting proceeding or forensic accounting services in an SEC enforcement matter. (Services such as tax compliance, tax planning and tax advice are not considered legal or expert services for this purpose, even in a foreign jurisdiction where tax advisors must be licensed to practice law.)
- **Create a mutual or conflicting interest**
  - Such as investment advising and brokerage services
Prohibited Services

- Actuarial services
- Bookkeeping or other services related to the accounting records or financial statements
- Preparation of financial statements
- Preparing original source data underlying the client’s financial statements
- Designing or implementing hardware/software system that aggregates source data

Prohibited Services

- Human Resources
  - Searching or seeking prospective candidates for managerial, executive or director positions
  - Undertaking reference checks
  - Acting as negotiator such as determining position, status/title, compensation, fringe benefits etc
- Preparation of tax returns or tax consulting for an individual in a financial reporting oversight role
### Acceptable Services

- Tax services including tax compliance, planning and advice for the entity
- Forensic accounting
- Due diligence
- Operational internal audits unrelated to internal accounting controls, financial statements or financial statements
- “Agreed upon procedures” engagements related to the company’s internal controls

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**LIQUIDATION BASIS OF ACCOUNTING**
Liquidation Basis of Accounting for Investment Funds

- FASB ASU 2013-7 effective for years beginning after December 15, 2013

Liquidation Basis of Accounting for Investment Funds

- Recap of main provisions -
  - Liquidation basis is required when liquidation is “imminent.”
  - Several statements and disclosures required
Liquidation Basis of Accounting for Investment Funds

- Definition of “imminent” –
  - Likelihood of returning from liquidation mode is remote
    - Plan of liquidation has been approved by fund’s management
    - Liquidation is imposed by outside forces

- Statements and disclosures required, at a minimum –
  - Statement of Net Assets in Liquidation
  - Statement of Changes in Net Assets in Liquidation
  - Assets and liabilities measured at estimated collection or settlement amounts
  - Costs and income expected through the liquidation date should be accrued
  - Disclosures regarding the plan of liquidation and its effect on the fund’s financial statements
  - Other statements and disclosures should continue to be presented (schedule of investments, cash flows, financial highlights, etc.) as long as they remain relevant
### Liquidation Basis of Accounting for Investment Funds

**• Does not apply to –**
- Registered funds
- Funds being merged or acquired
- Limited life entities (such as private equity funds) that are liquidating in accordance with a plan established at inception

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### Liquidation Basis of Accounting for Investment Funds

**• Challenges for investment funds –**
- Actual liquidation date may be uncertain, for instance when illiquid investments are held.
- Liquidation value may not equal fair value
- Plan of liquidation is adopted during the year versus year-end
- Liquidation of Private Equity Funds
### Liquidation Basis of Accounting for Investment Funds

**• Actual liquidation date may be uncertain, for instance when illiquid investments are held.**

- Estimating costs to be incurred and income to be recognized through an unknown liquidation date
- Costs should be accrued when they are reasonably estimable
  - Legal and audit fees
  - Management and incentive fees
  - Administrative costs
- Estimates should be reevaluated at each subsequent reporting date

### Liquidation Basis of Accounting for Investment Funds

**• Liquidation value may not equal fair value**

- Amount expected to be received in dissolution versus an orderly transaction
  - Liquidity or marketability discounts may be appropriate
- ASU specifically states that presumption should not be made that fair value equals liquidation value
Liquidation Basis of Accounting for Investment Funds

- Plan of liquidation is adopted during the year versus year-end
  - Will typically require stub-period reporting under ASC 946 and RIA requirements
    - Going concern up to date of adoption of plan of liquidation
    - Liquidation basis thereafter

Liquidation Basis of Accounting for Investment Funds

- Liquidation of Private Equity Funds
  - Exception for liquidation that follows a plan specified in the fund’s governing documents
  - If fund is forced to sell its assets at other than fair value, presumption is made that liquidation does not follow a pre-established plan.
Private Investment Fund Accounting, Operations and Compliance Forum
July 29, 2015

- Renee Ford, Shareholder – Elliott Davis Decosimo
- Matthew Maulbeck, Partner – EisnerAmper
- Frank Boutillette, Partner – WithumSmith+Brown, PC
Tales from an SEC Audits - Lessons Learned and Moving Forward

Gerald Esposito, Managing Director, CFO, CCO
NEWBURY PARTNERS

Mark Schein, Managing Director, CCO
YORK CAPITAL

Michael Cohn, Chief Compliance Officer and Deputy General Counsel
FORTRESS INVESTMENT GROUP
Gerald Esposito  
Managing Director, CFO & CCO  

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Mr. Esposito is a Managing Director and serves as the Chief Financial Officer and Chief Compliance Officer of Newbury, responsible for all aspects of operations, internal and external financial reporting, and regulatory oversight. Prior to Newbury, Mr. Esposito was the Chief Financial Officer and Chief Administrative Officer for the Private Capital Group of BNP Paribas where he oversaw the financial reporting and internal operations for the bank’s U.S. private equity arm. Previously, Mr. Esposito was a Senior Manager with the Deloitte & Touche Private Equity Investor Services Group, where he served some of the nation’s leading private equity and venture capital firms. Mr. Esposito is active as a Board Member of the NY Private Equity CFO Association and is a member of The American Institute of Certified Public Accountants as well as The Connecticut Society of CPAs. Mr. Esposito received a BBA degree from Siena College and is a CPA in the state of New York.
Mark Schein is the Chief Compliance Officer and Managing Director at York Capital Management. In 2005, Mr. Schein set up York’s Compliance Department. Since then he has been overseeing all aspects of regulatory compliance for the Firm which is registered in the US, UK, and Hong Kong. York Capital Management is a multi-strategy hedge fund manager with approximately $15 billion in assets under management. York has offices in New York, London, Hong Kong, Tel Aviv, Luxembourg, Sao Paulo and Washington D.C. Prior to joining York, Mr. Schein spent 5 years at the Bronx District Attorney’s Office prosecuting police corruption and organized crime, 5 years at the New York Stock Exchange prosecuting violations of Exchange rules and federal securities laws, and 4 years at US Trust in charge of broker dealer compliance and Schwab Capital Markets where he ran Anti-Money Laundering compliance.
MICHAEL COHN, FORTRESS INVESTMENT GROUP

Michael Cohn serves as Chief Compliance Officer and Deputy General Counsel of Fortress Investment Group LLC. Mr. Cohn leads a team of lawyers and compliance professionals who are responsible for various legal and compliance matters affecting Fortress and its affiliates around the world. Prior to joining Fortress, Mr. Cohn worked for the law firm Fried, Frank, Harris, Shriver & Jacobson where he specialized in securities regulation and enforcement matters and in the Goldman Sachs & Co. Sales and Trading Legal Department. Mr. Cohn began his career as a staff attorney in the Division of Enforcement of the United States Securities and Exchange Commission. He received a Juris Doctor from Hofstra University School of Law, where he served as an Articles Editor for the Hofstra Law Review, and a Bachelor of Arts in Political Science, with honors, from the University of Florida.
Effectively Addressing the Risks of Cybersecurity

Ashley Gimbel, Senior Vice President
DYAL CAPITAL PARTNERS

Chris Gimbel, Manager of Information Systems & Infrastructure
ABBOTT CAPITAL MANAGEMENT

Adam L. Menkes, Director
CREDIT SUISSE

Michael Koffler, Partner
SUTHERLAND, ASBILL, & BRENNAN
ASHLEY GIMBEL, DYAL CAPITAL PARTNERS

Ashley Gimbel is a Senior Vice President of Neuberger Berman and a member of Dyal Capital Partners, a private equity fund that takes minority ownership stakes in established hedge fund GPs. Ashley is a member of Dyal’s Business Services Platform, and is primarily responsible for providing operational and infrastructure best practice consulting and thought leadership to Dyal's Strategic Partners. Prior to joining Dyal, Ashley was a Vice President within Prime Services at Credit Suisse, where she was a key member of the Hedge Fund Consulting team for six years. Prior to Credit Suisse, Ashley was a Senior Sales Consultant for Eze Castle Integration, where she was responsible for assisting hedge funds with IT infrastructure and Disaster Recovery planning. Ashley graduated with Honors from Stephen F. Austin State University, with a B.A. in English.
Christopher J. Gimbel
Manager, Information Systems & Infrastructure | Joined in 2014

Chris Gimbel is responsible for Abbott Capital’s long-term strategic technology initiatives, as well as the day-to-day management of the firm’s network systems and infrastructure. In addition to overseeing the Abbott Capital’s business continuity and information security programs, Chris is responsible for software integration, hardware selection and other technology and infrastructure related matters.

Prior Experience:
Fore Research and Management LLC
Eze Castle Integration
Worldco LLC
CWN Networks

Education & Accreditations:
Thomas Edison State College, B.S.
Michael B. Koffler guides investment advisers, broker-dealers and investment funds in their compliance with federal and state securities laws and regulations, and SRO rules. Michael advises clients on the full spectrum of business operations, including advertising, portfolio management, trading, internal controls, compliance programs, mergers and acquisitions and other management issues. He also counsels other financial institutions—banks and insurance companies—on securities issues associated with the management and distribution of investment products.

Like many of his Sutherland colleagues, Michael began his legal career with a regulatory agency. He served two years on the staff of the U.S. Securities and Exchange Commission (SEC) in the Division of Investment Management, where he reviewed registration statements, no-action requests, exemptive applications and proxy statements. Michael also helped promulgate SEC rules and answer interpretive questions from financial institutions.

**Experience**

Sutherland helps restructure private hedge fund of fund arrangement.

Sutherland is designing and documenting the plan- and participant-level investment advice arrangements for retirement market products.

Sutherland helps restructure electronic delivery practices for broker-dealer.

**Awards and Rankings**


**Professional Activities**

Member, New York State Bar Association
Member, New York City Bar Association
Member, FINRA Corporate Financing Rules, Hedge Funds, Investment
Companies and Investment Advisers, and Trading and Markets
Subcommittees, Federal Regulation of Securities Committee, and Member,
Private Equity and Venture Capital Committee, Business Law Section,
American Bar Association (ABA)

Articles
Private Fund Related Performance—Avoiding the Pitfalls (February 2014)
Investment Adviser Association Monthly Newsletter, Compliance Corner

Welcome to the Party? FINRA Invites Investment Advisers to Utilize its
Arbitration Procedures (December 3, 2012)
Investment Adviser Association Newsletter

Regulatory watch list for 2012: the shifting landscape for hedge funds and
other private funds (June 2012)
Journal of Investment Compliance

SEC Revamps Investment Adviser Regulatory Scheme as Mandated by
the Dodd-Frank Act (August 30, 2011)
TerraLex Connections

Does a Statutory Fiduciary Duty Mean a More Substantive Fiduciary Duty?
What the Future May Hold (August 2010)
Reprinted with permission IAA Newsletter

The Brave New World of Fiduciary Duty for Broker-Dealers and Investment
Advisers (February 2010)
Envestnet

Traps for the Unwary: How to Avoid the Pitfalls of Form ADV (February
2010)
19 Compliance Review 2

Six Degrees of Separation: Principles to Guide The Regulation of Broker-
Dealers and Investment Advisers (April 27, 2009)
Reprinted with permission Securities Regulation & Law Report

Whither Fee-Based Accounts: The DC Circuit Vacates Investment Advisers
Act Rule 202(A)(11)-1 (June 2007)
The Investment Lawyer

MSRB Notice 2005-28 and NASD Enforcement: Where We Have Been and
Where We Are Headed (March 13, 2006)
Education
• J.D., University of Pennsylvania Law School
• B.A., *summa cum laude*, State University of New York at Binghamton
Tackling Key Regulatory and Compliance Issues that Private Investment Funds are Facing

Moderator:
Dianne Mattioli, Principal
REGULATORY COMPLIANCE SOLUTIONS INC.

Panelists:
Jason Ment, Partner, General Counsel, CCO
STEPSTONE

Moshe Luchins, Deputy General Counsel and Compliance Officer
ZWEIG-DIMENNA ASSOCIATES
Dianne Mattioli

Ms. Mattioli has over 20 years of broker dealer, investment advisor and hedge fund compliance experience ranging from major financial institutions to asset management regulatory services. Ms. Mattioli is the President of Regulatory Compliance Solutions Inc. (www.rcsi-group.com). Since Sept 2013, Ms. Mattioli is currently serving as the outsourced Chief Compliance Officer for HedgeMark.

Previously, Ms. Mattioli was the Chief Compliance Officer of EIM Management (USA) Inc, a fund of funds registered with the SEC, CFTC and a member of the NFA. Ms. Mattioli was also the CCO for EIM Securities (USA) Inc a broker dealer, a member of FINRA and the NFA. Ms. Mattioli joined EIM in 2004 and had primary responsibility for all Compliance/Regulatory matters including the development, implementation and assessment of the firm’s compliance program.

Prior to joining EIM, Ms. Mattioli was the Director of Compliance at a consulting firm where she developed compliance programs for the firm’s broker dealer, hedge fund and investment advisory clients. Previously, Ms. Mattioli was the Compliance Director at BLC, Inc. where in addition to compliance; she was responsible for the firm’s operations.

Ms. Mattioli holds Series 7, 14, 24, 63, 66, 79 and 99 licenses and Wharton’s CRCP Level 1 designation. Ms. Mattioli is a Board Member for National Society of Compliance Professionals (NSCP), the ALM, & Hedge Fund Business Operations Association (HFBOA). She is a member of SIFMA Compliance & Legal Society (SIFMACL), and Alternative Investment Management Association (AIMA). She has over 20 years of experience in hedge fund, investment adviser, and broker-dealer compliance. Ms. Mattioli is a frequent speaker on compliance and regulatory matters relating to hedge funds, broker dealers and investment advisors.
Jason Ment, Partner, General Counsel & Chief Compliance Officer, New York
Mr. Ment focuses on the firm’s legal and compliance activities.

Prior to StepStone, Mr. Ment was General Counsel of Citi Private Equity, a US$10 billion equity co-investment, mezzanine and fund of private equity funds business. While at Citigroup, Mr. Ment was also the General Counsel of Metalmark Capital, a middle-market private equity business, and Citi Sustainable Development Investments, a clean technology and renewable energy focused venture investment business. Prior to that, Mr. Ment was a member of O’Melveny & Myers LLP’s Mergers & Acquisitions/Private Equity Group and of McDermott Will & Emery LLP’s Mergers & Acquisitions Group.

Mr. Ment received his BS from Cornell University and his JD from the New York University School of Law.
Moshe Luchins
Deputy General Counsel and Compliance Officer
Zweig-DiMenna Associates LLC

Moshe Luchins is the Deputy General Counsel and Compliance Officer of Zweig-DiMenna Associates LLC. Zweig-DiMenna is among the most experienced long/short equity hedge fund managers. Moshe has a broad range of legal and compliance responsibilities on behalf of the Zweig-DiMenna hedge funds, investment advisers and in-house broker-dealer. Moshe is a frequent speaker at industry panels. He holds Series 7 and 24 FINRA registrations. Moshe serves on the Board of Directors of the Jewish Family Services and Children's Center of Clifton-Passaic. Moshe received his JD from the Columbia University School of Law and he holds a BA from Touro College.
TACKLING KEY REGULATORY AND COMPLIANCE ISSUES THAT PRIVATE INVESTMENTS FUNDS ARE FACING

JULY 29, 2015

Dianne Mattoli, Moderator
Principal
Regulatory Compliance Solutions Inc.

Jason Ment
Partner, GC, CCO
Stepstone

Moshe Luchins
Deputy GC and CO
Zweig-DiMenna Associates

Disclaimer: This presentation provides general information on the subject matter discussed, does not necessarily reflect the views of the presenters’ employers, and should not be relied upon for legal advice.

REGULATORY UPDATE

Insider Trading

Pay to Play/Political Contributions

Conflicts of Interest
Insider Trading

- U.S. v. Newman raised the bar on prosecutors bringing insider trading cases
- Downstream tippee is required to have knowledge of a personal benefit to the insider
- A benefit may be inferred, but only where there is “a meaningfully close personal relationship”
- Does Newman change the role of compliance?

PAY TO PLAY/POLITICAL CONTRIBUTIONS

- SEC Pay to Play Rules
- MSRB Rule G-37
- Federal and Local Rules
- FCPA
- UK Bribery Act
CONFLICTS OF INTEREST

Fees/Valuation  Best Execution  Personal Trading
Gifts and Entertainment  Allocation of Investments  Side Letters
Related Party Transactions  Use of Friendly Broker Marks  Co-Investments

CONFLICTS OF INTEREST - PROCESS

Conflicts of interest are the “overarching concern” of the Asset Management Unit (“AMU”) of the SEC’s enforcement division.* See http://www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html

Conflict Review  Eliminate  Mitigate  Disclose
Implementing OCIE’s Guidance

- Fiduciary responsibilities
- Issues that relate to market wide risk
- Tracking illegal activity
- Internal controls

Investment Adviser Fiduciary Duties

- Allocation
- Best Execution
- Disclose Conflicts of Interest
- Reasonableness of Fees
- Reasonableness and Suitability of Trades
- ERISA/Investment Company Act/state laws (if applicable)
Assessing Market-Wide Risks

The OCIE “Examination Priorities for 2015” includes the following in the “Assessing Market-Wide Risks” Section:

<table>
<thead>
<tr>
<th>Large Firm Monitoring</th>
<th>Clearing Agencies</th>
<th>Cybersecurity – initiative launched in 2014 which is being expanded in 2015</th>
<th>Potential Equity Order Routing Conflicts – assessing best execution conflicts</th>
</tr>
</thead>
</table>

Tracking Illegal Activity

The OCIE “Examination Priorities for 2015” states that they will be using data analytics to identify signals of potential illegal activity:

<table>
<thead>
<tr>
<th>Recidivist Representatives</th>
<th>Microcap Fraud</th>
<th>Excessive Trading</th>
<th>Anti-Money Laundering</th>
</tr>
</thead>
</table>
Preventing Illegal Activity

Tone at the top – culture of compliance
Follow and enforce your procedures
Technology
Proactive/Responsive

Internal Controls

Set Goals
- On a general level one needs infrastructure that matches the complexity of the fund. On a specific level – what are the specific objectives?

Policies and Procedures
- Document the process – have clear lines of responsibility

Implement
- Implement strong internal controls

Monitor & Review
- Internal/External review and testing
Fees and Expense Allocations

Who should be paying for what?

Which fees are investors most sensitive to?

What should standard procedures look like?

Fund Expenses

In general fund operating and investment costs will be paid by the fund:

- Incentive and management fees
- Investment expenses (e.g., commissions)
- Service providers (e.g., outside attorney)
- Certain extraordinary expenses
- Organizational and offering expenses
- Third party directors
- Fund regulatory filings
- Fund taxes and tax preparation
- Administrator expenses
Manager Expenses

In general, costs for the manager’s operations and overhead are paid by the management company:

- Rent
- Employee salaries, benefits and expenses
- IM taxes
- IM licenses
- Compliance
- Technology

Other Expenses – the Gray Areas

- Investment related travel
- Marketing related travel
- Consultants
- Research tools
- Specialized costs and expenses
Investors View of Fees

- Appropriate allocation methodology
- Clear detailed procedures
- Strong internal controls
- Transparency

Procedures for Expenses

Expenses are a key focus area of investors and the SEC

<table>
<thead>
<tr>
<th>Accurate disclosures in ADV, PPM and LPA</th>
<th>Identify potential conflicts</th>
<th>Compare disclosure in fund and organizational documents and actual practice</th>
<th>Review allocation among funds</th>
<th>Consider whether expense allocation documentation is sufficient</th>
</tr>
</thead>
</table>

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CCO Liability

Direct Violation
Aiding and abetting
Failure to supervise

CCO Liability Prevention

Robust policies and procedures
Do not assume supervisory responsibility
Do not ignore red flags
Train and create a culture of compliance
Custody Rule

Rule 206(4)-2 of the Advisers Act, the “custody rule,” defines custody as “holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them.” The rule provides the following three examples of what constitutes adviser custody*:

| Possession of client funds or securities unless an adviser receives them inadvertently from a client and returns them to the client within three business days of receiving such funds or securities. | Any arrangement which authorizes or permits an adviser to withdraw client funds or securities maintained with a custodian, e.g., a general power of attorney, direct debiting of advisory fees, etc. | Any capacity (such as a general partner of a limited partnership, managing member of a limited liability company, a comparable position for another type of pooled investment vehicle, or a trustee of a trust), that gives an adviser or its supervised persons, legal ownership or access to funds or securities. |

*These are merely examples of custody, and an adviser will be deemed to have custody over any account for which it holds “directly or indirectly, client funds or securities, or [has] any authority to obtain possession of them.”

Custody Rule Requirements

For accounts which one has custody – required to keep funds and securities at a qualified custodian
- Private securities exception

Notification Requirement
Surprise Audit Requirement
Account Statement Requirement

Rule 206(4)-2 provides an exception to the Surprise Audit Requirement, the Notification Requirement and the Account Statement Requirement for custody over assets in Pooled Vehicles, provided the Pooled Vehicle is subject to an annual audit by an independent public accountant registered with the PCAOB and the audited financial statements, prepared in accordance with GAAP, are distributed to the Pooled Vehicle’s investors within 120 days (180 days for a fund of funds) of the end of the Pooled Vehicle’s fiscal year.
Bad Actor Questionnaire

An offering is disqualified from relying on Rule 506(b) and 506(c) of Regulation D if the issuer or any other person covered by Rule 506(d) has a relevant criminal conviction, regulatory or court order or other disqualifying event that occurred on or after September 23, 2013. For disqualifying events that occurred before September 23, 2013, issuers may still rely on Rule 506, but will have to comply with the disclosure provisions of Rule 506(e).

Recently, the SEC created a bright-line standard regarding the term "voting equity securities" for purposes of the bad actor provisions. Rule 506(d) disqualifies securities offerings involving certain bad actors, including 20% beneficial owners of a fund's voting equity securities who have had a disqualifying event, from reliance on the Rule 506 offering exemptions. The new SEC guidance states that the term should be read to denote securities having a right to vote that is presently exercisable, irrespective of the existence of control or significant influence.

Recent Enforcement Actions

- **Valuation**

- **Fees & Expenses**
  - Robare - revenue sharing - [https://www.sec.gov/alj/aljdec/2015/id806jeg.pdf](https://www.sec.gov/alj/aljdec/2015/id806jeg.pdf)

- **Allocation of Investments**

- **Internal Controls & CCO Enforcement Action**
  - BlackRock - [https://www.sec.gov/litigation/admin/2015/ia-4065.pdf](https://www.sec.gov/litigation/admin/2015/ia-4065.pdf)
TRACK A – Private Equity and Venture Capital
Private Equity Tax Outlook 2015

Moderator:
Joshua Cherry-Seto, Chief Financial Officer
BLUE WOLF CAPITAL PARTNERS

Panelists:
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Joshua Cherry-Seto is the Chief Financial Officer at Blue Wolf Capital Partners LLC. The Blue Wolf Capital Funds are a family of private equity funds which focus on transformational investments in middle market companies.

Mr. Cherry-Seto is responsible for fund and management company reporting to the Limited Partners as well as the SEC and other regulatory agencies; the coordination of finance operations and the reporting of Blue Wolf's portfolio companies through their CFOs; and the investment and tax structuring of potential platform, add-on, and co-investment opportunities.

Before joining Blue Wolf in 2013, Mr. Cherry-Seto worked for five years as a portfolio and finance manager at Grove International Partners, a $5 billion global opportunistic private equity real estate fund manager. At Grove, he focused on portfolio management of Grove’s global platform and ASC 820 valuation audit and investor financial reporting and analysis.

From 2001–2008, Mr. Cherry-Seto held a variety of positions within Citigroup, acting principally as a Vice President with responsibilities including financial planning and analysis, tax structuring, SEC registration, and systems implementation within various units. In the finance department of Citigroup’s alternative investments business he covered the private equity, real estate and hedge fund asset classes for risk reporting and Basel implementation, sales projections, budgeting, performance, and executive reporting. He was a senior representative on the $2 billion asset agreement with Met Life as a result of the sale of Travelers. He completed his service with Citigroup as Product Manager within the Citi Fixed Income Alternatives group. He was responsible for the launch, SEC registration, risk management, NAV oversight, independent board coordination, tax structuring, and investor reporting of a novel SEC-registered fixed income alternatives fund.

Prior to Citigroup, Mr. Cherry-Seto held several roles within the organized labor movement. He was a union organizer for SEIU local 100 in Beaumont, TX, representing hospital workers and actively organizing nursing home and school support workers. He also was a union organizer for HERE organizing school support workers in Connecticut. He has served as the Executive Director of the National Writers Union; worked with 1199 SEIU in their political action and communications group, as well as assisting with financial analysis and contract negotiations; and has worked with the Jewish Labor Committee and United Hebrew Trades in New York City.

Mr. Cherry-Seto holds a Bachelor of Science degree from the Cornell University School of Industrial and Labor Relations, a post-graduate certification in Executive IT Management from Columbia University, and an M.B.A. from New York University’s Leonard N. Stern School of Business.
Anthony J. Tuths - JD, LLM, Partner

Tony is a tax attorney and the Alternative Investments Leader in WS+B’s Financial Services Group based out of the firm’s New York office. Tony serves as the engagement partner and business advisor to alternative investment funds of all kinds, including hedge funds, fund-of-funds, private equity funds, endowments and family offices. Tony is one of the leading experts in the structuring of alternative investment funds and related asset investments and has extensive experience in counseling start-up funds, alternative asset managers, commodity pools and mutual funds / ETFs. He adds value to his clients and the industry by combining his deep expertise, commitment and leadership with a collaborative style and a practical approach. Clients and colleagues seek Tony as a resource and a recognized industry expert in tax, accounting, financial reporting, internal control and operational issues impacting the alternative investment industry.

A graduate of Rutgers Law School, Tony received his juris doctor after earning his BA degree from Montclair State University. In addition, he earned his master of laws degree in taxation from New York University School of Law. Tony is a member of the New York State Bar Association (NYSBA) and the American Bar Association (ABA). As one of the country’s leading experts on tax issues affecting the asset management industry and those arising from the new U.S. rules governing the derivatives market, he regularly speaks at industry conferences and is a frequent contributor to industry publications. Prior to joining WS+B, Tony headed the tax planning function at Deutsche Bank (including its asset management arm) and was previously head of the tax function within Citigroup Alternative Investments. He resides in Essex County, NJ.
Private Equity Tax Outlook 2015

Private Investment Fund
Accounting, Operations and Compliance
Forum
July 29, 2015

Presenters

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BLUE WOLF
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Agenda

- Private Equity Tax Legislative and Regulatory Update
  - Carried Interest Legislation
  - Management Fee Waiver IRS Proposed Regulations
  - State and Local Tax Update

- Private Equity Trends in Tax Structuring – Flow Through Investments
  - Business Case
  - Issues Raised

- Future Tax Focus and Trends

Carried Interest Legislation

- Presidential Candidates Attack
  - Several candidates have identified the provision for repeal
  - Hillary Clinton and Bernie Sanders most vocal

- Carried Interest Fairness Act of 2015
  - Introduce in Senate (Tammy Baldwin, D-Wis) and House (Sander Levin, D-Mich)
  - Based in ISPI model
  - Applies to real estate
  - Allows capital gain for portion allocated to paid-in capital

- No Change Expected in 2015 (and maybe 2016)
  - Paul Ryan (R-Wis), Chair of House Ways and Means says he views carried interest as part of “individual side” tax reform that will not be taken up until 2017
  - Senate Finance Committee Chair Orrin Hatch, R-Utah, said that he has looked at the issue and that he generally agreed with Ryan
Carried Interest Legislation

- Current JCT revenue estimate for carried interest legislation
  - Approximately $16 billion over 10 years

- On February 27, 2015, Senator Bernard Sanders (I-Vt.) asked President Obama to take executive action to close certain “loopholes” including carried interest

- President Obama’s 2016 Budget Proposal: Tax carried interest as ordinary income using Levin Bill model (ISPI)

Fee Waivers - Overview

- Fund managers will reduce or eliminate management fees in exchange for a larger carried interest

- Unlike the typical GP carried interest, the carry received in exchange for the waived management fees is a priority profit allocation of a fixed dollar amount

- Often measured on one or more quarterly periods

- Fund documents permit this election and dictate timing and form of election
Fee Waivers - New Proposed Regulations

- An arrangement will be treated as a disguised payment for services (ordinary income treatment with no deferral) if:

  • Lacks Significant Entrepreneurial Risk
    - A cap that could be expected to be exceeded each year
    - An allocation when the Service Provider (“SP’s”) share of income is reasonably certain
    - Allocations of gross income items, not NET
    - An allocation designed to ensure sufficient profits
    - Non-binding or untimely waivers – 60 days before year end at a minimum

  • Secondary Factors
    - Partnership interest held for short duration
    - Does the allocation look like that to a 3rd party provider
    - Did the SP became a partner primarily to obtain tax benefits
    - Small true economic interest; i.e. ARE THEY REALLY A PARTNER
    - Different allocations for different services provided

Fee Waivers - Proposed Regulations Effects

- Need to Review Existing Waiver Programs
  - Congressional intent that even programs currently in place could be audited
  - Suggests Rev. Proc. 93-27 does not apply where non-partner (management company) waives fee in favor of profits interest issued to partner (GP)

- Each elective date triggers a new analysis of entrepreneurial risk, suggesting to fix the program at inception

- Service provider needs to show significant risk of loss, such as including a clawback provision similar to carry

- Comments are due by October 21st
State & Local Taxation Update

- Market based sourcing is being utilized by more states
  - The objective is to source receipts from sales to the location of the market
  - What and who is the market depends on the state (adding complexity and can result in allocating more than 100% of income)
  - Customer based sourcing states that look at where the benefits are received:
    - AZ, CA, IA, MI, NY, RI, UT, WI
  - States that look at where service are delivered:
    - AL, IL, ME, MA, MN, PA

- EXAMPLE:
  - NY based management company earning management fees from a Fund previously used sales factor and looked at where services were performed NOW NY is a benefits received state
  - If all of the partners of the NY domiciled Fund were CA pensions. CA would apply a 100% sales factor to CA as it looks through the Fund. NY would apply 100% sales factor to NY as it does not look through and would say it is a NY fund so benefits received in NY.

Tax Structuring Trend – Flow Throughs

- Income passed to partners through K-1s versus addressed in C-corps

- Flow through AIV structures provide investors the ability to elect to invest direct or through a Fund administered C-corp blocker
  - Non-tax exempts choice to invest direct to avoid double taxation in corp and on dividends
  - US tax exempts not subject to UBTI invest direct
  - US tax exempts subject to UBTI may invest direct, requiring state and federal filings for flow through UBTI, but would avoid corporate tax on capital gains
  - Foreign investors subject to ECI may invest direct, managing withholding requirements and branch tax concerns
  - Expenses generally borne exclusively by blocker electing investors outside the partnership – not treated as a capital call
Tax Structuring Trend – Flow Throughs

- Flow throughs create additional Fund administration challenges and costs
  - Creation of multiple AIVs to manage elections and reporting
  - Increase the coordination of Fund tax reporting – K-1s required to complete Fund taxes
  - Proliferation of state inquires for the Fund – increase Fund Tax partner coordination scope
  - Tax consideration for buying and selling portfolio companies including corporate stock
    - Increased requests to buy the corporate stock with imbedded tax gains and no step up in basis
    - Increased consideration for restructuring purchased corporate stock to limit future tax corporate tax leakage
    - Increased situations to consider selling corporate stock for Funds
      - More tax efficient for holders of blocking investors
      - Less attractive to buyers as no step up and inherits imbedded tax gains driving a discount to purchase
      - LPAs may speak to the requirement to attempt sale of corporate stock and how to allocate discounts

Future Tax Focus and Trends

- Continued evolution in management fee waiver programs to ensure significant entrepreneurial risk
- Expectation of carry to continue to be at risk in legislation
- Focus on improved administration and coordination regarding investments made in flow through structures
- Emerging impact of management fee offsets moving towards 100% (continued exception for emerging managers)
  - e.g. potential residual offset carry over at liquidation
Proposed regulations on disguised payments for services and implications for management fee waivers

The IRS and Treasury released proposed regulations on July 22, 2015 [REG-115452-14] under Section 707(a)(2)(A) that recharacterize certain allocation and distribution arrangements as disguised payments for services. The proposed regulations are effective on the date final regulations are published. Any arrangement entered or modified after the effective would be governed by the final regulations.

The proposed regulations further provide that taxpayers should look to Section 707(a)(2)(A) and its legislative history in determining the consequences of arrangements entered or modified before the proposed regulations are finalized, noting that the IRS and Treasury believe that the proposed regulations generally reflect Congressional intent as to which arrangements are appropriately treated as disguised payments for services. Such language indicates that the IRS believes it could apply the principles of the proposed regulations to arrangements not subject to the final regulations. Accordingly, taxpayers under IRS audit should expect the government to argue for the application of the principles articulated in the proposed regulations, even before they are finalized.

General background

Section 707(a)(2)(A) was enacted in 1984 to address situations intended to avoid certain capitalization and deduction limitation provisions through the use of allocations and distributions. Although no regulations were promulgated in the intervening 30 years, the IRS and Treasury recently began to publicly express concern regarding certain management fee waivers (MFWs) used by investment fund sponsors of private equity and other alternative asset funds (e.g., real estate, energy, and hedge funds), indicating that they planned to propose regulations addressing those concerns. Should the proposed regulations be finalized in their present form, it appears that the US federal income tax consequences of certain forms of MFWs could change, depending on the particular facts and circumstances presented. The principles articulated in the proposed regulations are not exclusive to MFWs, however, and other interests granted in exchange for services could be affected.

Characterization of an arrangement

General characterization principles

Consistent with the language of Section 707(a)(2)(A), the proposed regulations state that an arrangement will be treated as a disguised payment for services if: (i) a person in a partner capacity (or in anticipation of being a partner) performs services to, or for the benefit of, the partnership; (ii) there is a related direct or indirect allocation and distribution to such person; and (iii) when viewed together, (i) and (ii) are properly characterized as a transaction occurring between the partnership and a person acting other than in that person’s capacity as a partner. The proposed regulations apply even if they cause a partner to be treated as a non-partner or if their application results in a determination that no partnership exists. If no partnership is found to exist, the service provider would be treated as having provided services directly to the other purported partner.

The proposed regulations characterize the nature of an arrangement at the time the arrangement is
entered (or modified), regardless of when income is allocated and/or property is distributed. Further, the proposed regulations apply to both one-time transactions and continuing arrangements.

**Consequences**

An arrangement that is treated as a disguised payment for services will be treated as a payment for services for all purposes of the Code. Thus, for example, the partnership must treat the payments as payments to a non-partner for services rendered in determining the remaining partners’ shares of taxable income or loss, the character of the service provider’s income, the time at which the payments are taken into account, and the application of Sections 162 and 263, withholding rules, and Section 409A.

**Factors considered**

The proposed regulations list six non-exclusive factors that are to be considered in determining whether an arrangement should properly be characterized as a payment for services. The most important factor, the existence of significant entrepreneurial risk, is accorded more weight than the other factors. In particular, an arrangement that lacks significant entrepreneurial risk constitutes a payment for services.

**Significant entrepreneurial risk.** Whether an arrangement lacks significant entrepreneurial risk is based on the service provider’s entrepreneurial risk relative to the overall entrepreneurial risk of the partnership. For example, it is possible for a service provider to bear entrepreneurial risk in a partnership that invests in US Treasury securities as well as a partnership that invests in technology start-ups. The proposed regulations list five arrangements that are presumed to lack significant entrepreneurial risk (and therefore, constitute a disguised payment for services) unless facts and circumstances establish otherwise by clear and convincing evidence. Those arrangements are:

1. Capped allocations of partnership income, if the cap is reasonably expected to apply in most years
2. Allocations for a fixed number of years under which the service provider’s distributive share of income is reasonably certain
3. Allocations of gross income items
4. Allocations that are: (i) predominantly fixed in amount, (ii) reasonably determinable under all the facts and circumstances, or (iii) designed to ensure that sufficient net profits are highly likely to be available to make the allocation to the service provider
5. Arrangements in which a service provider either waives its right to receive payment for the future performance of services in a manner that is non-binding or fails to timely notify the partnership and its partners of the waiver and its terms

**Secondary factors.** In addition to significant entrepreneurial risk, the proposed regulations list five “secondary factors” (the first four of which are stated in the legislative history to Section 707(a)(2)(A)) that may be relevant to the characterization of the arrangement:

1. Whether the service provider holds or is expected to hold a transitory partnership interest or a partnership interest for only a short duration
2. Whether the service provider receives an allocation and distribution in a time frame comparable to the time frame that a non-partner service provider would typically receive payment
3. Whether the service provider became a partner primarily to obtain tax benefits that would not have been available in a third-party capacity
4. Whether the value of the service provider’s interest in general and continuing partnership profits is
small in relation to the allocation and distribution

5. Whether the arrangement provides for different allocations or distributions for different services received, the services are provided by one person or by related persons, and the terms of the differing allocations or distributions are subject to significantly varying levels of entrepreneurial risk

Proposed change to existing Section 707(c) regulations

The proposed regulations also modify current Example 2 of Section 1.707-1(c). Under the existing example, a partner entitled to receive the greater of a percentage of partnership income or a specified amount is treated as receiving a guaranteed payment only to the extent the allocated share is less than the minimum amount. For example, if a partner is to receive the greater of $10,000 or 20% of partnership income (determined without regard to the payment) and the partnership reports $20,000 of income for the year, the partner would be entitled to $10,000, the larger amount. Under the existing regulations, $4,000 of the payment (20% of $20,000) would be characterized as an allocable share of income and $6,000 would be treated as a guaranteed payment. The proposed regulations modify this example to state that the entire minimum amount ($10,000) is to be treated as a guaranteed payment in light of the fact that the minimum amount is not subject to significant entrepreneurial risk.

Proposed changes to existing revenue procedures on profits interests

The preamble to the proposed regulations also discusses modifying Revenue Procedure 93-27 upon finalization of the proposed regulations. The modified revenue procedure would not apply to situations in which a profits interest was issued as a result of a partner forgoing a substantially fixed payment (e.g., a MFW).

The preamble also states that the IRS and Treasury have concluded that Revenue Procedure 93-27 does not apply when one taxpayer waives a fee and a related taxpayer receives a future partnership profits interest if the profits interest value approximates the value of the waived fee.

Implications

The proposed regulations are an important development as they provide substantive guidance on the scope and application of Section 707(a)(2)(A). The importance placed on entrepreneurial risk is not surprising given the legislative history of Section 707(a)(2)(A)’s enactment. Because the IRS and Treasury issued the regulations in response to their expressed concerns with certain MFWs, the proposed regulations should be considered in the structuring of new MFWs and also considered when fee waivers are exercised under pre-existing MFW provisions. The proposed regulations appear less sensitive to the standard “20% carry” structure, but could be sensitive to other aspects of the general partner’s relationship to its fund.

Fund MFWs

Alternative asset managers, especially private equity fund managers, often employ a MFW whereby the sponsor surrenders all, or some, of its management fee in exchange for an increased share of a fund’s profits or carried interest. The proposed regulations would, if finalized in their present form, change the US federal income tax consequences of a management fee waiver in which the manager’s recovery of its waived fee was not subject to significant entrepreneurial risk.

Example 4 of the proposed regulations describes a fund whose securities are readily tradable on an established securities market. In this example, the elimination of any subjectivity to the valuation of the portfolio seems to provide the interest received in exchange for the management fee with sufficient entrepreneurial risk to be respected as a partnership interest. Certain hedge funds whose portfolios have a readily ascertainable value may still satisfy the proposed regulations, assuming the other tests are met.
Examples 5 and 6 of the proposed regulations provide insight into the kinds of facts and circumstances that are meaningful in determining whether the critical concept of significant entrepreneurial risk has been satisfied by a particular MFW. Key facts in these examples include the presence of a legally enforceable clawback obligation that the obligated partner is expected to be capable of satisfying and written notice of the partner’s exercise of the waiver delivered to the partnership’s limited partners at least 60 days (or more) prior to the commencement of the partnership tax year for which the waived fee is payable.

**Broader context**

Because the proposed regulations provide general guidance on when a service provider is acting in a partner or non-partner capacity, the regulations should be considered when structuring compensation arrangements intended to qualify as partnership profits interests.

The consequences of a payment being treated as non-partner payment are significant for both the service provider and the partnership. For example, the service provider would be treated as receiving a compensatory payment (ordinary income) rather than a distributive share allocation (potentially capital gains income). Such a compensatory payment could be subject to withholding for the partnership (or the other sole purported partner) and create a high risk that the payment is not exempt from Section 409A, which governs deferred compensation arrangements for cash-basis taxpayers, or Section 457A, which governs deferred compensation arrangements for both cash and accrual-basis taxpayers that provide services to entities in certain tax-favorable jurisdictions. Both Section 409A and Section 457A may result in significant additional taxes (i.e. an additional 20% income tax and a premium interest tax). An arrangement that appears to have more than one equity interest holder and, therefore, purports to be a tax partnership, might be disregarded if all but one member were treated as service providers (rather than partners).

**Proposed change to existing guaranteed payment regulations**

The proposed change to existing Example 2 of Section 1.707-1(c) is also significant. The rationale of the conclusion in the existing example provides support for the position that a payment or liquidation right (for example, a right of a preferred capital partner) can be either a guaranteed payment or a distributive share right depending on whether the partnership has net income in an amount at least equal to the preferred partner’s preference in a particular tax year. Treasury and the IRS note that some taxpayers have expressed uncertainty concerning whether a partnership must allocate gross income or make a guaranteed payment to a partner whose partnership liquidation right increased even though the partnership does not have sufficient income in the relevant tax year to match the partner’s increased liquidation right. It is not clear that the IRS and Treasury proposed this change in Example 2 of Section 1.707-1(c) in order to provide guidance on whether guaranteed payment or distributive share treatment of such a transfer is the better view, although it is possible that their consideration of any comments they receive may result in guidance regarding these matters.

**Proposed change to Revenue Procedure 93-27 safe harbor**

The proposed change to Revenue Procedure 93-27 is also significant in that it would exclude from the revenue procedure’s “safe harbor” the issuance of a partnership profits interest in conjunction with a partner waiving payment of a substantially fixed amount including, for example, a fee based on a percentage of partner capital commitments.
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TRACK B – Hedge Fund
Successfully Addressing Key Valuation Issues for Hedge Funds

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Hillel Kamionski is the Controller for ALJ Capital Management. He is responsible for investment accounting and operations for the partnership funds and the general partner. Prior to joining ALJ Capital in 2012, Hillel worked at Kayne Anderson Capital Advisors from July 2007 to December 2011 and Grant Thornton from August 2005 to June 2007. Hillel earned a B.S. in Accounting from Yeshiva University, and a Masters in Business Taxation from the University of Southern California.

Hillel, his wife Sabrina, and their three children live in Los Angeles, where he is an avid bike rider, community leader and involved with various charities.
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Marni Pankin is a Partner in the Firm's National Alternative Investment Industry group responsible for advising clients on the formation and operation of investment funds. She assists with the Group’s administration and policy setting and provides technical support to the financial statement audit engagement team.

Ms. Pankin successfully spearheads the Firm’s Alternative Investment Group training program. She develops the curriculum and provides hedge fund training to smaller accounting firms. She is a frequent presenter at industry conferences and currently serves as the editor-in-chief for the Firm’s alternatives-focused newsletter, Private Investment Forum.

Ms. Pankin has more than 20 years experience. She began her career in the audit department of a “Big 4” accounting firm and later served as Controller for a privately-held hedge fund management firm. In addition, she remains active with her alma mater and involves the Firm with on-campus recruiting.

**Professional Affiliations**
- American Institute of Certified Public Accountants (AICPA), Peer Reviewer
- New York State Society of Certified Public Accountants (NYSSCPA)
- Hedge Funds Care
- Mid Island Y Community Center, K.I.S.S. Program
- Long Island Children’s Museum Trustee

**Seminars & Presentations**
- Financial Research Associates
- Foundation for Accounting Education Investment Conference

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**KEY CLIENTS**
- Investment Partnerships
- Hedge Funds
- Private Equity Funds
- Fund of Funds
- Registered Funds
- Management Companies
- General Partnerships

**EDUCATION**
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TRACK A – Private Equity and Venture Capital
Successfully Addressing Key Valuation Issues for Private Equity Funds

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Keith is a Managing Director of Empire Valuation Consultants. Previously, he worked PricewaterhouseCoopers LLP in Los Angeles as a Manager in the Valuation Services business, a Senior Technical Analyst with Management Consulting & Research, and a Captain in the U.S. Air Force. Keith is also a Chartered Financial Analyst (CFA) charterholder.

Keith has over 10 years of experience in financial consulting and business valuation. He has valued the equity, debt, derivatives, liabilities and NOLs of publicly and privately held businesses for acquisitions, divestitures, estate and gift tax reporting, liquidation, financial reporting, and general corporate planning purposes.

In addition, he has valued intangible assets including technology, in-process research and development, trademark/trade names, customer and subscription lists, on-line audiences, covenants-not-to compete, inventory, workforce, and co-marketing agreements/alliances, as well as hardware and software maintenance contracts. Keith has a significant amount of experience in valuing technology, telecommunications, Internet and finance companies, as well as early stage businesses.

He has earned an M.B.A. in Finance from the University of California, Los Angeles and a B.S. in Electrical Engineering from Union College.
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- Valuation
- Private Equity
- Venture Capital
- Hedge Funds

Certifications
- CFA

Professional Associations
- CFA Institute
- NYSSA
- ACG

Craig has more than 18 years of experience providing valuation services to public and private clients. Craig delivers services across a range of industries including consumer products, apparel, technology, business services, financial services, manufacturing, media, retail and health care. Craig’s depth of experience and skill set is a unique combination, positioning him as a specialist with client-facing concerns as well as an expert in fair value measurement issues for audit engagements. Types of engagements include allocation of purchase price, goodwill impairment, corporate strategic and tax planning, corporate transactions (e.g., mergers, acquisitions), litigation and arbitration.

He focuses on valuations relating to alternative asset managers including private equity, hedge funds and venture capital. At the fund level, he performs valuations and conducts reviews of valuations of Level III (difficult-to-value) securities performed by fund management and third-party specialists. At the portfolio company level, he leads engagements related to the valuation of business enterprises and equity and debt interests, as well as various intangible assets. Craig serves as an instructor for EisnerAmper University and has presented, as well as served as panel member, to industry associations regarding valuation issues for alternative asset investments.

In addition to his B.S. in Management, with a concentration in Finance from Binghamton University, Craig holds the designation of Chartered Financial Analyst and is a member of the CFA Institute, the New York Society of Security Analyst and Association for Corporate Growth.
Key Valuation Issues for Private Equity Funds

Craig Ter Boss, CFA

Agenda

A look at what’s been coming out of recent SEC examinations and ensuring that your implementing best practices.

A look at valuation committees and how they’ve evolved recently.
Valuation

• The National Examination Program staff will review the advisor's valuation policies and procedures, including their methodology for fair valuing illiquid or difficult-to-value instruments. Looking at consistency regarding the application of the policies and procedures and documentation of divergence from them.

• The review includes examining the models utilized, the inputs to the models and exceptions to the use of those models, and the procedures for the one-offs.

• Review the advisors' procedures for calculating management and performance fees, and allocation of expenses to private funds.

Interviewing the personnel responsible for implementing and maintaining these policies and procedures.

- Is everyone responsible, at all levels, on the same page

One of the critical issues the NEP staff is focusing on regarding valuation is inflating performance during the fund marketing stage and then writing them down after the period closes.
Presence Exams

- Commenced October 2012 and ended by May 2015.
- The SEC has conducted approximately 400 audits which was one of their goals (25% of the firms).
- The SEC is issuing deficiency letters for about half the exams as compared to 80% of regular or routine exams.

- Presence exams before May 2014 (Spreading Sunshine in Private Equity speech by Andrew Bowden – former OCIE Director) compared to after.
- 2014 – Formed Private Funds examination unit.

Going Forward

- Beefing up inter-division cooperation and coordination.
- Adding more subject-matter specialists – Valuation Experts.
- Examining other specialized areas – Real Estate.
Analysis of Recent Cases

- SEC intends to take a much more aggressive approach towards valuation decisions. Both the determination of the valuations as well as the processes surrounding such determinations.
- Challenged the specific valuation determinations and the extent to which those determinations allegedly deviated from the "true" value of assets.
- Rejected the idea that market dysfunction during the financial crisis justified disregarding actual market inputs.
- Examined the processes used in making valuation decisions and criticized allegedly deficient internal processes and alleged failures to implement meaningful guidance.
- This focus on valuation determinations as well as the processes utilized in making those decisions is consistent with recent initiatives by the SEC and related public statements.
Best Practices – Policies and Procedures

- Establish effective valuation policies and specific and detailed procedures including a methodology for estimating the fair value of Level III assets.
- Make sure that the policies and procedures are robust, transparent and flexible. Market participant viewpoint - GAAP.
- Also make sure that there is consistency in the application of the policies and procedures and document any divergence from them. Do they reflect the actual practice of the firm?
- Create a valuation committee and define roles for the personnel responsible for implementing and maintaining the valuation policies and procedures. Make sure that the personnel at all levels in the process are all on the same page.
- Continuously monitor and amend as applicable.

Advice from an Operational Due Diligence Director

- What is your risk and how do you mitigate it?
- Do not build a policy that does not fit your model. There is no one size fits all model.
- Do not have a cookie cutter policy.
Best Practices - Valuations

• Utilize multiple valuation approaches, when appropriate, and explain the rational for the weighting of the approaches. If an approach is not utilized, provide an explanation for the exclusion of that approach.
• Document and explain the selection of key valuation assumptions (both observable and unobservable) and make all inputs into the model transparent.
• Provide a risk assessment update that considers macroeconomic, industry and company specific factors that may change the value of the investment in the near future.
• Calibrate the current valuation to the investment thesis and provide key facts based on monitoring the investment since your investment.
• Consider utilizing independent, third-party verification for the fund’s most significant Level 3 assets at least on an annual basis. These specialists can help funds mitigate valuation risk and facilitate a more efficient audit process.

Valuation Committees

• Include non-investment personnel on the committee
  – CFO and Controller
  – Chief Compliance/Risk Officer

• Maintain minutes and document ultimate approval of valuations

• Third party valuation firms – scope of work is clear

• Periodically testing valuation methodologies (back testing)

• Other Oversight
  – Limited Partner Advisory or Risk Committee
Overview

- Types of Analysis by Levels of Assurance
- Reducing Valuation Errors
- Investor Memos
- Third Party Valuation Services
- Best Practices - Valuation Approaches for Private Equity Assets (including Benchmarking)
Analysis by Level of Assurance

- **Positive Assurance**
  - Develop independent value or range of values to test mark
  - Typically for portfolio assets or smaller assets
  - Examples: NPL portfolios

- **Negative Assurance**
  - Test reasonableness of a model (methodology, inputs & conclusions)
  - Typically for assets valued using complex models
  - Examples: P-to-P loans, distressed RMBS portfolios

- **Valuation of Security/Asset**
  - Provide an estimate of FMV that may be used for mark
  - Larger assets
  - Side pocketed assets
  - Example: valuation of entire companies/assets

Reducing Valuation Errors

- **Multiple valuation approaches**
- **Stress test valuation using key assumptions**
- **Benchmark similar asset values or subject’s securities purchase price**
- **Is value consistent with asset’s story**
  - Value and market multiple trending
  - Do changes in value make sense given corporate events?
  - Do changes in multiples make sense given corporate events and changes in comparable multiples?
## Investor Memos

- Document valuation analysis used to derive and test the mark
- Include description of observable and unobservable inputs
- Sensitivity analyses of key inputs used in valuation model
- Summary of approach, key inputs and sensitivities can be included in financial statement footnotes

## Third-Party Appraisers

- Provide independent validation of value used for NAV determination
- Typically used for larger or sampled assets on a quarterly or annual basis
- Can be used as a marketing tool for fund
- Can bring another perspective to asset valuation
Third Party Appraisers

How much reliance should be put upon independent appraisers? Investment managers?

• Who is performing the valuation?
  – Client
    • Fund’s investment/ valuation committee
  – Third party provider
    • Investment banking firm
    • Certified business appraiser
      – Need to assess qualifications of Client’s Appraiser-management, and/or valuation specialists (internal or external)

Third Party Appraisers

Valuations prepared by third-parties:

• Negative Assurance
• Positive Assurance
• Limited Scope Valuation
• Full Valuation
Third Party Appraisers

Positive Assurance Language:

Among other things, the terms of Valuation Firm’s engagement provide that Valuation Firm is not responsible for determining the Fair Value of any individual portfolio company or the aggregate Fair Value of any portfolio companies. Valuation Firm’s role is limited to reviewing the application of the Investment Advisor’s valuation policies and procedures in determining the carrying value of certain investments, being an advisor and providing additional support with respect to such valuation policies and procedures.

Private Equity Asset Valuation Techniques

- Performing Loans
  - Income Approach (DCF)
    - Use scheduled cash flows
    - Estimate discount rate from leverage coverage ratios, loan-to-value for subject company relative to market data
  - Market Approach
    - Compare DCF derived value to comparable publicly traded security prices/yields

- Non-performing Loans (Value underlying collateral)
  - Income Approach
    - Discounted cash flows plus stabilized exit value
    - Liquidation value
    - Scenario analysis (performing, early redemption, default)
  - Market Approach
    - Real estate appraisals
    - Comparable asset trading prices or transactions (including claims)

- Asset/Equity Interest
  - Income Approach
    - Discounted future cash flow
    - Projections based upon benchmarked management cash flows
    - Discount rate based upon cost of capital
  - Market Approach
    - Comparable firms trading prices or transactions
    - Traded equity or debt securities
    - Option Pricing Model used for third party transaction in target’s securities
  - Asset Approach
    - Typically used if asset value greater than value derived from cash flows
    - Based upon value of equity if firms assets are sold
Valuation Overview

- Performing Loans/Leases
  - Cash Flow Estimation/Validation
    - Revenues benchmarked versus market lease rates and property history
    - Costs margins benchmarked versus history
  - Discount Rate Estimation/Validation
    - Based upon coverage and loan-to-value and comparable bond/preferred yields
    - Overall property/collateral value determined via market capitalization rate/multiples or appraised value

- Non-performing Loans (Value underlying collateral)
  - Develop asset value and discount rate for each developed scenario
  - Asset Value Estimation/Validation
    - NOLV benchmarked versus comparable real estate, asset or firm values
    - Timing benchmarked versus state foreclosure timeline, planned exit and other property history
    - Distressed cash flows benchmarked against current income or components
  - Discount Rate Estimation/Validation
    - Based upon collateral discount rates and distressed investor expected rates of return
    - Overall property/collateral value determined via market capitalization rate/multiples or appraised value

- Consideration of regional versus national price appreciation and recovery data

Valuation Overview

- Asset/Equity Interest
  - Cash Flow Estimation/Validation
    - Estimate cash flows from management plan benchmarked against market data
  - Discount Rate Estimation/Validation
    - Based upon entity discount rates and VC investor expected rates of return (if applicable)
    - If complex capital structure, allocate firm value using OPM
  - If asset value greater than cash flow value, use/consider asset approach
  - Benchmark implied multiples to comparable firms and transactions
TRACK B – Hedge Fund
Hedge Fund Tax Outlook 2015

Lucy Gates, Manager
ELLIOTT DAVIS DECOSIMO

Steve Yardumian, Partner
WITHUM SMITH+BROWN, PC
Lucy Gates, CPA  
Senior Manager  

**Services:** Tax  |  **Industries:** Investment Companies, Private Equity Groups, Manufacturing & Distribution, Consumer Finance  

**Professional Overview**  
Lucy has more than 10 years of experience in tax planning and compliance. She focuses primarily in the areas of corporate, partnership and state taxation. Working with flow-through entities with an emphasis on hedge funds, offshore funds, mezzanine funds, private equity funds and venture capital groups, Lucy has advised and assisted clients with federal, state and local tax preparation and review. Lucy has significant experience in hedge fund taxation including partnership consulting, K-1 preparation and distribution, complex tax allocation issues and foreign compliance issues. Lucy has extensive experience in multi-state corporate consolidated returns, multistate tax planning and federal tax planning.  

**Education, Credentials and Special Training**  
Certified Public Accountant  
Master of Professional Accounting, University of Texas  
B.A., Business Administration/Accounting, magna cum laude, University of Georgia  

**Professional Affiliations**  
American Institute of Certified Public Accountants  
Tennessee Society of Certified Public Accountants  
Chattanooga Tax Practitioners  

**Civic and Community Activities**  
Board Member, Tennessee Society of Certified Public Accountants  
Board Member, Girls Inc. of Chattanooga  
Member, Chattanooga Women’s Leadership Institute  
Graduate, Leadership Chattanooga  
Member, Leadership Chattanooga Alumni Association  
Graduate, Alabama Society of Certified Public Accountant’s Leadership Academy
Stephen R. Yardumian - CPA, CGMA, Partner

Based in WS+B’s Boston, MA, office, Steve has extensive public accounting experience as well as a five-year term in private industry as a chief financial officer. Steve focuses principally on providing audit and tax services to investment advisors and pooled investment vehicles such as hedge funds, private equity funds and funds-of-funds. He has experience serving retirement plans and closely-held companies in a variety of industries, including manufacturers, wholesalers, franchises, financial services firms and professional services firms. Prior to joining WS+B, Steve was a partner at Walsh, Jastrem & Browne, LLP, which merged with WS+B in March 2015.

Steve graduated from Columbia University with a BA degree in economics and also received his MBA degree from Rutgers University. Steve is a member of the Massachusetts Society of Certified Public Accountants (MSCPA) and the American Institute of Certified Public Accountants (AICPA). He is also a frequent speaker at various conferences and seminars relating to investment and financial services.
Federal Tax Update Section 871(m)

- The central issue: Withholding tax for non-U.S persons on dividend-like payments under notional principal contracts
- A U.S source dividend paid to a non-U.S person would be subject to a 30% withholding, but...
- An equity swap potentially offering similar economics would not
- Enactment of Hiring Incentives to Restore Employment Act (“HIRE Act”) in 2010 changed this via enactment of Section 871(l), which subsequently became 871(m).
Federal Tax Update Section 871(m) – Key Provisions

• Introduces concept of “specified notional principal contract” ("SNPC"), defined as an NPC that satisfies one of the following:
  - In entering the contract, any long party to the contract transfers the underlying security to any short party to the contract ("cross-in")
  - In terminating the contract, any short party to the contract transfers the underlying security to any long party ("cross-out")
  - Underlying security is not readily tradable on established securities market
  - Underlying security is posted as collateral by any short party to the contract with any long party to the contract

Federal Tax Update Section 871(m) – Current Status

• Final and proposed regulations issued on December 4, 2013
  - Final regulations extended four-factor test through December 31, 2015
  - Proposed regulations:
    • Created “dividend equivalent payment” for payments made on or after January 1, 2016 on NPCs or “equity-linked instruments” ("ELI")
    • Introduced concept of “delta” in determining whether ELIs will be subject to withholding
  - Effective date for proposed regulations will not be 1/1/16
Federal Tax Update Section 871(m)

- May 8, 2015 public statement by Karl Walli, senior counsel, Treasury Office of Tax Legislative Counsel that effective date for any final regulations would be pushed back to January 1, 2017.
- Unclear whether final regulations will change significantly from proposed; appears that proposed regulations are still the starting point for the finals.

Federal Tax Update Section 871(m) – Equity-Linked Instruments and Delta Concept

- Equity-linked instrument – contracts that reference U.S. equities
- Delta – “ratio of change in the fair market value of NPC or ELI to change in the fair market value of the property referenced by the NPC or ELI”
- ELIs and NPCs where the contract delta as compared with underlying equity delta is equal to or greater than 0.7
- Delta is to be determined in a “commercially reasonable manner”
- A delta calculated for non-tax business purposes would generally be used as the 871(m) delta
Federal Tax Update
Section 871(m) – Equity-Linked Instruments and Delta

• Example of delta used for “non-tax” business purposes:
  - A dealer who calculates delta to determine the number of shares to
    balance its position on the option, even if this does not correspond to
    the actual hedge used

• Potential examples of equity-linked instruments
  - Futures contract
  - Forward contract
  - Option
  - Debt instrument

Federal Tax Update Section 871(m)
– Equity-Linked Instruments and Delta Concept

• Constant Delta Concept
  - If the delta of an NPC or ELI is not reasonably expected to
    vary during the term of the transaction, the NPC or ELI has
    a constant delta which is treated as 1.0. To achieve this
    result, number of shares of the underlying security is
    adjusted to achieve constant delta of 1.0

• Goal – to avoid structuring transactions that reduce calculated
  delta while retaining economics of owning set amount of
  shares
Federal Tax Update Section 871(m)
– Equity-Linked Instruments and Delta Concept

• Example: a transaction provides 50% of appreciation, dividends and depreciation on 200 shares of stock throughout the transaction.
• Parties will achieve 50% of economics of underlying stock throughout the transaction term, delta could potentially be calculated as 0.5 (below the withholding threshold)
• Transaction will be re-cast as providing 100% of economics on 100 shares, delta will be calculated as 1.0

Federal Tax Update Section 871(m)
– Dividend Equivalent Payments

• Covers substantially all financial contracts where delta exceeds 0.7%
• Dividends are presumed to exist in any contract that references a U.S equity – no longer limited to “explicit dividends”
• Exemption from withholding requirements for
  - Cases where long party is “Qualified Dealer” acting in its capacity as dealer in securities
    • “Qualified Dealer” is defined as any dealer in securities within meaning of Section 475 that is subject to regulatory supervision by a governmental authority in the jurisdiction in which it was created or organized.
    • Dealer must certify to the short party that it is a qualified dealer acting in its capacity as a dealer in securities
  - Transaction is part of a plan pursuant to which one or more persons are obligated to acquire 50% or more of the entity issuing the underlying securities
Federal Tax Update
Section 871(m) – Dividend Equivalent Payments

- “Qualified Index” Exemption provided for dividend equivalent payments made with respect to a “qualified index”
  - References 25 or more securities
  - References only long positions in underlying securities
  - Contains no underlying security that represents more than 10% of the index’s weighting
  - Rebalances based on objective rules at set intervals
  - Does not provide for high dividend yield and
  - Is referenced by futures or options contracts that trade on a national securities exchange or a domestic board of trade.
- Not clear that major indices would meet these criteria

Federal Tax Update Carried Interest

- Various initiatives to tax carried interest at ordinary rates have been put forth dating to 2007 (a Democratic campaign favorite in past elections, will likely be a discussion topic in the upcoming presidential election as well).
- Change seemed “inevitable” in 2010-2011 timeline, but change in law was never enacted.
- Political push-pull
  - Perceived dwindling support to not change carried interest taxation
  - Inertia in making “one-off” reforms to tax code under Republican congress
- Most recent (FY 2016) Obama budget proposal would tax carried interest as ordinary income under mechanics originally set forth in a 2012 bill sponsored by Congressman Sandy Levin (D-Michigan)
Federal Tax Update Carried Interest – Levin Bill Mechanics

• Creates “Investment Partnership Services Interest” (“IPSI)
  - Loose definition: interest in an investment partnership acquired or held by any person in connection with the conduct by that person (or a related person) of a trade or business primarily involving the performance of certain services with respect to assets held (directly or indirectly) by the investment partnership
  - GPs of investment partnerships would generally fall in this category
• Capital gain with respect to IPSI will be treated as ordinary income, net ordinary losses will be limited to net ordinary income, all dividends allocated to the IPSI would be treated as non-qualifying.
• IPSI income would be subject to self-employment tax
• Potential carve out for “qualified capital interest”
  - General concept: requires investment of after-tax capital
• Sale of IPSI is taxed as ordinary income

State and Local Update

• Operative concepts (to be discussed in more detail later in this presentation)
  - “cost of performance” vs “market-based sourcing” as criteria for allocating income to states
  - Carve outs for investment partnerships managed by investment managers don’t apply to other assets under management (e.g. separate accounts).
  - Thus, a manager’s SALT situation can differ for fund and non-fund assets, even though to the manager “managing money is managing money”.

State Taxation

- States generally recognize partnerships as flow-through entities (no entity level tax) however the fund itself could be subject to income tax in states that impose entity-level taxes on partnerships and/or LLCs
  - Entity-level income taxes
  - Entity-level fees
  - Non-income type entity-level taxes

Physical Nexus vs. Economic Nexus

- What constitutes nexus?
  - State of incorporation
  - Physical presence
  - Residency
  - Many states have discarded the physical presence standard for determining tax nexus and have replaced it with the economic standard
    - States that apply the economic nexus standard use a variety of allocation formulas to determine taxable income
      - Sales, rents, fixed assets, payroll
      - Single-factor states
State Taxation

• When a partnership conducts an active business, states generally require partners to pay tax on their share of partnership income apportioned or allocated to the state
• What about when a partnership’s activities are limited to merely investing the capital of its partners and not actively engaged in business activities?
• Over 20 states have created safe harbors to protect certain types of investment partnerships and non-resident partners from state taxation

State Taxation

• Sample Exemption Provision:
  - Entity is treated as a partnership for federal income tax purposes and meets the following three requirements:
    • 1) At least 90% of the partnership’s cost of its total assets consists of “qualifying investment securities,” bank deposits and office space, and equipment necessary to carry on its investment activities
    • 2) At least 90% of gross income consists of interest, dividends and gains from the sale or exchange of qualifying investment securities
    • 3) The entity is not a dealer of such securities
State Taxation and Investment Activities

• State-sourced income can be generated by
  - Loan origination
  - Pass-through businesses
  - Investing in MLP’s, PTP’s

• With investments in underlying entities passing through state income, state tax filing requirements can be triggered for investors who have only a small share of state sourced income

State Withholding – Nonresident Partners

• Effectively requires partnerships to pay their partners’ taxes
• Basis for withholding varies – cash distributions vs. allocable share of taxable income
• State requirements vary as to type of nonresident in which withholding is required (individuals, trusts, corps, other partnerships)
• Exemptions available to avoid withholding
• States vary as to whether withholding can be remitted annually vs. required quarterly
Composite Filings

• Composite filing – the fund itself files the composite return and pays the related tax on behalf of its partners
  - Withholding at the highest possible rate
  - Cannot participate if you have additional state-sourced income
• Underlying partnerships generating income may have filed a composite return and satisfied the filing requirements for you and your partners
• K-1’s may be provided to your partners indicating that they are responsible for handling state filings

State Tax Rates

• California
  - Composite tax rate – 12.3%
  - Withholding – 7% for domestic nonresident owners
• New York
  - Composite tax rate – 8.82%
  - Withholding – 7.1% for nonresident individuals and C corps
• New Jersey
  - Composite tax rate – up to 8.97%
PFIC’s – Passive Foreign Investment Companies

• What is a PFIC?
  - A PFIC is defined as any foreign corporation where:
    • 75 percent or more of its gross income is passive income OR
    • 50 percent or more of its assets are assets that produce or are held to produce passive income
  - Note: There are exceptions for bona fide banks, insurance companies and foreign companies engaged in the securities industry (meaning the active marketing of securities)

PFIC Reporting Requirements

• Tax Code Sections 1291 through 1298 provide the rules for US persons who invest in PFICs
  - Sec. 1291 ~ Interest on Tax Deferral
  - Sec. 1293-1295 ~ Treatment of Qualified Electing Funds
  - Sec. 1296 ~ Election of Mark to Market of Marketable Stock
  - Sec. 1297 ~ General Provisions
  - Sec. 1298 ~ Special Rules
Passive Income

• Passive income is basically income received on a regular basis, with little effort required to maintain it.

• The IRS categorizes income into three broad types, active (earned) income, passive income and portfolio income. It defines passive income as only coming from two sources: rental activity or "trade or business activities in which you do not materially participate."

• When investing in a foreign company, passive income differs in its meaning from the standard income produced by the operation of a business and generally includes (but is not limited to) various types of Portfolio Income including dividends, interest, royalties, rents, annuities, certain gains from property transactions, commodities trading and foreign currency (with exceptions).

Proposed regulations – PFIC status of foreign insurance companies

• Proposed regulations were issued in April 2015 that address the status of non-U.S. insurance and reinsurance companies as PFICs
  - Clarify the circumstances under which certain investment income of a foreign insurance company is excluded from the definition of passive income under section 1297(b)(2)(B)
  - “Active conduct” and “insurance business” are not defined in section 1297
• For purposes of applying the Passive Income Test, Section 1297(b)(2)(B) of the Code provides that, except as provided in regulations, the term “passive income” does not include any income that is derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business and which would be subject to tax under subchapter L (relating to the taxation of U.S. insurance companies) as an insurance company if the non-U.S. corporation were a U.S. corporation
• Proposed regulations offer guidance as to proper interpretation of this "insurance exception"
Proposed regulations – PFIC status of foreign insurance companies

- Proposed regulations would provide that income (including income from certain investment activities) will qualify for the insurance exception from passive income only to the extent the income is derived in the active conduct of an insurance business.
- “Active conduct” defined – insurance business will generally be in the active conduct of a trade or business if its officers and employees carry out substantial managerial and operational activities
  - The activities of independent contractors and the activities of officers and employees of related entities are not taken into account.
- “Insurance business” defined – business of issuing insurance and annuity contracts and the reinsuring of risks underwritten by insurance companies, together with investment activities and administrative services that are required to support or are substantially related to the insurance contracts issued or reinsured by the non-U.S. insurance company.
- Effective date will be the date on which final regulations are published.

How Is a PFIC Taxed?

- There are 3 ways that PFIC stock are taxed:
  - Section 1291 Fund (a.k.a. the default method)
  - Mark to Market Election
  - Qualified Electing Fund

- Outside of the initial year, you will be forced to use the default method (deemed distribution or dividend) unless you make a “mark-to-market” election or a “QEF” election.
Form 8621

When do you make the election?
• Section 1291 Fund
  - No election necessary, it’s the default method
• Mark-to-Market Election
  - Election made on or before the due date (including extensions) of the US persons income tax return for the tax year in which the stock is marked to market
• QEF Election
  - Shareholder must make the election to be treated as a QEF by the due date, including extensions, for filing the shareholder’s income tax return for the first taxable year to which the election will apply (the “election due date”)
  - Retroactive elections are possible when its not entirely certain the foreign fund qualifies as a PFIC under the Protective Statement or Consent regimes

Form 8621 (continued)

• Who must file
  - Generally, a US person that is a direct or indirect shareholder of a PFIC must file Form 8621 for each tax year under the following three circumstances:
    • Receives certain direct or indirect distributions from a PFIC
    • Recognizes gain on a direct or indirect disposition of PFIC stock
    • Is making an election reportable in Part II of the form
  - A separate Form 8621 must be filed for each PFIC in which stock is held directly or indirectly
Who Must File: Indirect shareholder
- Generally, a US person is an indirect shareholder of a PFIC if it is:
  - A direct or indirect owner of a pass-through entity that is a direct or indirect shareholder of a PFIC,
  - A shareholder of a PFIC that is a shareholder of another PFIC, or
  - A 50-percent-or-more shareholder of a foreign corporation that is not a PFIC and that directly or indirectly owns stock of a PFIC
- For purposes of these rules, a pass-through entity is a partnership, S corporation, trust, or estate

Interest holder of pass-through entities:
- The following interest holders must file Form 8621 under the three circumstances described earlier:
  1. A US person who is an interest holder of a foreign pass-through entity that is a direct or indirect shareholder of a PFIC,
  2. A US person who is considered (under sections 671 through 679) the shareholder of PFIC stock held in trust, and
  3. A US partnership, S corporation, US trust (other than a trust that is subject to sections 671 through 679 for the PFIC stock), or US estate that is a direct or indirect shareholder of a PFIC
- Notes:
  - US persons who are interest holders of pass-through entities described in 3 above must file Form 8621 if the pass-through entity fails to file such form or the US person is required to recognize any income under section 1291.
  - Chain of ownership: Under the three circumstances described earlier, if the shareholder owns one PFIC and through that PFIC owns one or more other PFICs, the shareholder must either file a Form 8621 for each PFIC in the chain, or they must complete Form 8621 for the first PFIC and, in an attachment, provide the information required on Form 8621 for each of the other
Form 8621 (continued)

• Additional information now required (Part I)
  - A shareholder of a PFIC must attach certain information to Form 8621. This information includes:
    • The number of shares in each class of stock owned by the shareholder at the beginning of its tax year
    • Any changes in the number of shares in each class of stock during its tax year and the dates of such changes
    • The number of shares in each class of stock at the end of its tax year
    • Value of the shares held at the end of the taxable year
    • Type of PFIC and amount of any excess distribution or gain treated as an excess distribution under section 1291, inclusion under section 1293, or inclusion or deduction under section 1296

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TRACK A – Private Equity and Venture Capital
Portfolio Company Due Diligence and Optimization – Value-Add Tactics for Your Fund’s Investments

James M. Haluszczak, Managing Partner
STEELBRIDGE CONSULTING

Joshua Cherry-Seto, Chief Financial Officer
BLUE WOLF CAPITAL PARTNERS
FOUNDER & MANAGING PARTNER

James is recognized as an industry-leading expert and consultant to private equity and venture capital firms, with over 15 years of experience in a variety of operations, finance and technology roles. His expertise centers on operational excellence, and James has been trusted as an advisor to many of the world’s leading alternative investment organizations. James is invited regularly to industry events as a speaker or panel moderator to discuss trending issues within the alternative investment industry.

James founded SteelBridge in 2008.

He holds a Bachelor of Science in Economics from Pennsylvania State University.

On a personal note

To solve our clients’ challenges we need to have smart people who are passionate about what they do. I am proud of the team we have and love what we do! What motivates me is finding the right solution to a problem and deploying that solution – which is why when I came across our firm mantra I knew it was perfect – “Determine the best conceivable option and make it happen.”

SteelBridge has given me a platform to be in the center of change that takes place in the alternative investment industry. But I also know that without you, the client, wanting to change to be better, SteelBridge would not exist, and we never take that for granted!

I believe in providing boutique, white-glove service and am driven to play an active, hands-on leadership role in our firm and in all client engagements. Please feel free to give me a call anytime – 646.737.7960 ext. 1001.

ON MY TIME OFF

I consider myself a weekend warrior – be it whiffle ball, wakeboarding or snow skiing – I have a passion for enjoying the great outdoors.
Joshua Cherry-Seto
Chief Financial Officer
jcs@bluewolfcapital.com
(212) 488-1347

Joshua Cherry-Seto is the Chief Financial Officer at Blue Wolf Capital Partners LLC. The Blue Wolf Capital Funds are a family of private equity funds which focus on transformational investments in middle market companies.

Mr. Cherry-Seto is responsible for fund and management company reporting to the Limited Partners as well as the SEC and other regulatory agencies; the coordination of finance operations and the reporting of Blue Wolf’s portfolio companies through their CFOs; and the investment and tax structuring of potential platform, add-on, and co-investment opportunities.

Before joining Blue Wolf in 2013, Mr. Cherry-Seto worked for five years as a portfolio and finance manager at Grove International Partners, a $5 billion global opportunistic private equity real estate fund manager. At Grove, he focused on portfolio management of Grove’s global platform and ASC 820 valuation audit and investor financial reporting and analysis.

From 2001–2008, Mr. Cherry-Seto held a variety of positions within Citigroup, acting principally as a Vice President with responsibilities including financial planning and analysis, tax structuring, SEC registration, and systems implementation within various units. In the finance department of Citigroup’s alternative investments business he covered the private equity, real estate and hedge fund asset classes for risk reporting and Basel implementation, sales projections, budgeting, performance, and executive reporting. He was a senior representative on the $2 billion asset agreement with Met Life as a result of the sale of Travelers. He completed his service with Citigroup as Product Manager within the Citi Fixed Income Alternatives group. He was responsible for the launch, SEC registration, risk management, NAV oversight, independent board coordination, tax structuring, and investor reporting of a novel SEC-registered fixed income alternatives fund.

Prior to Citigroup, Mr. Cherry-Seto held several roles within the organized labor movement. He was a union organizer for SEIU local 100 in Beaumont, TX, representing hospital workers and actively organizing nursing home and school support workers. He also was a union organizer for HERE organizing school support workers in Connecticut. He has served as the Executive Director of the National Writers Union; worked with 1199 SEIU in their political action and communications group, as well as assisting with financial analysis and contract negotiations; and has worked with the Jewish Labor Committee and United Hebrew Trades in New York City.

Mr. Cherry-Seto holds a Bachelor of Science degree from the Cornell University School of Industrial and Labor Relations, a post-graduate certification in Executive IT Management from Columbia University, and an M.B.A. from New York University’s Leonard N. Stern School of Business.
Portfolio Company Due Diligence and Optimization – Value-Add Tactics for Your Fund’s Investments

Private Investment Fund Accounting, Operations and Compliance Forum
July 29, 2015

Presenters

Joshua Cherry-Seto
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James Halusczak
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Agenda

- Overall Trends in Portfolio Company Value Creation

- Optimizing Portfolio Company Value Creation
  - Internal/External Resource Evaluations
  - Diligence Process
  - Portfolio Company Onboarding
  - 100-day Plans
  - Monitoring and Reporting
  - Sales Process

- Special Themes
  - ESG (Environmental, Social and Governance) Framework

Overall Trends in Value Creation

- Industry focus on operational and special situation value creation rather than financial engineering, especially in the middle market

- Value creation occurring in a variety of areas calling on niche specialties
  - strategic planning
  - commercial growth
  - operational efficiency
  - financial controls

- Proliferation of specialty firms and technology tools creating greater opportunities for partnering with external resources, for not just IT projects, but also on strategic portfolio company initiatives
Internal/External Resource Evaluations

- Identify sponsor core competencies to maintain internal sourcing
- Identify value creation opportunities and source core competency challenges internally while seeking strategic partners for non-core opportunities
- Recognize atypical operational areas, such as Fin/Ops as value creation opportunities

Diligence Process

- Engage experts, beyond quality of earnings, to set groundwork for 100 day plans and on-going projects
- Take an ‘outside-in’ approach, in addition to ‘inside-out’
- Do your homework by interviewing customers, suppliers and if possible competitors. As well as, interview and discussion with the target company’s management, key personnel and operations leaders
- Diligence should be done in all areas of a company to identify true Operational Value Creation opportunities, leveraging external experts (e.g. sales, HR, Culture, Management Reporting, etc.)
**Portfolio Company On-boarding**

- Increased focus on planning for significant dollars spent incorporating sponsor and outside support

- Outside support – We are seeing movement to more consideration for outside support rather than just assembling internal portfolio teams through internal and external operating partners and specialty firms

- **Benefits:**
  - Expanded Talent Pool
  - Process Breakdown – Failures in hand-off from deal team to portfolio team create strain at the private equity firm
  - Establishing right level of continued involvement of deal team

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**100 Day Plans**

- Develop Short and Long Term Roadmap – Identifying the priority of value creation and putting detailed action plans with accountability into place

- Focus on the “must-haves” early, not just “low hanging fruit”

- Retain Talent – Holding management workshops for adoption of the change

- Foster Accountability and a Results-Oriented Culture

- Engage the right resources – Bain and Company identified 6 distinct roles, 2 are summarized below:
  - **Operating Partner** – Seasoned mentor and sounding board for company CEO; help a newly invested CEO affect the change and evolution
  - **Facilitators** – These resources work with the portfolio company to quickly deploy resources and affect change according to that plan
Monitoring and Reporting

- Create and articulate an aligned portfolio company monitoring and reporting and expectations from the first management meeting
  - Transparency day one of expectations and discuss aligned with management
  - Recognize user adoption of the data collection process is a major challenge

- Concentrate sponsor time and attention on action analysis not collection
  - Leverage consultants and technology to efficiently collect and report
  - Focus on company board strategic touch point and outsource regular and repeatable monitoring

- Maturing industry – Investors and regulators want access to information
  - Deploy tools that enable efficient data collection without being over burdensome to all process participants

Sales Process

- Preparing company for exit – not just divisions and books, but focus on people

- Evaluate the optimal mix business cycle timing, equity/debt market conditions, and success of value creation activities

- Execute “reverse due diligence” to pre-qualifying buyers

- Most important is leveraging resources to get management and employees excited for the exit and prepared for the process
ESG (Environmental, Social and Governance)

- Socially responsible investing is trending upward in last 10-15 years, more robust in Europe, but trending in US
- ESG intangible factors are now widely assumed be factored in investment decisions as drivers of value creation and/or realization
- ESG needs industry-wide adoption for universally accepted standards for identifying, measuring and reporting on ESG themes
The Next Phase of FATCA Compliance - Working out the Kinks and Ensuring that Your Fund is Doing Everything Right

Vic DeMaise, Manager
ELLIOTT DAVIS DECOSIMO

Justin Rindos, Vice President, Structuring Services
PARTNERS GROUP
Victor DeMaise
Tax Manager

Services: Tax | Industries/Specializations: Consumer Finance, Manufacturing & Distribution, Investment Partnerships, Private Equity Firms, Hedge Funds

Professional Overview
Vic specializes in tax services and planning for investment entities including hedge funds, offshore funds, private equity groups, mezzanine funds and venture capital funds. In addition to federal and state tax compliance preparation, review and planning, Vic has significant experience providing partnership consulting regarding transaction/entity structures, partnership/operating agreements, partnership tax allocation and accounting for uncertainty in income taxes including foreign capital gains. He manages maintenance of tax allocation schedules by investor, Form 1065, Schedules K-1 preparation and distribution, as well as preparation of PFIC Annual Information Statements and related shareholder allocations. Vic is also an expert on matters related to Mutual Fund Tax Compliance (including Excise and RIC tax filings), Passive Foreign Investment Companies (PFICs), Foreign Bank Account Reports (FBAR), Foreign Corporations (Form 5471) and Foreign Partnerships (Form 8865), Foreign Disregarded Entities (Form 8858), and Foreign Trusts (Forms 3520 and 3520A).

Prior to joining Elliott Davis Decosimo, Vic served as the Managing Director of Taxation for Bank of New York Mellon Alternative Investment Services and PNC Global Investment Servicing, Inc. During his career, Vic has consulted with entity managers and personnel providing structuring, transaction, and compliance solutions for domestic and offshore investment entities.

Education, Credentials and Special Training
Tax Certificate, Widener University
B.S., Economics & Accounting, Drexel University

Professional Affiliations
American Institute of Certified Public Accountants
Tennessee Society of Certified Public Accountants
Chattanooga Tax Practitioners

Civic and Community Activities
Volunteer, Chattanooga Area Food Bank
Justin Rindos, Vice President, Partners Group

Justin Rindos is head of Partners Group’s structuring services business unit in the Americas. He also serves as Chief Financial Officer of Partners Group Private Equity, LLC, a 1940 Act registered investment company. Prior to joining Partners Group, Justin worked in KPMG LLP’s state and local tax practice where he was responsible for providing state and local tax (including income, M&A, sales, employment, realty transfer and insurance premium tax) structuring and planning advice to numerous Fortune 500 companies. He holds an LL.M. in taxation from New York University School of Law, a J.D. with a concentration in taxation (with honors) from Quinnipiac University School of Law and a B.A. in Economics and Politics from Fairfield University. Justin is also licensed to practice law in the State of New York.
The Next Phase of FATCA Compliance

Working out the Kinks and Ensuring that Your Fund is Doing Everything Right

Vic DeMaise

Vic DeMaise (423-266-7831), vic.demaise@elliottdavis.com is a tax consultant with the accounting and business advisory firm of Elliott Davis Decosimo. Vic specializes in tax services and planning for investment entities including hedge funds, offshore funds, private equity groups, mezzanine funds and venture capital funds. Vic has significant experience providing partnership consulting. He also has expertise with federal and state tax compliance preparation, review and planning, regarding transaction/entity structures, partnership/operating agreements, partnership tax allocation and accounting for uncertainty in income taxes including foreign capital gains. Vic previously served as the Managing Director of Taxation for Bank of New York Mellon Alternative Investment Services and PNC Global Investment Servicing, Inc.
Justin Rindos

Justin Rindos [212-908-2734], justin.rindos@partnersgroup.com is head of Partners Group’s structuring services business unit in the Americas. He also serves as Chief Financial Officer of Partners Group Private Equity, LLC, a 1940 Act registered investment company. Prior to joining Partners Group, Justin worked in KPMG LLP’s state and local tax practice where he was responsible for providing state and local tax (including income, M&A, sales, employment, realty transfer and insurance premium tax) structuring and planning advice to numerous Fortune 500 companies. He holds an LL.M. in taxation from New York University School of Law, a J.D. with a concentration in taxation (with honors) from Quinnipiac University School of Law and a B.A. in Economics and Politics from Fairfield University. Justin is also licensed to practice law in the State of New York.

• What to Report (with respect to 2014)
  o Account Holder’s Name
  o Account Holders US TIN
  o Account Holders Address
  o Account Number
  o Account Balance or Value
  o For accounts held by recalcitrant/ non-consenting account holders: report aggregate number and balance or value

Lessons learned from year one implementation
Reporting Best Practices

• What forms do you need?
• How do you get them?
• When do you need them by?

FATCA Related items
W-9
W-8 BEN W-8 BEN E
Form 1042
Form 8966
Form 8938
Publication 515
Foreign Jurisdiction Info

Cayman Islands Reporting and Filings

On July 1, 2015, the Cayman Islands Tax Information Authority issued Version 2.1 of the Cayman Islands Guidance Notes.
Working with your Administrator

• What should they be doing?
• What should you be doing?
• How are you staying on the same page?

Putting Protocols in Place

• Identify reportable persons and beneficial owners
• Change management for compliance
• Standardization
• Information Security
• Taxpayer Awareness

Operational Challenges
• Operations
• Technology
• Remediation
Managing any serious side effects on withholding

- Is Information missing?
- Chapter 4 vs Chapter 3 withholding?
- Ensuring no payments liable to withholding tax are routed through an NPFFI
- What policies are in place to meet compliance in the future?

What should you expect if you’re subject to a FATCA audit?

- Document review
- Return audits
- Without proper documentation, the presumptive rules generally apply
- Penalties for non-compliance
What’s next?

2015

- Withholding on FDAP payments to undocumented pre-existing NPFFIs began January 1
- Look at IGAs between the investors and where fund is domiciled (not just US!)
- Annual Reporting for 2014 due
- Withholding on US FDAP payments to recalcitrant high value-pre-existing accounts began July 1
- Foreign jurisdictions begin reporting to the IRS on an annual basis by Sept 30
- Due diligence for pre-existing accounts

2016

- Limited FFI/Limited branch status expires Jan. 1st
- 2015 Annual Reporting
  - Annual reporting for US accounts includes payments other than gross proceeds
  - PFFIs report YE 2015 non-US reportable amounts paid to NPFFIs
- All remaining pre-existing account documentation due June 30 and withholding begins on recalcitrant individual and undocumented entity accounts
- Responsible Officer makes certifications related to due diligence and FATCA anti-avoidance
What’s next?

- Withholding on gross proceeds begins for USWAs, WAs and PFFIs on Jan. 1st
- 2016 Annual Reporting
- PFFIs also report YE 2016 non-US reportable amounts paid to NPFFIs
- FATCA reporting adds gross proceeds
Chair’s Welcome

Private Equity and Venture Capital (Track A) Chair:
Karl Jordan, CPA, GCMA, Domestic and International Principal
ELLIOTT DAVIS DE COSIMO
Karl Jordan, CPA, CGMA
Shareholder

Services: Business Advisory | Industries/Specializations: Investment Partnerships, Private Equity, Hedge Funds, Banking & Financial Services, Family Office, Captive Insurance, Real Estate

Professional Overview

Karl has over 35 years of experience in tax, auditing and corporate finance consulting services. He provides services to financial institutions, private investment partnerships, alternative investment groups, hedge funds, broker/dealers, real estate companies, captive insurance, investment companies, family offices and high-net-worth individuals.

Karl’s family office operations services include merger and acquisition consultation, financial planning and estate considerations. He also assists clients with investment partnerships, including initial setup, accounting systems and procedures consultations, regulatory assistance and other related management planning and consultation. He has actively worked with the Federal Deposit Insurance Corporation and the Resolution Trust Corporation in closing numerous financial institutions, as well as with the Securities and Exchange Commission and other governmental regulatory authorities. He is a recognized national speaker, leading seminars and discussion groups on investment fund formations, fund operations and regulatory issues.

Education, Credentials and Special Training
Certified Public Accountant
Chartered Global Management Accountant
Master of Business Administration, University of Tennessee System
A.S., Accounting, Chowan College
B.S., Accounting, East Tennessee State University

Professional Affiliations
American Institute of Certified Public Accountants
Tennessee Society of Certified Public Accountants
Georgia Society of Certified Public Accountants
Cayman Islands Society of Professional Accountants

Civic and Community Activities
Grant Committee, Hedge Funds Cares Southeast
Chairman, Board of Accountancy, East Tennessee State University College of Business & Technology
Treasurer, Peach State PETS (President Elect Training Seminar)
Chair’s Welcome

Hedge Fund (Track B) Chair:
Anthony Tuths, Partner
WITHUM SMITH+BROWN, PC
Tony is a tax attorney and the Alternative Investments Leader in WS+B’s Financial Services Group based out of the firm’s New York office. Tony serves as the engagement partner and business advisor to alternative investment funds of all kinds, including hedge funds, fund-of-funds, private equity funds, endowments and family offices. Tony is one of the leading experts in the structuring of alternative investment funds and related asset investments and has extensive experience in counseling start-up funds, alternative asset managers, commodity pools and mutual funds / ETFs. He adds value to his clients and the industry by combining his deep expertise, commitment and leadership with a collaborative style and a practical approach. Clients and colleagues seek Tony as a resource and a recognized industry expert in tax, accounting, financial reporting, internal control and operational issues impacting the alternative investment industry.

A graduate of Rutgers Law School, Tony received his juris doctor after earning his BA degree from Montclair State University. In addition, he earned his master of laws degree in taxation from New York University School of Law. Tony is a member of the New York State Bar Association (NYSBA) and the American Bar Association (ABA). As one of the country’s leading experts on tax issues affecting the asset management industry and those arising from the new U.S. rules governing the derivatives market, he regularly speaks at industry conferences and is a frequent contributor to industry publications. Prior to joining WS+B, Tony headed the tax planning function at Deutsche Bank (including its asset management arm) and was previously head of the tax function within Citigroup Alternative Investments. He resides in Essex County, NJ.
Private Investment Fundraising and Beyond: Marketing, Due Diligence and Investor Relations

Adam Nadborny, General Counsel & Chief Compliance Officer
ATALAYA CAPITAL MANAGEMENT

Harsh Jadhav, Chief of Internal Audit
ALAMEDA COUNTY EMPLOYEES RETIREMENT ASSOCIATION

Justin Rindos, Vice President, Structuring Services
PARTNERS GROUP
Adam D. Nadborny, General Counsel & Chief Compliance Officer

Mr. Nadborny serves as Atalaya's General Counsel and Chief Compliance Officer. Previously, Mr. Nadborny was General Counsel and Chief Compliance Officer at C12 Capital Management, a multi-strategy hedge fund, as well as General Counsel and Senior Vice President of DHM Mortgage Servicing, a C12 subsidiary focused on the residential mortgage sector. Prior to C12, Mr. Nadborny served as Real Estate Counsel – Americas at Babcock & Brown, a global merchant bank, overseeing the legal aspects of real estate, private equity and structured finance transactions across various asset classes. Mr. Nadborny began his career in the mergers and acquisitions and real estate groups at Skadden, Arps, Slate, Meagher & Flom. He holds a BA in history, with honors, from Yale University and earned a JD from the University of Virginia School of Law.

nadborny@atalayacap.com
BIO – Harsh Jadhav, CPA, CISA, CIDA

Harsh Jadhav serves as Chief of Internal Audit for the Alameda County Employees Retirement Association (ACERA), where his department is responsible for conducting audits of participating employers, enforcing policy and contract compliance and providing independent assurance and advisory services designed to improve operational efficiencies and protect against misappropriation of public funds. As part of the executive management team, the Chief of Internal Audit is tasked with bringing a systematic, disciplined approach to evaluate and improve the effectiveness of key financial and operational controls, and reports directly to the ACERA Board of Retirement.

Prior to joining ACERA, Jadhav worked in various finance and management capacities, including positions with Mirabelle Investments, Deloitte & Touche, Intel, and American Express. Jadhav is licensed as a CPA, CISA, CITP, CRISC, CGMA, CRMA, CIDA, CGAP and holds a Bachelors of Science in Accounting from San Diego State University, and a Masters of Business Administration from California State University, Hayward. In addition to his position with ACERA, Jadhav teaches as a business and information systems professor with University of California, Berkeley (Extension).
Justin Rindos bio

Justin Rindos, Vice President, Partners Group
Justin Rindos is head of Partners Group’s structuring services business unit in the Americas. He also serves as Chief Financial Officer of Partners Group Private Equity, LLC, a 1940 Act registered investment company. Prior to joining Partners Group, Justin worked in KPMG LLP’s state and local tax practice where he was responsible for providing state and local tax (including income, M&A, sales, employment, realty transfer and insurance premium tax) structuring and planning advice to numerous Fortune 500 companies. He holds an LL.M. in taxation from New York University School of Law, a J.D. with a concentration in taxation (with honors) from Quinnipiac University School of Law and a B.A. in Economics and Politics from Fairfield University. Justin is also licensed to practice law in the State of New York.
TRACK B – Hedge Fund
State of the Derivatives Market and its Impact on Your Fund’s Operations

Joel Telpner, Partner
JONES DAY

Stephen Humenik, Of Counsel
COVINGTON & BURLING LLP

Joshua Sterling, Partner
MORGAN, LEWIS & BOCKIUS LLP
Profile

Joel Telpner represents financial institutions, derivative dealers, Fortune 500 corporations, hedge funds, pension funds, and other end-users in designing, structuring, and negotiating complex derivative and structured finance transactions. Joel advises clients on a broad variety of financial products and transactions, including credit, equity, and commodity derivatives; synthetic products; credit and equity-linked products; hedge fund-linked products; structured and leveraged finance transactions; CDOs/CLOs; and other securitization products. In addition, Joel advises financial institutions and end-users on understanding and complying with the regulatory requirements arising from the financial reform legislation, as well as new opportunities resulting from the legislation.

He also advises clients on risk management and mitigation strategies concerning CDOs/CLOs, derivatives, and other structured finance transactions. For the past several years he has worked extensively with clients in analyzing their structured finance investments and associated counterparty risk and devising strategies for managing credit exposures and resolving disputes. His recent focus also has involved restructuring existing financings, and he has represented investment banks, issuers, and trustees in those restructurings. He has worked with financial institutions in reviewing and analyzing their global exposures to various structured credit investments including credit derivatives and CDOs/CLOs, has restructured and unwound extremely complex synthetic structured finance transactions, and has helped to develop new "repack" programs and the next generation of structured finance products.

Financial institutions for which Joel has worked on substantial matters include Bank of America, Citibank, Deutsche Bank, JPMorgan Chase, Morgan Stanley, Nomura, Société Générale, and Sumitomo Bank.

EXPERIENCE

Highlights

A. Schulman completes Cumulative Perpetual Convertible Special Stock offering

Jin Investment Management forms Jin Japan Funds

City of Detroit’s chapter 9 plan of adjustment confirmed

Areas of Focus

Banking & Finance
Structured & Derivative Products
Financial Institutions
Litigation & Regulation

HONORS & DISTINCTIONS

Described in The Legal 500 (2009) as being “particularly expert in complex derivative and structured products linked to private investment funds”; listed as a leading lawyer in the IFLR 1000 (2009) as receiving “high praise from clients and competitors”; recognized in New York Super Lawyers

Languages

View biography in Simplified Chinese
Stephen M. Humenik
Of Counsel
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Tel: +1 202 662 5803

Stephen Humenik leads the firm’s futures and derivatives practice. He has extensive experience on regulatory and enforcement matters involving the U.S. Commodity Futures Trading Commission (CFTC) and the derivatives and commodities markets. Specifically, Mr. Humenik advises clients on regulatory and policy matters relating to the registration and compliance obligations of the Dodd-Frank Act and represents clients in CFTC enforcement investigations and proceedings.

Prior to joining Covington, Mr. Humenik was general counsel and chief regulatory officer of Eris Exchange, LLC, an interest rate swap derivatives market, where he oversaw the legal and regulatory affairs of the exchange, including the exchange’s designation as a contract market and ongoing compliance with CFTC regulations. Mr. Humenik previously served as Special Counsel and Policy Advisor to Commissioner Scott O’Malia where he assisted on rulemaking, enforcement and legislative matters. Mr. Humenik began his career at the CFTC and primarily served as Senior Trial Attorney for the CFTC’s Division of Enforcement where he investigated and litigated complex fraud and market manipulation cases, specifically those involving energy and financial derivatives and physical commodities. Mr. Humenik also practiced in the SEC enforcement group of a law firm in Washington, DC.

Previous Experience
■ Eris Exchange LLC, General Counsel and Chief Regulatory Officer (August 2010–April 2013)
■ U.S. Commodity Futures Trading Commission, Special Counsel and Policy Advisor to Commissioner Scott O’Malia (November 2009–August 2010)

Honors and Rankings
■ Legal 500 US, Energy: Regulatory

Memberships and Affiliations
■ District of Columbia Bar Association
■ Chicago Bar Association, Futures and Derivatives Law Committee

Publications
■ "EMIR: Incomplete Reports Will Be Sent Back, Creating Costs and Other Burdens for Counterparties," Covington E-Alert (7/28/2014), Co-Author
■ "Three, Two, One: The Regulatory Launch of Swaps Trading," FIA Law & Compliance Division Conference on the Regulation of Futures, Derivatives and OTC Products (May 2014), Co-Author
■ "CFTC Proposes Revised Position Limits and Aggregation Rule," Covington E-Alert (11/20/2013), Co-Author
■ "Proceed with Caution - Roles and Regulatory Issues of Derivatives," ACC Docket (October 2012), Co-Author
■ "Disruptive Regulatory Practices: The ‘New’ DCM Core Principles," FIA Law & Compliance 2012 (May 2012), Co-Author

Presentations and Speeches
■ "Futures and Derivatives: Advising the Smartest People in the Room," Chicago Bar Association (June 2015)
"Derivatives Markets: Regulatory Reform Update," Chicago Bar Association (March 2015)
"Regulation: Are We There Yet?," FIA Asia Derivatives Conference (December 2014)
"International Regulators Meeting," Monetary Authority of Singapore International Regulators Meeting (December 2014)
"SIFMA Asset Management Group presents: A View from the Buy-Side on Cleared Derivatives," FIA Derivatives Expo (November 2014)
"Regulatory Update for Derivatives Operations Professionals," SIFMA AMG - AMF Derivatives Operations Committee (October 2014)
"CFTC Compliance: Examining the Latest CFTC Guidance and Regulatory Issues," Corporate Counsel's 8th Annual Hedge Fund General Counsel Summit (October 2014)
"Compliance and Enforcement "Of Counsel" Panel," Commodity Markets Council Compliance Conference (September 2014)
"The Developing Regulation of Swaps: Will it Spark or Stifle Trading?," SIFMA AMG (September 2014)
"Taking Stock: Where We Are And What Is To Come," SIFMA AMG Derivatives Conference (September 2014)
"SEF Market Structure - Do We Have a Market and Does It Have a Structure?," FIA L&C: 36th Annual Law & Compliance Division Conference on the Regulation of Futures, Derivatives and OTC Products (May 2014)
"Dodd-Frank and EMIR: Where We Are Now and What It Means to You Webinar," (January 2014)
"Chief Compliance Officers: Establishing a Successful Compliance Program at FCMs, Broker- Dealers, Swap Dealers, DCMs and DCOs," ACI Derivatives Conference: Reform and Regulation of Derivative Transactions (January 2014)
"From Theory to Practice: Complying with New CFTC Rules," FIA Expo 2013 - 29th Annual Futures and Options Expo (November 2013)
"How Regulatory Changes Will Affect Execution and Compliance," Oilseed and Grain Trade Summit 2013 (October 2013)
"Regulatory Environment of the FCM," Committee of Chief Risk Officers: Symposium on FCM Clearing and Capital Management (July 2013)
"Dodd-Frank: Finalization, Implementation, and Futurization," Chicago Bar Association (December 2012)
"Proposed Regulations Implementing Core Principle 9 for Designated Contract Markets," CFTC Staff Public Roundtable (June 2012)
""Available to Trade" Provision for Swap Execution Facilities and Designated Contract Markets," CFTC Staff Public Roundtable (January 2012)
Josh Sterling represents managers of private and public funds globally, including the sponsors of hedge funds, registered investment companies, and other pooled investment vehicles. He helps these clients develop and offer their products and services in the United States. Josh also assists managers of alternative investment strategies in structuring their derivatives activities in compliance with the Dodd-Frank Act and related US Securities and Exchange Commission (SEC) and US Commodity Futures Trading Commission (CFTC) requirements.

Josh counsels financial services clients on how their investment and trading activities may trigger requirements to register with the CFTC as commodity pool operators, commodity trading advisors, swap dealers, and introducing brokers. In addition, Josh regularly advises managers on regulatory, registration, and transactional matters affected by the Commodity Exchange Act, the Investment Advisers Act, and the Investment Company Act. He also represents clients in responding to examinations and inquiries by the SEC, the CFTC, and the National Futures Association.

The Legal 500 US (2014) recognized Josh as an “excellent attorney...able to provide highly customized advice” in his practice areas.

Before joining Morgan Lewis, Josh was a partner at another international law firm, where he was a co-leader of the derivatives group and a member of its investment management practice.

AWARDS AND AFFILIATIONS
Listed, The Legal 500 US (2014)
Member, American Bar Association, Business Law Section
Member, District of Columbia Bar, Corporation, Finance and Securities Law Section

ADMISSIONS
- District of Columbia
- New York

EDUCATION
- University of Pennsylvania Law School, 2001, J.D.
- Vanderbilt University, 1998, B.A.

SECTORS
- Financial Services
- Technology

SERVICES
- Securities and Corporate Governance
- Investment Management

REGIONS
- North America
Private Investment Fund Accounting, Operations, & Compliance Forum

State of the Derivatives Market and its Impact on Your Fund’s Operations

Stephen Humenik, Of Counsel
Covington & Burling LLP

Joshua Sterling, Partner
Morgan, Lewis & Bockius LLP

Joel Telpner, Partner
Jones Day

Overview

• Overall Themes in Regulation
• Key CPO and CTA Considerations
• Regulatory Developments
• Clearing and Collateral Update
• Basel III
• Margin for Uncoled Swaps
• Swap Execution Facilities (SEFs)
• Reporting Swaps
• Position Limits
• Enforcement Update
Overall Themes in Derivatives Regulation

• Derivatives market reforms have the potential to affect your firm in two principal ways
  – As a registrant with the CFTC
    • Commodity Pool Operator (CPO)
    • Commodity Trading Advisor (CTA)
  – As a firm that trades in highly regulated markets for futures, swaps, and other instruments
    • Dodd-Frank rules affecting swaps and security-based swaps
    • Parallel requirements in non-U.S. jurisdictions
    • Enhanced reporting, surveillance, and enforcement/oversight powers over specific markets

Key CPO and CTA Considerations
Key CPO and CTA Considerations

Regulation of Asset Managers:
• CPOs are fund sponsors
  – General partners, managing members, trustees
  – CPO responsibility can be delegated to manager based on CFTC staff guidance
  – 1940 Act fund directors are not regarded as CPOs
• CTAs are investment managers
  – Sub-advisers
  – Managers of non-1940 Act funds, other investment vehicles
• Same entity can be CPO and CTA in some fund structures
  – Dual registration can arise where a manager has its own complex and sub-advises other funds
• The CFTC does not directly regulate commodity pools or require them to register in any way

Key CPO and CTA Considerations

• Analysis of CPO and CTA status now part of fund formation/advisory mandate playbook
• Principal Exemptions and Gating Issues:
  – CPO:
    • Is a vehicle a “commodity pool”  4-factor analysis under Lopez
    • Rule 4.13(a)(3) “de minimis” exemption  Identifying and testing covered products; look-through analysis for funds-of-funds
  – CTA:
    • Section 4m(3)/Rule 4.14(a)(8)  business not “primarily” giving commodity trading advice or advice is “solely incidental”
    • Section 4m(1)/Rule 4.14(a)(10)  15 or fewer clients and no “holding out”
  – For U.S.-based firms, non-U.S. mandates should be considered in any analysis
Key CPO and CTA Considerations

• Open Issues for Registered Firms:
  – Delegation/Identification of CPO → CFTC Letter 14-126
    • Real-world impact with exchange membership/privileges
  – NFA Bylaw 1101 review and analysis
    • Room for some discretion in scope of review
  – NFA Annual and Periodic Responsibilities
    • Self-Exam → your firm’s roadmap for NFA audit
    • Reporting on CPO-PQR and CTA-PR → Consistent approach where overlap with Form PF
    • Pool Annual Reports → Expect questions in key areas
    • Registration Update → NFA is comparing with Form ADV (e.g., principals)
  – Enhanced Recordkeeping under CFTC Rule 1.35 → CFTC Letter 14-147
  – Generalized Recordkeeping Relief → CFTC Letter 14-114
  – JOBS Act harmonization on general solicitation → CFTC Letter-14-116
    • Applies to 4.13(a)(3) exempt CPOs as well

• NFA Audit Process:
  – More firms registered in 2012/2013 are now undergoing first audit
  – Basic Process:
    • Notice
    • Document Request
    • On-Site Review
    • Exit Interview
  – Key Points:
    • Insist on confidential treatment/submission of documents to NFA
    • Prepare firm/fund overview for day one of on-site review
    • Make sure there are opportunities to discuss findings before exit interview
    • If there are findings/open matters, make sure process for resolving them is clear
      – Also consider related consequences (e.g., investor/ADV disclosure)
    • Review and, where appropriate, negotiate terms of management representation letter on conclusion of audit
Key CPO and CTA Considerations

• **NFA Rulebook Expansion?**
  • In January 2014, NFA requested comment on potential new measures applicable to CPOs and CTAs:
    – Minimum Regulatory Capital
    – Independent Authorization of Disbursements of Pool Assets
    – Valuation and Reporting on Pool Assets
    – Third Party Preparation or Review of Pool Performance Information
    – Verification of Pool Assets (Daily Reconciliation)
    – Removal of Inactive Members
  
• Next steps currently unclear

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Regulatory Developments
Dodd-Frank Largely Implemented for Swaps

<table>
<thead>
<tr>
<th>Clearing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Swap Dealer Oversight</td>
</tr>
<tr>
<td>Price Transparency</td>
</tr>
</tbody>
</table>

Swaps Market Reform – Reduction of Systemic Risk

Central clearing is **one of the three major building blocks of Dodd-Frank swaps market reform** — in addition to **promoting market transparency** and **bringing swap dealers under comprehensive oversight** — and this rule completes the clearing building block.

- Central clearing lowers the risk of the highly interconnected financial system. It also **democratizes the market** by eliminating the need for market participants to individually determine counterparty credit risk, as now **clearinghouses stand between buyers and sellers**.
- In a cleared market, more people have access on a **level playing field**.
- Small and medium-sized businesses, banks and asset managers can **enter the market and trade anonymously and benefit from the market’s greater competition**.

Chairman Gensler, November 28, 2012 (Statement on Clearing Determinations).

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Clearing and Collateral Update
Normal Transaction Flow

Cleared Derivatives in the U.S.: Status Update

- The clearing mandate in the U.S. began on February 11, 2013 with phased compliance over the course of the remainder of 2013.
- Current CFTC clearing mandate covers the following products:
  - **Interest Rate Swaps** (Fixed-to-Floating Swaps, Basis Swaps, Forward Rate Agreements and Overnight Index Swaps); and
  - **Credit Default Swaps** (North American Untranch CDS Indices and European Untranch CDS Indices)
- Clearing Requirement Determination Under Section 2(h) of the CEA; Final Rule, 77 Fed. Reg. 74284 (Dec. 13, 2012); see also http://www.cftc.gov/PressRoom/PressReleases/pr6684-13
- Asset classes under review by the CFTC for mandatory clearing:
  - Non-Deliverable Forwards (“NDFs”)
- Asset classes anticipated for review by the CFTC for mandatory clearing:
  - Swaptions
Cleared Derivatives in the U.S.: Status Update

• On December 22, 2014, the CFTC’s Global Markets Advisory Subcommittee on Foreign Exchange Markets (the “Subcommittee”) issued a report to the Global Markets Advisory Committee (the “GMAC”) concerning the clearing of NDFs.
• The Subcommittee requested harmonization among U.S. and European regulators to maintain “a robust liquidity pool”. Specifically, the report provided that the regulators should harmonize the products to be cleared (e.g., currency pairs and tenors no longer than 12 months), counterparty categorization and implementation dates.
• The Subcommittee believes that the CFTC’s NDF clearing determination should be proposed no later than August 1, 2015, with the following phased-in implementation:
  • Category 1 counterparties: February 1, 2016;
  • Category 2 counterparties: May 1, 2016; and
  • Category 3 counterparties: August 1, 2016.
• For more information, see Response To Request For Recommendation On An FX NDF Mandate (December 5, 2014) (the “NDF Report”), http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/gmac_fxndfmandate122214.pdf
• However, the European Securities and Markets Authority (ESMA) recently determined not to proceed with mandatory NDF clearing in the EU at this time, noting many of the concerns raised at the CFTC roundtable.

Cleared Derivatives in the U.S.: Status Update

• Recent Swaptions Clearing Developments in the U.S.
• Although in its infancy, many market participants believe that short duration swaptions should be available for clearing but not subject to a mandatory clearing requirement.
• Enhanced transparency and understanding of CCP models is required before the issuance of a clearing mandate.
Accounting for Segregated Customer Funds

- CFTC regulations require separation of customer funds from the proprietary trading accounts of the FCM and DCO capital. These accounts must be titled as Segregated Customer Accounts and deposited with approved depository. Such depository must acknowledge in writing the receipt of customer funds and title the depositing account as containing segregated customer funds.

- Notwithstanding segregation requirements, FCMs deposit its own funds in segregated customer accounts to ensure that customers meet collateral requirements at all times. These FCM funds in segregated customer accounts, referred to as targeted residual interest, are available to meet DCO margin calls on customer positions. CFTC regulations require FCMs to establish policies regarding targeted levels of residual interest and maintain these levels at all times.

Collateral Protection for Cleared Derivatives – U.S.


- Complete Legal Segregation or “LSOC” - Final rule requiring that FCMs and DCOs segregate swaps customer collateral from their own assets. 17 CFR Part 22, Part 190.

- LSOC with excess.
Recent Customer Protections - CFTC

- On October 30, 2013 the CFTC voted to finalize additional customer protection rules. See Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations; Final Rule, 78 Fed. Reg. 68506 (November 14, 2013). The rules were effective January 13, 2014, however, certain rules have different compliance dates.
- The rules build on customer protections established earlier by the National Futures Association.
- The rules require FCMs to increase the amount of residual interest held in customer funds accounts, restrict the ability to withdraw such residual interest, and impose increased recordkeeping and reporting requirements on FCMs.

Residual Interest

- The residual interest requirements are in addition to the FCM minimum capital requirements.
- FCMs must also meet minimum levels of targeted residual interest in their segregated customer account.
- Targeted residual interest allows the FCM to continuously meet DCO and DSRO collateral requirements and margin calls on customer accounts.
- A customer margin call that remains unmet for more than one full business day incurs a capital charge for the FCM. 17 CFR 1.17(c)(5)(viii).
- At a minimum, CFTC regulations require FCMs to maintain targeted residual interest in segregated customer accounts held by DCOs equal to the aggregate of the FCM’s under-margined customer accounts. 17 CFR 1.22(c); 17 CFR 22.2(f).
Residual Interest

- Residual interest insures that the FCM can at all times cover customer losses on under-margined accounts.
- FCMs must calculate, report, and adjust amounts of targeted residual interest daily to fully offset these under-margined accounts and immediately report any deficits in targeted residual interest. 17 CFR 1.22(c); 17 CFR 1.32; 17 CFR 1.12(j); 17 CFR 22.2(g).
- Even if a FCM remains otherwise in compliance with minimum targeted residual interest policies, the FCM cannot withdraw more than targeted residual interest in excess of 25 percent of its total residual interest from the previous day without approval from senior management and CFTC notification. 17 CFR 1.23(d).

Basel III
Basel III is based around five building blocks:

1. Strengthening capital: change the definition of capital to improve the quality, consistency and transparency of banks’ capital base;
2. Enhancing risk coverage: strengthen the risk coverage of the framework with new standards for counterparty credit risk exposures arising from derivatives, repos and securities financing activities;
3. Leverage: introduce a leverage ratio that serves as a backstop to risk-based capital measures and is intended to constrain the build up of excessive leverage in the banking system and provide an extra layer of protection against model risk and measurement error;
4. Limiting procyclicality: improve measures to address procyclicality (i.e. the cyclical effects of risk based capital requirements) – in particular, the introduction of countercyclical buffers in addition to capital requirements that vary with the economic cycle; and
5. Improving liquidity management: introduce a new liquidity framework, which includes two minimum liquidity risk ratios – a 30-day LCR and a 1-year NSFR – and a set of common monitoring metrics and application standards.

The U.S. banking agencies (the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency) are responsible for rules related to the comprehensive revision of the regulatory capital framework for the U.S. banking sector.

The U.S. implementation of Basel III through final rulemaking represents the most complete overhaul of U.S. bank capital standards since the U.S. adoption of Basel I in 1989.

The final rules of the U.S. banking agencies implement many aspects of the Basel III capital framework agreed upon by the Basel Committee and incorporate changes required by the Dodd-Frank Act.
The Leverage Ratio

Leverage Ratio = \[ \frac{\text{Capital Measure}}{\text{Exposure Measure}} \]

Exposure Measure

(a) On-balance sheet exposures (cash margin)

(b) Derivatives Exposures

Derivatives Exposures – Current Exposure Method

Add-on factors for determining potential future exposure

The following add-on factors apply to financial derivatives, based on residual maturity:

<table>
<thead>
<tr>
<th>Residual Maturity</th>
<th>Interest Risk</th>
<th>FX and gold</th>
<th>Equities</th>
<th>Precious metal-except gold</th>
<th>Other counterparty</th>
</tr>
</thead>
<tbody>
<tr>
<td>One year or less</td>
<td>0.0%</td>
<td>1.0%</td>
<td>6.0%</td>
<td>7.0%</td>
<td>18.0%</td>
</tr>
<tr>
<td>Over one year to five years</td>
<td>0.0%</td>
<td>5.0%</td>
<td>8.0%</td>
<td>7.0%</td>
<td>12.0%</td>
</tr>
<tr>
<td>Over five years</td>
<td>1.0%</td>
<td>7.0%</td>
<td>10.0%</td>
<td>0.0%</td>
<td>18.0%</td>
</tr>
</tbody>
</table>

Notes:
1. For contracts with multiple exchanges of principal, the factors are to be multiplied by the number of remaining payments in the contract.
2. For contracts that are structured to settle outstanding exposures following specified payment dates and where the terms are such that the notional value of the contract is zero on those specified dates, the residual maturity could be set equal to the time until the next reset date. In the case of interest rate contracts with remaining maturities of more than one year that meet the above criteria, the add-on is subject to a floor of risk.
3. Forwards, swaps, purchased options and similar derivative contracts not covered by any of the columns in the table are to be treated as “other counterparties.”
4. No potential future credit exposure would be calculated for single currency forward / floating interest rate swaps; the credit exposure on these contracts would be evaluated solely on the basis of their mark to market value.

Leverage Ratio

- The Basel leverage ratio adopted what is known as the Current Exposure Method (“CEM”) to capture off-balance sheet derivatives exposures, including centrally cleared derivative exposures, in its measure of total leverage exposure.

- In the risk-based context, CEM is used to calculate an institution’s Potential Future Exposure (“PFE”) with respect to derivatives exposures, and the PFE calculation recognizes the exposure reducing effect of margin.

- In the leverage ratio context, however, the CEM approach does not permit margin to reduce off-balance sheet derivatives exposures (other than cash variation margin) based solely on the stated policy rationale that such margin can “increase the economic resources at the disposal of the bank, as the bank can use the collateral to leverage itself.”

- Unlike non-segregated collateral that can arise in certain uncleared derivatives transactions, client margin that is segregated may not be leveraged by a bank to fund the bank’s operations.

- Instead, segregated margin is solely exposure-reducing with respect to a bank’s cleared derivatives exposures.

- Industry trade associations and financial institutions are in active discussions to have the reduction recognized by the leverage ratio.

- This reduction concerns the rule’s calculation of off-balance sheet exposures, which is a regulatory standard that is not driven by accounting treatment (unlike the part of the leverage ratio that governs on-balance sheet exposures).
Margin for Uncleared Swaps

Margin Rules for Uncleared Derivatives

• Following the release by the Basel Committee on Banking Supervision (“BCBS”) and the International Organization of Securities Commissions (“IOSCO”) of their final framework setting forth minimum standards for margin requirements for non-centrally cleared derivatives, U.S. regulators are re-proposing margin requirements for uncleared swaps under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).

• The BCBS/IOSCO standards are intended to be adopted by all jurisdictions of Basel and IOSCO, including the U.S. However, given the differences between the BCBS /IOSCO agreement and the previously-issued uncleared margin proposals of U.S. regulators, which require significant changes to U.S. rules, U.S. regulators are re-proposing the rules rather than issuing final rules.
Margin Rules for Uncleared Derivatives

• In the U.S. the duty to implement these requirements is placed on several regulators.

• There are three proposed rules on uncleared margin in the U.S.: (1) issued by the Department of the Treasury Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Fed), Federal Deposit Insurance Corporation ("FDIC"), Farm Credit Administration ("FCA"), and Federal Housing Finance Agency ("FHFA") (collectively, the "Prudential Regulators") for bank swap dealers ("SDs"); (2) issued by the Commodity Futures Trading Commission ("CFTC") for non-bank SDs; and (3) issued by the Securities and Exchange Commission ("SEC") for non-bank security-based SDs.
  
  – The Prudential Regulators re-proposed their rule setting margin, capital, and segregation requirements for uncleared swaps on September 3, 2014.
  

  – The CFTC re-proposed the uncleared margin requirements on September 17, 2014.


  – The SEC has not yet announced its plan.

CFTC Re-proposed Margin Rules for Uncleared Swaps

• Effective Date: December 1, 2015 for variation margin requirements. Phased in compliance between December 1, 2015 and December 1, 2019 for initial margin based on aggregate notional amount of uncleared swaps. (Further delays likely.)

• What is Covered: Uncleared swap transactions between two swap dealers and between swap dealers and financial end users.

• What is Excluded:
  
  – Uncleared swap transactions between swap dealers and non-financial end users.

  – Physically settled FX swaps and forwards.

  – Foreign Uncleared Swaps (defined below).
Margin Rules for Uncleared Swaps

• *Who is a Financial End User (FEU):*
  – U.S. and foreign banks and certain other financial services firms.
  – Market intermediaries—e.g., broker-dealers, investment advisors, FCMs.
  – Investment funds, commodity pools and ERISA employee benefit plans.
  – Insurance companies.
  – A non-U.S. entity that would be a financial end user if it were organized under U.S. law.
  – Sovereign entities are not FEUs.

• *Material Swap Exposure (MSE):* If FEU has MSE (aggregate daily swap exposure for uncleared swaps, including FX exposure) greater than $3 billion, FEU must collect and post both initial and variation margin.

• *FEU Without MSE:* Must collect and post variation margin. Must collect and post initial margin if determined appropriate by swap dealer counterparty based on product and counterparty credit risk.

• *Commercial End User:* Could be required to post variation margin if determined appropriate by swap dealer counterparty based on product and counterparty credit risk.
### Margin Rules for Uncleared Swaps

<table>
<thead>
<tr>
<th>Swap Dealer</th>
<th>Collect IM from Swap Dealer?</th>
<th>Post IM to Swap Dealer?</th>
<th>Collect VM from Swap Dealer?</th>
<th>Post VM to Swap Dealer?</th>
</tr>
</thead>
<tbody>
<tr>
<td>FEU with MSE</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>FEU without MSE</td>
<td>No</td>
<td>Dealer’s determination</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Commercial-End Users</td>
<td>No</td>
<td>Dealer’s determination</td>
<td>No</td>
<td>Dealer’s determination</td>
</tr>
</tbody>
</table>

*Subject to a minimum transfer amount of $650,000 (the cumulative amount of initial and variation margin).

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### Margin Rules for Uncleared Swaps

- **Initial Margin Calculation**: Based on standardized table or dealer initial margin model approved by regulators. Varies based on asset class and swap tenor. Limited portfolio margining—requirement can be calculated on aggregate basis across all uncleared swap transactions for same asset class covered by same master netting agreement.

- **Initial Margin Threshold**: Initial margin required is equal to the amount calculated using either the table or approved model less any initial margin threshold. However, these thresholds cannot exceed $65 million on an aggregate basis across all affiliates.

- **Variation Margin Calculation**: No credit thresholds permitted. Limited portfolio margining--can be calculated on aggregate basis across all uncleared swap transactions covered by same master netting agreement.
Margin Rules for Uncleared Swaps

• **Eligible Collateral:**
  - *For Initial Margin:* Cash in USD or other “major currencies” identified in rule or non-cash collateral consisting of “high-quality liquid assets” identified in rule, subject to haircuts.
  - *For Variation Margin:* Cash in USD or in currency in which payment obligations are settled under the swap.

• **Third-Party Custody and Segregation:** Required for initial margin. No rehypothecation of initial margin will be permitted.

• **Affiliates:** No exclusion for swaps between affiliates.

• **Capital Requirements:** No additional capital requirements other than risk-based and leverage capital requirements that are already applicable to bank entities. Note that CFTC may still impose additional capital requirements on swap dealers.

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Margin Rules for Uncleared Swaps

• **Extraterritorial Treatment—Prudential Regulators:** Excludes “foreign uncleared swaps” of a “foreign covered swap entity.”
  - *Foreign Covered Swap Dealer:* A swap dealer that is not (i) organized under U.S. law, (ii) a branch of an entity organized under U.S. law, (iii) controlled directly or indirectly by an entity organized under U.S. law or (iv) guaranteed by an entity organized under U.S. law.
  - *Foreign Uncleared Swap:* An uncleared swap with a Foreign Covered Swap Dealer where its counterparty is not (i) organized under U.S. law, (ii) a branch of an entity organized under U.S. law, (iii) controlled directly or indirectly by an entity organized under U.S. law or (iv) guaranteed by an entity organized under U.S. law.

• **Extraterritorial Treatment—CFTC:** New proposal June 29, 2015.
CFTC Proposed Rule on Cross-Border Application of Margin

• Similar to Prudential Regulator approach.
• Applies to Covered Swap Entities (CSE)—
  – CFTC registered swap dealers and major swap participants that do not have a Prudential Regulator.
• Would apply to all uncleared swaps of a U.S. CSE.
• Substituted compliance only available with respect to initial margin posted by (but not collected from) non-U.S. persons whose obligations are not guaranteed by U.S. persons.

CFTC Proposed Rule on Cross-Border Application of Margin

• Applies to uncleared swaps non-U.S. CSE as follows:
  – If non-U.S. CSE’s swap obligations are guaranteed by U.S. person, CFTC margin requirements apply to same extent as U.S. CSE.
  – If non-U.S. CSE consolidates its financial statements with those of an ultimate U.S. parent, CFTC margin rules would apply to same extent as applicable to non-U.S. CSE whose obligations are not guaranteed or consolidated with a U.S. parent except that the non-U.S. CSE would not be eligible for the below exclusion.
  – If non-U.S. CSE’s swap obligations are not guaranteed by U.S. person and it does not consolidate its financial statements with those of its U.S. parent, and if its counterparty is neither a U.S. CSE or a non-U.S. CSE whose obligations are guaranteed by a U.S. person, substituted compliance would be available.
  – If non-U.S. CSE’s swap obligations are not guaranteed by U.S. person and it does not consolidate its financial statements with those of its U.S. parent, and if its counterparty is a U.S. CSE or a non-U.S. CSE whose obligations are guaranteed by a U.S. person, substituted compliance would be available only with respect to initial margin collected from the counterparty.
CFTC Proposed Rule on Cross-Border Application of Margin

• A U.S. branch of a foreign CSE is treated the same as a non-U.S. CSEs whose obligations are not guaranteed by a U.S. person but who consolidate its financial statements with those of a U.S. parent.

• Swaps between non-U.S. CSEs and non-U.S. persons are excluded (assuming no U.S. guarantee or consolidation with U.S. parent).

• Availability of substituted compliance subject to determination by CFTC as to foreign comparable margin requirements.

CFTC Proposed Rule on Cross-Border Application of Margin

• New U.S. person definition—
  i. Any natural person who is a resident of the United States;
  ii. Any estate of a decedent who was a resident of the United States at the time of death;
  iii. Any corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of entity similar to any of the foregoing (other than an entity described in subparagraph (iv) or (v)) (a legal entity), in each case that is organized or incorporated under the laws of the United States or having its principal place of business in the United States, including any branch of the legal entity;
  iv. Any pension plan for the employees, officers or principals of a legal entity described in subparagraph (iii), unless the pension plan is primarily for foreign employees of such entity;
  v. Any trust governed by the laws of a state or other jurisdiction in the United States, if a court within the United States is able to exercise primary supervision over the administration of the trust;
  vi. Any legal entity (other than a limited liability company, limited liability partnership or similar entity where all of the owners of the entity have limited liability) owned by one or more persons described in subparagraph (i), (ii), (iii), (iv) or (v) who bear(s) unlimited responsibility for the obligations and liabilities of the legal entity, including any branch of the legal entity; and
  vii. Any individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described in subparagraph (i), (ii), (iii), (iv), (v) or (vi).
Swap Execution Facilities (SEFs)

SEF – Main Concepts

- **SEF Registration**: Any person operating a facility that offers a trading system or platform in which more than one market participant has the ability to execute or trade swaps (required or permitted) with more than one other market participant on the system or platform.

- **Permitted execution methods for required transactions**: In the order book (including via cross-trade), through RFQ (in conjunction with the order book), or in a block trade.

- **Permitted execution methods for permitted transactions**: In the order book, through RFQ, in a block trade, or by any other means of interstate commerce, including by voice.

- **Minimum number of recipients of an RFQ**: Two initially, moved to three recipients beginning 14 months from the effective date of the Final SEF Rule, which was October 2, 2014.
SEF – Main Concepts

• SEF Access: The Final SEF Rule sets forth the SEF registration process, which includes a "temporary registration" stage. Temporary registration only requires an application be complete on its face and has not involved a substantive review of the application and the rulebook, which is part of the application.

SEF – Recent Issues

• The Staff reacted to the criticism that not all SEFs were allowing impartial access by issuing guidance reiterating that any criteria for an Eligible Contract Participant (ECP) to access a SEF must be "impartial, transparent, and applied in a fair and non-discriminatory matter" and expressly prohibited the use of "enablement mechanisms," which it defined as "any mechanism, scheme, functionality, counterparty filter, or other arrangement that prevents a market participant from interacting or trading with, or viewing the bids and offers (firm or indicative) displayed by, any other market participant on that SEF."
SEF – Recent Issues

• In addition, the guidance specifically stated that intermediated access (or "agency access"), which allows market participants to connect to SEFs indirectly through an agent, thereby avoiding signing up to multiple hundred-plus-page rulebooks, is a permissible means of accessing SEFs.

• Currently, the CFTC is looking at issues related to the "embargo rule" for work-ups and name give-up in pre- and post-trade situations.

Made Available to Trade

• Swaps that are subject to mandatory clearing may be submitted by a SEF or DCM to the CFTC to be deemed "made available to trade."

• Swaps that are "made available to trade" or "MAT" are subject to mandatory trading (also known as the "trade execution requirement").

• Swaps that are MAT must be executed on or pursuant to the rules of a DCM or SEF.
Reporting Swaps – U.S. and EMIR

Reporting Under EMIR

- Counterparties must ensure that the details of any derivative contract they have entered into and of any modification or termination of the contract are reported to a trade repository.
- The details must be reported no later than the working day following the execution, modification or termination of the contract.
- Unlike Dodd-Frank, both counterparties MUST report each trade unless by prior arrangement, one party has agreed to report on behalf of both counterparties.
- Either counterparty to the trade may delegate reporting to a third-party (such as a central counterparty or trading platform).
- Where one counterparty reports on behalf of another counterparty, or a third-party reports a contract on behalf of one or both counterparties, the details reported must include the full set of details that would have been reported had the contracts been reported by each counterparty separately.
Position Limits

• Position limits reproposed—
  – 28 physical exempt and agricultural commodity futures and option contracts as well as economically equivalent swaps
    • Examples of contracts: NYMEX light sweet crude oil, NYMEX NY Harbor ULSD (ultra low sulfur diesel), NYMEX RBOB Gasoline, NYMEX Henry Hub Natural Gas
    • Swaps are “economically equivalent” if linked to the price of the future or the price of the commodity at the delivery location
  – Position limits exist for spot month, single month, all months
  – Bona fide hedging exemptions exist
Position Aggregation

• Generally a person must aggregate all positions for which a person
  – Directly or indirectly **controls** trading; or
  – Holds a 10% or greater ownership or equity interest in an account holding a position; or
  – Has an express or implied agreement for trading; or
  – Controls trading strategies in accounts or pools with substantially identical trading strategies.

Position Aggregation

• Some exemptions available
  – Use of independent account controller (IAC) to manage positions
    • Person cannot exercise day-to-day control over trading or IAC
    • IAC must trade independently
    • IAC must be registered as FCM, IB, CTA or AP or be the GP of a pool where the CPO is exempt under 4.13
    • Does not apply to spot month limits in physical contracts
  – Pooled accounts
    • A pool participant does not have to aggregate pool positions in which there is a 10% or greater interest, unless it is the CPO of the pool or a principal/affiliate of the CPO or it holds 25% ownership of a pool where the CPO is exempt from registration as a CPO under 4.13
Position Aggregation

– Ownership or equity interest greater than 10% but not more than 50% of an entity
  • Cannot have knowledge of trading decisions; need independent trading systems; written procedures for information barriers; no sharing employees that control trading decisions; risk management systems cannot share information

– Ownership or equity interest greater than 50% of an entity
  • Very difficult exemption to utilize and subject to CFTC approval
  • Must certify to the CFTC that the entity is not and is not required to be consolidated; must satisfy all of the tests for a greater than 10% interest; must demonstrate to the CFTC that procedures are in place that are reasonably effective to prevent coordinated trading decisions; each representative on the board must certify that he or she does not control the entity; must certify that all positions are bona fide hedges or that speculative positions do not exceed 20% of any position; and must agree that the owned entity shall provide information to the CFTC upon call

Enforcement Update
Enhanced CFTC Enforcement Powers

- Anti-Disruptive Practices and Fraud → 7 USC §§ 6c(a)(5), 6o:
  - **Section 6c(a)(5):** Prohibits any trading, practice, or conduct on or subject to the rules of a registered entity satisfying any one of three criteria:
    - It violates bids or offers;
    - It involves an intentional or reckless disregard for the orderly execution of transactions during the closing period; or
    - It involves “spoofing” — bidding or offering with the intent to cancel the bid or offer pre-execution
  - **Section 6o:** Prohibits fraud by CTAs, CPOs, and associated persons, including:
    - Use of any device, scheme, or artifice to defraud a current or potential client; or
    - Any representation or implication by registered person that he or she is sponsored, recommended, or approved, or that any governmental entity has passed on his or her abilities or qualifications

Enhanced CFTC Enforcement Powers

- **Commodities Fraud → CFTC Regulation Rule 180.1 (17 C.F.R. § 180.1)**
- **Rule 10b-5 Model:** CFTC antifraud authority patterned Rule 10b-5; look to Rule 10b-5 jurisprudence. Post–Dodd Frank expanded authority for CFTC.
  - **Connection:** Must be “in connection with any swap, or contract of sale of any commodity, or contract for future delivery on or subject to the rules of any registered entity.”
    - Broader than Rule 10b-5, which is in connection with purchase/sale.
  - **Mental State:** Intentional or reckless
  - **Prohibits:**
    - Using or employing, or attempting to use or employ, any manipulative device, scheme, or artifice to defraud;
    - Making, or attempting to make, any untrue or misleading statement of a material fact or to omit to state a material fact necessary in order to make the statements made not untrue or misleading;
    - Engaging, or attempting to engage, in any act, practice, or course of business, that operates or would operate as a fraud or deceit upon any person.
    - **NOTE:** Covers “attempts,” unlike Rule 10b-5.
Enhanced CFTC Enforcement Powers

• Case Study – Spoofing/High Frequency Trading
  – Panther/Coscia: Owner of Panther Energy Trading, Michael Coscia, indicted on six counts of commodities fraud and six counts of “spoofing.”
    • The Scheme: Manipulated commodities futures prices using algorithmic trading program that submitted—then promptly cancelled—bids and offers before execution to create illusion of market interest. 98% of 400,000 large orders placed were cancelled. $1.6mm in profits in 2011 from trades in domestic/European markets.
    • Dodd-Frank: First case to use Dodd-Frank’s antimanipulation authority to charge spoofing in commodities context.
    • Penalties: Each count of commodities fraud → 25-year maximum sentence, $250,000 maximum fine. Each count of spoofing → 10 year maximum sentence, $1 million maximum fine.
  – CME Group: CME, a U.S. agricultural commodity futures and options exchange, imposed $800,000 fine; required Coscia to disgorge $1.3 million in profits.
  – CFTC: Settled spoofing action against Coscia → $2.8 million ($1.4 million civil penalty, $1.4 million disgorged profits). CFTC brought multiple civil actions in 2013 against suspected spoofer.

Enhanced CFTC Enforcement Powers

• Case Study – Spoofing/High-Frequency Trading (cont’d)
  – Evidence of stated desire by all authorities to develop precedent in this space
  – Case may be template for future actions:
    • Specialized criminal task force, working hand-in-hand with federal regulators and exchanges
    • Substantial reliance on trading records and other electronic information captured as part of trade activity
    • Review of algorithm code and intense scrutiny of manual trading behavior (“blink of an eye” test)
CFTC Enforcement Cases: Customer Collateral Rules

- Federal Court in New York Orders MF Global Holdings Ltd. to Pay $1.212 Billion in Restitution for Unlawful Use of Customer Funds and Imposes a $100 Million Penalty (Dec. 24, 2014)
- CFTC Orders Deutsche Bank Securities Inc. to Pay $3 Million to Settle Charges of Improper Investment of Customer Segregated Funds, Reporting and Recordkeeping Violations, and Supervision Failures (Dec. 22, 2014)
- CFTC Settles Action against Friedberg Mercantile Group, Inc., a Registered Futures Commission Merchant, for Secured Amount Deficiency, Commingling of Customer Funds and Failure to Timely Report Secured Amount Deficiency (Oct. 8, 2014)
- CFTC Orders Morgan Stanley Smith Barney LLC to Pay $490,000 to Settle Charges Relating to Rules and Regulations Pertaining to Segregated and Secured Amount Funds (March 27, 2014)
- CFTC Orders ADM Investor Services, Inc. to Pay a $425,000 Penalty for Unlawfully Commingling Customer Funds with Funds in Non-Customer Accounts (Sept. 30, 2013)
- CFTC Orders R.J. O’Brien & Associates LLC to Pay $125,000 for Violation of Customer Protection Regulation (Sept. 27, 2013)
- CFTC Orders Vision Financial Markets LLC to Pay a $525,000 Penalty for Violations of Customer Fund Segregation Requirements, Failure to Notify the CFTC of its Under-Segregation, and Misstatements to the CFTC (Sept. 27, 2013)
STRATEGIC PARTNERSHIP

COMMODITY POOL OPERATORS AND COMMODITY TRADING ADVISORS:

KEY REGISTRATION AND COMPLIANCE CONSIDERATIONS FOR FUND SPONSORS, MANAGERS, AND PERSONNEL
INTRODUCTION

In February 2012, the Commodity Futures Trading Commission (the “CFTC”) adopted final amendments to its rules governing commodity pool operators (“CPOs”) and commodity trading advisors (“CTAs”). Among other things, the CFTC determined to rescind Rule 4.13(a)(4) of its regulations, an exemption from CPO registration upon which many sponsors of private funds have relied. In addition, the CFTC amended Rule 4.5 of its regulations, the exclusion from CPO status for investment companies registered with the Securities and Exchange Commission (the “SEC”) under the Investment Company Act of 1940 (the “1940 Act”). The CFTC also determined to impose new reporting requirements for registered CPOs and CTAs.

In light of these developments, this outline highlights certain key considerations for fund sponsors and managers that are evaluating whether they are required to register as CPOs or CTAs or whether they qualify for an exemption from registration. The outline also addresses important ongoing requirements to which registered CPOs and CTAs are subject under the Commodity Exchange Act (the “CEA”) and the CFTC’s regulations adopted thereunder. In addition, the outline discusses key elements of the rules and bylaws of the National Futures Association (the “NFA”), the self-regulatory organization for CFTC-registered firms.

While we hope it proves helpful, this outline only speaks in very general terms about the registration and compliance requirements applicable to CPOs, CTAs, and their personnel. As a result, it omits many specific details that may be important to fund sponsors and managers considering these matters, including requirements that are specific to swap transactions under the CEA as amended by the Dodd-Frank Act.

Please note that this outline is not intended as legal advice and should not be relied upon as such. The contents of this outline are current as of the date set forth on the cover page.
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PART A
COMMODITY POOL OPERATORS AND THEIR PERSONNEL

I. Background Matters

“Commodity Interests” Definition. Neither the CEA nor the CFTC’s regulations provide an express definition of this term. Rather, it is a term used to capture all categories of products of the type that are subject to regulation under the CEA. In brief, the major categories of commodity interests include the following instruments: commodity futures, commodity options, security futures products, swaps, retail forex transactions, retail commodity transactions, and leverage transactions.

The Dodd-Frank Act amended the CEA to expand the CFTC’s jurisdiction to include swap contracts, and many provisions of the CEA and the CFTC’s regulations have been amended to include references to swaps. As a result, the term “commodity interests” includes swaps for several purposes under the CEA. (Special Note: The SEC has jurisdiction over security-based swaps, and the SEC and CFTC share jurisdiction over the limited category of mixed swaps.)

For further detail on these categories of commodity interests, please see Annex A.

“Commodity Pool” Definition. The term “commodity pool” refers to any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading commodity interests. Commodity pools can encompass a broad array of entities, including registered investment companies, hedge funds, other types of private investment funds, and certain securitization vehicles. Even a fund with a single investor can be considered a commodity pool, such as the wholly-owned subsidiary of a registered investment company or a private fund.

“Commodity Pool Operator” Definition. The term “commodity pool operator” includes any person engaged in a business that is in the nature of a commodity pool and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in commodity interests. The definition also includes any entity or person that registers with the CFTC as a CPO for whatever reason.

CPO Registration Requirements. Absent an available exemption, a firm that falls within the CPO definition must register as a CPO with the CFTC. The registration process is administered by the NFA. Certain firm personnel will fall within the definitions of “principal” and “associated person” and are also subject to registration or other filing requirements.

Certain exemptions from CPO registration are discussed in Part D of this outline.

II. Registration Requirements for Firms

General Considerations. A firm files for registration as a CPO by using the NFA Online Registration System (“ORS”). The ORS may be accessed at www.nfa.futures.org. In general, the registration process can take several weeks. The timing of registration for a firm should generally be coordinated with the individual registration and filing requirements for firm personnel discussed below in Part C.

Registration Requirements for Firms. In order to register with the NFA, a firm must take the following steps:

• Complete the online version of Form 7-R, the Firm Application;¹
• Submit a non-refundable application fee of $200; and
• Pay NFA-mandated CPO membership dues of $750. (Special Note: A CPO, like most other registrants under the CEA, is required to be a member of the NFA. Thus, being denied membership in the NFA or being subsequently disciplined by the NFA by being barred from membership is tantamount to being barred from acting as a CPO.)

As part of the registration process, CPOs are required to design and implement a program for complying with the rules and regulations of the CFTC and the NFA. Key topics that must be covered by a firm’s compliance program include:

• Ethics training for employees;
• Annual compliance reviews;
• Inspections of branch offices;³
• Registration of new employees; and
• Disaster recovery planning.

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

III. Annual Filing Requirements with the NFA

CPOs are required to provide an Annual Registration Update regarding their own registration and the registrations/filings with respect to their associated persons and principals. In addition to completing the Annual Registration Update, a registered CPO must complete an Annual Questionnaire. A registered CPO must also pay annual NFA membership dues of $750.

CPOs are required to complete the Annual Registration Update and the Annual Questionnaire in the ORS. The NFA typically sends a registered CPO a letter or email (for firms that have signed up for electronic notices) reminding the firm of its obligation to complete these steps.⁴

Further information on these requirements, as well as other annual obligations of registered CPOs, is available on the NFA website.⁵

¹ The Form 7-R template is available at http://www.nfalutures.org/NFA-registration/templates-and-forms/form7-r.HTML.
² A branch office is any location of a CPO at which a person carries out activities requiring registration as an associated person (i.e., solicitation of investors). For further information regarding branch offices and associated licensing and supervisory requirements, see http://www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=9002&Section=9.
³ For further information regarding these matters, see http://www.nfalutures.org/NFA-registration/registration-advisories/advisory-08-13-07.HTML.
⁴ For further information regarding these requirements, see http://www.nfalutures.org/nfa-compliance/NFA-commodity-pool-operators/annual-cpo-requirements.HTML.
⁵ For further information regarding these requirements, see http://www.nfalutures.org/nfa-compliance/NFA-commodity-pool-operators/annual-cpo-requirements.HTML.

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IV. Key Compliance Requirements for CPOs under Part 4 of the CFTC’s Regulations

The following discussion summarizes the principal disclosure, recordkeeping, and reporting requirements applicable to registered CPOs under Part 4 of the CFTC’s regulations. A registered CPO may be able to rely on certain relief from these requirements, as discussed later in this section.

**Disclosure Documents.** CFTC Rule 4.21 requires a registered CPO to deliver a Disclosure Document to a prospective fund investor no later than the time that the CPO delivers a subscription agreement to that prospective investor. CFTC Rules 4.24 and 4.25 specify the particular requirements for the content of Disclosure Documents. At a high level, those requirements include:

- Prominent and specifically worded cautionary statements and risk disclosure statements, some of which vary based on the types of commodity interests traded by a fund;
- A table of contents and identifying information for the CPO and the fund;
- The break-even point per unit of initial investment in the fund;
- Identities of (i) the principals of the CPO and each “major CTA,”6 (ii) trading managers, and (iii) each “major investee pool”7 and its CPO;
- Business background information for the CPO, the fund’s trading manager, each major CTA, the CPO of each major investee pool, and the principals of those firms;
- Information about the fund’s investment program and related risk factors;
- Fee, commission, and expense information for the fund;
- Disclosure of actual or potential conflicts of interest (e.g., with the CPO, the trading manager, a major CTA, etc.), related party transactions, and material litigation;
- Disclosure regarding trading for the account of the fund’s CPO, trading manager, CTAs, and the principals of those firms;
- Past performance disclosures;
- If applicable, disclosures specific to “principal-protected pools;”8
- Disclosure of any restrictions on the transferability of fund interests;
- Discussion of the potential liability of fund investors;
- Discussion of distribution of profits and taxation;
- Minimum and maximum aggregate subscription levels;
- Information regarding beneficial ownership of fund interests by interested persons (e.g., the CPO, the trading manager, major CTA, etc.); and
- Other material information.

If a firm is required by CFTC Rule 4.21 to prepare a Disclosure Document with respect to a pool, the Disclosure Document cannot be used until it is reviewed and accepted by the NFA. Registered CPOs must submit Disclosure Documents for review and acceptance by the NFA through the NFA’s electronic systems.

6. With respect to a pool, a “major commodity trading advisor” is any commodity trading advisor that is allocated or is intended to be allocated at least 10% of the pool’s funds available for commodity interest trading. See CFTC Rule 4.10(i).

7. With respect to a pool, a “major investee pool” is any investee pool that is allocated or intended to be allocated at least 10% of the net asset value of the pool. See CFTC Rule 4.10(d)(5).

8. A “principal-protected pool” is a pool (commonly referred to as a guaranteed pool) that is designed to limit the loss of the initial investment of its participants. See CFTC 4.10(d)(3).
Disclosure Document System. The NFA generally seeks to complete its review of a Disclosure Document within 14 days of receipt, although the process may take longer due to the complexity of the investment strategy or other features of the pool or offering, whether the review pertains to a new or updated Disclosure Document, the Disclosure Document size, the availability of NFA staff resources, and other factors.

The NFA will generally take less time to review a Disclosure Document if it is eligible for “instant filing” treatment. Under the NFA’s instant filing procedures, the NFA’s review will generally be completed within 3 business days if a previously-accepted Disclosure Document is on file, there have been no material changes to the Disclosure Document, and the member firm requests instant filing treatment.9

Generally speaking, a Disclosure Document must be updated at least every 9 months if a firm is continuing to use the Document to solicit new investors in the related pool. However, a Disclosure Document must be updated more frequently to reflect material changes in information that must be disclosed.

The NFA has published a Disclosure Document Guide for its member firms, which addresses the required disclosures and the filing and review process in further detail.10

Account Statements and Annual Reports. CFTC Rule 4.22 requires a registered CPO to prepare and disseminate to fund investors an Account Statement, which must be presented in the form of a Statement of Operations and a Statement of Changes in Net Assets. In most cases, the Account Statement must be disseminated monthly, although CPOs may prepare Account Statements on a quarterly basis for investors in a fund with assets of $500,000 or less. In any case, the Account Statement must be distributed within 30 days after the end of the reporting period.

In addition, Rule 4.22 requires a registered CPO to prepare and disseminate to fund investors an Annual Report with respect to the funds it operates. A registered CPO must also file Annual Reports and certain key financial balances from the Annual Reports with the NFA. The fund’s financial statements must generally be prepared in accordance with U.S. GAAP, although they may be prepared under IFRS in specified cases.11 The financial statements must also be audited by an independent public accountant. A registered CPO must disseminate and file the Annual Report within 90 days after the end of the fund’s fiscal year, absent a substantial hardship and upon applying for an appropriate extension with the NFA.12

Account Statements and Annual Reports must contain an oath or affirmation as to their accuracy and completeness, which are provided on the basis of the best knowledge and belief of the individual making the oath or affirmation.

The specific details regarding the information to be provided in Account Statements and the Annual Reports are further described in Rule 4.22.


11. A fund’s financial statements may be prepared in accordance with IFRS for this purpose if: (i) the fund is organized under the laws of a non-U.S. jurisdiction; (ii) the annual report includes a condensed schedule of investments (or, if required by the alternate accounting standards, a full schedule of investments); (iii) preparation of the fund’s financial statements under IFRS is not inconsistent with any representations in its offering memorandum or other operative document made available to fund investors; and (iv) special allocations of ownership equity will be reported as specified in CFTC Rule 4.22(e)(2). A CPO would be required to file a notice with the NFA claiming eligibility for relief from the requirement to prepare annual report financial statements in accordance with U.S. GAAP. See CFTC Rule 4.22(d)(2).

12. See CFTC Rule 4.22(f).
**Recordkeeping.** CFTC Rule 4.23 imposes recordkeeping requirements on registered CPOs, both with respect to its funds and the CPO itself. In particular, with respect to its funds, Rule 4.23(a) requires a registered CPO to maintain:

- Itemized daily records of the fund’s commodity interest transactions;
- Original journal entries or equivalent records showing all receipts and disbursements;
- Acknowledgements from fund investors of receipt of disclosure documents under CFTC Rule 4.21;  
- A subsidiary ledger or equivalent record for each fund investor containing identifying information and other information concerning securities and other property that the fund received from or distributed to the investor;
- Adjusting entries and any other equivalent records forming the basis of entries in any ledger;
- A general ledger or equivalent record detailing all asset, liability, capital, income, and expense accounts;
- Trade confirmations, purchase and sale statements, and monthly statements received from futures brokers and retail foreign exchange dealers;
- Cancelled checks, bank statements, journals, ledgers, invoices, computer generated records, and all other records, data, and memoranda prepared or received in connection with operating the fund;
- Originals or copies of written reports, communications, and advertising (including written transcriptions of standardized oral presentations and mass media presentations) distributed to existing or prospective investors, as well as any such materials the CPO received from any CTA;
- A statement of financial condition for the fund as of the close of each month (if the fund had net assets of less than $500,000, the report would be quarterly);
- A statement of income (loss) for the fund for a specified period; and
- Manually signed copies of Account Statements and Annual Reports, and records of the key financial balances submitted to the NFA for each Annual Report.

As to the CPO itself, Rule 4.23(b) requires a registered CPO to keep itemized daily records of each commodity interest transaction by the CPO and its principals, as well as confirmations, purchase and sale statements, and monthly statements furnished by futures brokers and retail foreign exchange dealers to the CPO or to its principals. The Rule also requires a registered CPO to keep books and records of transactions in all other activities in which the CPO engages (e.g., cancelled checks, bank statements, journals, ledgers, invoices, computer generated records, etc.).

**CFTC Rule 1.35 — Records with Respect to On-Facility and Related Commodity Interest Transactions.** CPOs are also subject to comprehensive recordkeeping requirements under CFTC Rule 1.35 in connection with transactions executed on contract markets and swap execution facilities, as well as related cash market transactions. Rule 1.35 includes a requirement to keep records of certain oral communications, which has sparked some controversy. However, this requirement does not apply to CPOs.

13. The CFTC has adopted additional recordkeeping requirements that apply specifically to swaps. See CFTC Rules 45.2 and 46.2. Firms may wish to consider these requirements in the context of other applicable recordkeeping obligations, whether under Part 4 of the CFTC’s regulations, the federal securities laws, or otherwise.

14. See CFTC Rule 1.35(a)(1)(iv). Rule 1.35 also includes a general requirement for an account manager to have been granted written investment discretion by a client (pool or other account) to participate in post-execution allocations of commodity interest transactions, whether effected bi-laterally or on a contract market or an exchange. See CFTC Rule 1.35(b)(5)(i)-(ii).
CFTC Rule 4.7 — Relief Available under the “CFTC Lite” Regime. A registered CPO may be able to rely on the “CFTC Lite” regime under Rule 4.7, which substantially reduces the disclosure, recordkeeping, and reporting requirements that, as discussed above, would otherwise apply under Rules 4.21 through 4.25. The CFTC Lite regime is available with respect to a fund in which each investor is a “qualified eligible person” and the offering of interests therein is exempt from registration under the Securities Act of 1933 (the “1933 Act”). The definition of “qualified eligible person” is rather lengthy, but notably includes “qualified purchasers” and “knowledgeable employees” as those concepts are defined for purposes of the 1940 Act. Accordingly, the CFTC Lite regime may be available to sponsors of funds that rely on the Section 3(c)(7) exception to the “investment company” definition contained in the 1940 Act.

The “qualified eligible person” definition also includes the term “non-United States person.” A registered CPO would need to file a notice of exemption with the NFA in connection with relying on the CFTC Lite regime.

The CFTC staff also permits a CPO to submit a consolidated annual report for both a private fund and a wholly-owned subsidiary upon filing a no-action request that makes certain undertakings, as specified in a recent staff letter.

Alternative Relief for CPOs of Certain Non-U.S. Funds. Firms registered as CPOs may also be able to avail themselves of other relief from disclosure, recordkeeping, and reporting requirements under an applicable CFTC staff interpretation.

In order to rely on this relief, a firm registered as a CPO must satisfy the following criteria:

- Each pool the CPO operates remains organized and operated outside of the United States;
- Each pool will not hold meetings or conduct administrative activities within the United States;
- No shareholder of or other investor in a pool is or will be a U.S. person;

For further information on requirements with respect to allocations, including recordkeeping obligations, see generally CFTC Rule 1.35(b).

15. Certain filings must be made if a CPO relying on Rule 4.7 elects not to maintain books and records at its main business office. See CFTC Rule 4.7(b)(4)-(5).

16. Rule 4.7(b) provides that a commodity pool for which a CPO relies on CFTC Lite must be offered in a manner that qualifies for the exemption from registration provided by Section 4(a)(2) of the 1933 Act (i.e., a private share offering). There is language in Rule 4.7(b) that may raise a question as to whether such a pool could offer shares by means of general solicitation permitted under Rule 506(c) of SEC Regulation D, as amended pursuant to the JOBS Act. However, the CFTC staff has issued an exemption that is intended to enable CPOs relying on CFTC Lite to offer commodity pools by means of general solicitation as permitted under Regulation D. See CFTC Letter 14-116 (Sept. 9, 2014).

17. Generally speaking, a “qualified purchaser” is an individual or family-owned company that owns at least $5 million in investments or institutional purchaser or other company that in the aggregate owns and invests at least $25 million in investments. See Section 2(a)(51) of the 1940 Act. A “knowledgeable employee” is generally considered to be any individual closely involved in the management of the fund or similar operations, but excludes an employee performing solely clerical, secretarial, or administrative functions. See Rule 3c-5 under the 1940 Act.

18. It is possible that an “accredited investor” — as that term is defined for purposes of Regulation D under the 1933 Act — could count as a “qualified eligible person” for purposes of Rule 4.7. However, accredited investors would have to satisfy the portfolio requirement specified in the Rule (i.e., ownership of securities or other investments with an aggregate market value of at least $2 million, at least $200,000 in initial margin and option premiums on deposit with a futures commission merchant, or a combination of investments and margin/premium satisfying the requirements of the Rule).

19. In general, a “non-United States person” is a natural person who is not a resident of the United States or a partnership, corporation or other business entity, organized under the laws of a non-U.S. jurisdiction and which has its principal place of business in a non-U.S. jurisdiction. See CFTC Rule 4.7(a)(1)(iv).


Each pool will not receive, hold, or invest any capital directly or indirectly contributed from sources within the United States; and

The CPO, the pool, and any person affiliated therewith will not undertake any marketing activity for the purpose, or that could reasonably be expected to have the effect, of soliciting participation from U.S. persons.

A CPO must notify the CFTC and the NFA that it is claiming this relief.

CFTC Rule 4.12 — Relief Available for CPOs of Registered Investment Companies; No-Action Relief for Wholly-Owned Subsidiaries. In 2013, the CFTC finalized rule amendments that adopt a “substituted compliance” approach available to the CPO of a commodity pool that is a registered investment company. In essence, these amendments allow a CPO to follow rules applicable to registered investment companies under the federal securities laws and related SEC regulations as a means of addressing requirements that would otherwise apply under the CFTC’s Part 4 regulations. This relief requires certain filings to be made with the NFA.

The CFTC staff also permits a CPO to submit a consolidated annual report for both a registered investment company and a wholly-owned subsidiary upon filing a no-action request that makes certain undertakings, as specified in a recent staff letter.22

The table provided in Annex B summarizes this “substituted compliance” approach and the related no-action relief. The table also identifies the filings with the NFA that a CPO must make in order to rely on this relief.

CFTC Rule 4.12 — Reduced Reporting Obligations for CPOs of Securities Funds. A registered CPO engaged primarily in securities transactions but that uses commodity futures only to a limited extent may rely on Rule 4.12 with respect to a fund in order to omit information that Rule 4.21 would otherwise require to appear in the fund’s Disclosure Document. In addition, the firm would be able to distribute Account Statements to the fund’s investors quarterly rather than monthly. Rule 4.12 also relaxes certain other reporting obligations.23

In order for a CPO to be eligible to rely on Rule 4.12, it must satisfy the following conditions:

- Interests in the fund must be offered pursuant to an effective 1933 Act registration statement or an exemption from 1933 Act registration;
- The fund must engage generally and routinely in the buying and selling of securities and securities-derived instruments;
- The fund must not enter into transactions in commodity interests for which the aggregate initial margin and premiums exceed 10% of the fair market value of the fund’s assets, after taking into account unrealized profits and unrealized losses on any such contracts it has entered into; and
- The commodity interests held by the fund must be traded in a manner that is “solely incidental” to its securities trading activities.

In addition, a CPO relying on Rule 4.12 would be required to inform existing and prospective investors in writing that the pool will comply with the 10% and “solely incidental” limits described above before the date on which the fund begins trading commodity interests.

A CPO seeking to rely on Rule 4.12 must file a claim of exemption with the NFA that makes certain representations as to how the CPO will operate each fund for which the exemption is sought.

23. See CFTC Rule 4.12(b).
Reporting on Form CPO-PQR. CFTC Rule 4.27 requires registered CPOs to file information on Form CPO-PQR. A substantially similar requirement also applies under NFA Compliance Rule 2-46. This Form mirrors the reporting that SEC-registered investment advisers must make on Form PF with respect to their private fund clients. Form CPO-PQR is divided into three Schedules (A, B, and C), which reflect a tiered system of disclosure based on the size of the firm and, in some respects, the pools it operates:

- **Schedule A** requests basic information about a CPO, its assets under management, the pools managed by the CPO, certain service providers to those pools, monthly rates of return, and subscription and redemption activity. Each registered CPO must file Schedule A, regardless of the amount of its assets under management.

- **Schedule B** requests detailed information about commodity pools managed by “mid-sized CPOs” and “large CPOs.” Generally speaking, Schedule B requires those CPOs to report information about pool strategies, borrowings and types of creditors, counterparty credit exposure, pool trading and clearance mechanisms, aggregate derivatives positions, and pool investments. (Special Note: Schedule B includes a schedule of investments. Under the NFA Rule 2-46, however, a CPO must file a schedule of investments in all cases when reporting on Form CPO-PQR)

- **Schedule C** requests additional detailed pool information from large CPOs. Schedule C requires those CPOs to provide a geographic breakdown of pool investments and the turnover rate of aggregate pool portfolios. In addition, with respect to “large pools,” large CPOs must report counterparty credit exposure, risk metrics, borrowing information, derivative positions and posted collateral, financing liquidity, and investor information.

The NFA requires filing of these reports on a quarterly basis.

The table provided in Annex C provides a summary of the CPO-PQR reporting requirements applicable to CPOs.

The CFTC has sought to avoid mandating duplicate reporting by CPOs that are also registered as investment advisers with the SEC. Accordingly, the CFTC has explained that, under Rule 4.27, a dual-registered CPO will be permitted to satisfy the requirement to report information on Schedules B and C of Form CPO-PQR by filing Form PF with the SEC. In addition, the CFTC staff will permit a CPO to provide a consolidated report on Form CPO-PQR for a parent-level commodity pool and its wholly-owned subsidiary, upon filing a claim of no-action relief to do so.27

24. According to the instructions for Form CPO-PQR, a “mid-sized CPO” is any CPO that had at least $150 million in aggregated pool assets under management as of the close of business on any day during the “reporting period.” For a mid-sized CPO, the “reporting period” is the calendar year end.

25. The instructions for Form CPO-PQR provide that a “large CPO” is any CPO that had at least $1.5 billion in aggregated pool assets under management as of the close of business on any day during the reporting period. For a large CPO, the “reporting period” is any individual calendar quarter ending March 31, June 30, September 30, or December 31.

26. The Form CPO-PQR instructions define “large pool” as any pool with a net asset value (individually or in combination with any “parallel pool structure”) of at least $500 million as of the close of business on any day during the reporting period. A “parallel pool structure” is any structure in which one or more pools pursues substantially the same investment objective and strategy and invests side-by-side in substantially the same assets as another pool.

27. See CFTC Letter Nos. 13-51 (Sept. 5, 2013) (available to CPOs of registered investment company commodity pools) & 14-112 (Sept. 8, 2014) (available to CPOs of private commodity pools). Separate relief may be required if a wholly-owned subsidiary has a different CPO than its parent-level commodity pool.
V. Annual Compliance Self-Examination

CPOs are required to review their operations each year in light of the topics covered in the NFA’s then-current Self-Examination Questionnaire. The Questionnaire includes points that are applicable to all NFA member firms and a supplement that contains questions specific to CPOs. The Questionnaire also includes appendices that address specific compliance topics (i.e., anti-money laundering, business continuity and disaster recovery, ethics training, and privacy). In essence, the Questionnaire requires a firm to assess its compliance with applicable requirements under both the CEA and the NFA’s own rules. An appropriate representative of a CPO must sign the Questionnaire and attest that, in light of the matters covered by the Questionnaire, the firm’s current procedures are adequate to meet its supervisory responsibilities. Copies of these signed Questionnaires must be kept as part of a firm’s records and, for the first two years, the copies must be kept in an easily accessible place. Member firms are required to provide their completed Questionnaires to the NFA for inspection upon request.

28. See NFA Compliance Rule 2-9; NFA Interpretive Notice 9020 (rev. Apr. 8, 2011).

29. For a copy of the current Self-Examination Questionnaire and for other related information, see http://www.nfa.futures.org/NFA-compliance/publication-library/self-exam-questionnaire.HTML.
PART B
COMMODITY TRADING ADVISORS AND THEIR PERSONNEL

I. Background Matters

"Commodity Interests" Definition. Neither the CEA nor the CFTC’s regulations provide an express definition of this term. Rather, it is a term used to capture all categories of products of the type that are subject to regulation under the CEA. In brief, the major categories of commodity interests include the following instruments: commodity futures, commodity options, security futures products, swaps, retail forex transactions, retail commodity transactions, and leverage transactions.

The Dodd-Frank Act amended the CEA to expand the CFTC’s jurisdiction to include swap contracts, and many provisions of the CEA and the CFTC’s regulations have been amended to include references to swaps.\(^{30}\) As a result, the term “commodity interests” includes swaps for several purposes under the CEA. (Special Note: The SEC has jurisdiction over security-based swaps, and the SEC and CFTC share jurisdiction over the limited category of mixed swaps.)

For further detail on these categories of commodity interests, please see Annex A.

"Commodity Trading Advisor” Definition. The term “commodity trading advisor” includes any person who, for compensation or profit, engages in the business of advising others, either directly or through publications, writings or electronic media, as to the value of or the advisability of trading in commodity interests. The term also includes any person who, for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning commodity interests. The definition also includes any entity or person that is otherwise registered with the CFTC as a CTA for whatever reason.

The definition of “commodity trading advisor” expressly excludes the following persons, provided that the rendering of commodity trading advice is “solely incidental” to the conduct of their business or profession: (i) any bank or trust company or any person acting as an employee thereof; (ii) any news reporter, news columnist, or news editor of the print or electronic media, or any lawyer, accountant, or teacher; (iii) any floor broker or futures broker, (iv) the publisher or producer of any print or electronic data of general and regular dissemination, including its employees; (v) the named fiduciary, or trustee, of any defined benefit plan which is subject to ERISA or any fiduciary whose sole business is to advise that plan; (vi) any contract market or derivatives transaction execution facility, and (vii) such other persons not within the intent of this definition as the CFTC may specify by rule.

CTA Registration Requirements. Absent an available exemption, a firm that falls within the CTA definition must register as a CTA with the CFTC. The registration process is administered by the NFA. Certain firm personnel will fall within the definitions of “principal” and “associated person” and will also be subject to registration or filing requirements.

Certain exemptions from CTA registration are discussed in Part D of this outline.

II. Registration Requirements for Firms

General Considerations. A firm files for registration as a CTA by using the ORS. The ORS may be accessed at www.nfa.futures.org. In general, the registration process can take several weeks. The timing of registration for a firm should generally be coordinated with the individual registration and filing requirements for firm personnel discussed below in Part C.

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Registration Requirements for Firms. In order to register with the NFA, a firm must take the following steps:

- Complete the online version of Form 7-R, the Firm Application; 31
- Submit a non-refundable application fee of $200; and
- Pay NFA-mandated CTA membership dues of $750. (Special Note: CTAs, like CPOs, are required to be members of NFA and so, similarly, if someone is denied membership or later disciplined by the NFA by being barred from membership, that person cannot act as a CL4)

As part of the registration process, CTAs are required to design and implement a program for complying with the rules and regulations of the CFTC and the NFA. Key topics that must be covered by a firm’s compliance program include:

- Ethics training for employees;
- Annual compliance reviews;
- Inspections of branch offices; 32
- Registration of new employees; and
- Disaster recovery planning.

In addition, firms typically include in their compliance manuals procedures for complying with other CFTC/NFA requirements, including notably the disclosure, reporting, and recordkeeping requirements relating to commodity pools found in Part 4 of the CFTC’s regulations. We discuss those requirements below. Firms that are registered with the SEC as investment advisers may be able to incorporate these separate procedures in their existing manuals.

III. Annual Filing Requirements with the NFA

CTAs are required to provide an Annual Registration Update regarding their own registration and the registrations/filings with respect to their associated persons and principals. In addition to completing the Annual Registration Update, a registered CTA must complete an Annual Questionnaire. A registered CTA must also pay annual NFA membership dues of $750.

CTAs are required to complete the Annual Registration Update and the Annual Questionnaire in the ORS. The NFA typically sends a registered CTA a letter or email (for firms that have signed up for electronic notices) reminding the firm of its obligation to complete these steps. 33

Further information on these requirements, as well as other annual obligations of registered CTAs, is available on the NFA website. 34

31. The Form 7-R template is available at http://www.nfalutures.org/NFA-registration/templates-and-forms/form7-r.HTML.
32. A branch office is any location of a CTA at which a person carries out activities requiring registration as an associated person (i.e., solicitation of clients). For further information regarding branch offices and associated licensing and supervisory requirements, see http://www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=9002&Section=9.
33. For further information regarding these matters, see http://www.nfa.futures.org/NFA-registration/registration-advisories/advisory-0 8-1 3 -07.HTML.
34. For further information on these requirements, see http://www.nfa.futures.org/NFA-compliance/NFA-commodity-trading-advisors/annual-cta-requirements.HTML.

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IV. Key Compliance Requirements for CTAs under Part 4 of the CFTC’s Regulations

The following discussion summarizes the principal disclosure, recordkeeping, and reporting requirements applicable to registered CTAs under Part 4 of the CFTC’s regulations. A registered CTA may be able to rely on certain relief from these requirements, as discussed later in this section.

**Disclosure Documents.** CFTC Rule 4.31 requires a registered CTA to deliver a Disclosure Document to a prospective client no later than the time that the CTA delivers to the prospective client an advisory agreement to direct or guide the client’s account. CFTC Rules 4.34 and 4.35 specify the particular requirements for the content of Disclosure Documents. At a high level, those requirements include:

- Prominent and specifically worded cautionary statements and risk disclosure statements, some of which vary based on the trading program and investments pursued by the CTA;
- A table of contents and identifying information for the CTA;
- Identities of the CTA’s principals, the relevant futures broker and/or retail foreign exchange dealer, and the introducing broker through which the client may introduce its account;
- Business background information for the CTA and its principals;
- Information about the trading program and related risk factors;
- Fees the CTA will charge the client;
- Disclosure of actual or potential conflicts of interest (with the CTA, any relevant futures broker and/or retail foreign exchange dealer, any introducing agent, and any principal of the foregoing) and material litigation;
- Disclosure regarding trading for the account of the CTA and its principals;
- Past performance disclosures; and
- Other material information.

If a firm is required by CFTC Rule 4.31 to prepare a Disclosure Document, the Disclosure Document cannot be used until it is reviewed and accepted by the NFA. Registered CTAs must submit Disclosure Documents for review and acceptance by the NFA through the NFA’s electronic Disclosure Document System. The NFA generally seeks to complete its review of a Disclosure Document within 14 days of receipt, although the process may take longer due to the complexity of the investment program, whether the review pertains to a new or updated Disclosure Document, the Disclosure Document size, the availability of NFA staff resources, and other factors.

The NFA will generally take less time to review a Disclosure Document if it is eligible for “instant filing” treatment. Under the NFA’s instant filing procedures, the NFA’s review will generally be completed within 3 business days if a previously-accepted Disclosure Document is on file, there have been no material changes to the Disclosure Document, and the member firm requests instant filing treatment. 35

Generally speaking, a Disclosure Document must be updated at least every 9 months if a firm is continuing to use the Document to solicit new clients. However, a Disclosure Document must be updated more frequently to reflect material changes in information that must be disclosed.

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35. The NFA’s procedures for instant filing treatment are described at http://www.cftc.gov/tm/tminstant.htm.
The NFA has published a Disclosure Document Guide for its member firms, which addresses the required disclosures and the filing and review process in further detail.36

**Recordkeeping.** CFTC Rule 4.33 imposes recordkeeping requirements on registered CTAs, both with respect to the clients and subscribers of the CTA and the CTA itself. In particular, with respect to its clients and subscribers, Rule 4.33(a) requires a registered CTA to maintain:

- The name and address of each client and each subscriber;
- Acknowledgements from clients of receipt of disclosure documents under CFTC Rule 4.31;
- All powers of attorney and other documents authorizing the CTA to direct the commodity interest account of each client and each subscriber;
- All other written agreements entered into by the CTA with each client and each subscriber;
- A list or record of all commodity interest accounts of clients directed by the CTA and of all transactions effected for such accounts;
- Confirmations of commodity interest transactions, purchase and sale statements, and monthly statements received from futures brokers and retail foreign exchange dealers; and
- Reports, letters, circulars, memoranda, publications, writings, advertisements and other literature or advice distributed or caused to be distributed by the CTA to existing and prospective clients and subscribers.

As to the CTA itself, Rule 4.33(b) requires a registered CTA to keep itemized daily records of each commodity interest transaction by the CTA, as well as confirmations, purchase and sale statements, and monthly statements furnished by futures brokers and retail foreign exchange dealers to the CTA or to its principals. The Rule also requires a registered CTA to keep books and records of transactions in all other activities in which the CTA and its principals engage.37

**Rule 1.35 — Records with Respect to On-Facility and Related Commodity Interest Transactions.** CTAs are also subject to comprehensive recordkeeping requirements under CFTC Rule 1.35 in connection with transactions executed on contract markets and swap execution facilities, as well as related cash market transactions. Rule 1.35 includes a requirement to keep records of certain oral communications, which has sparked some controversy. This requirement applies to CTAs, although the CFTC staff has issued no-action relief that is scheduled to expire on December 31, 2014.38

Rule 1.35 also includes a general requirement for an account manager to have been granted written investment discretion by a client (pool or other account) to participate in post-execution allocations of commodity interest transactions, whether effected bi-laterally or on a contract market or an exchange.39

**CFTC Rule 4.7 — Relief Available under the “CFTC Lite” Regime.** A registered CTA may be able to rely on the “CFTC Lite” regime under Rule 4.7, which substantially reduces the disclosure and recordkeeping requirements discussed above. The CFTC Lite Regime is available with respect to the commodity interest accounts of qualified eligible persons who have given due consent to their account being an exempt account under Rule 4.7. (Special Note: As a practical matter, the “due consent”

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37. The CFTC has adopted additional recordkeeping requirements that apply specifically to swaps. See CFTC Rules 45.2 and 46.2. Firms may wish to consider these requirements in the context of other applicable recordkeeping obligations, whether under Part 4 of the CFTC’s regulations, the federal securities laws, or otherwise.


39. See CFTC Rule 1.35(b)(5)(i)-(ii). For further information on requirements with respect to allocations, including recordkeeping obligations, see generally CFTC Rule 1.35(b).
requirement can be addressed through appropriate language in an advisory agreement or in other account documentation.)

The definition of “qualified eligible person” is rather lengthy, but notably includes “qualified purchasers” and “knowledgeable employees” as those concepts are defined for purposes of the 1940 Act. The “qualified eligible person” definition also includes the term “non-United States person.” A registered CTA would need to file a notice of exemption with the NFA in connection with relying on the CFTC Lite regime.

**Reporting on Form CTA-PR.** CFTC Rule 4.27 requires registered CTAs to file information on Form CTA-PR. A substantially similar requirement also applies under NFA Compliance Rule 2-46. Form CTA-PR requires a CTA to report basic identifying information, the total assets and total pool assets directed by the CTA, the names of the pools the CTA advises, and the name of the CPO that is reporting information for each identified pool. CTAs are required to complete Form CTA-PR annually and to submit the Form to the NFA, even if the CTA is also registered with the SEC and reporting on Form PF.

A CTA must file its Form CTA-PR within 45 days of the end of each calendar quarter. The table provided in Annex C provides a summary of the CTA-PR reporting requirement applicable to CTAs.

V. **Annual Compliance Self-Examination**

CTAs are required to review their operations each year in light of the topics covered in the NFA’s then-current Self-Examination Questionnaire. The Questionnaire includes points that are applicable to all NFA member firms and a supplement that contains questions specific to CTAs. The Questionnaire also includes appendices that address specific compliance topics (i.e., anti-money laundering, business continuity and disaster recovery, ethics training, and privacy). In essence, the Questionnaire requires a firm to assess its compliance with applicable requirements under both the CEA and the NFA’s own rules. An appropriate representative of a CTA must sign the Questionnaire and attest that, in light of the matters covered by the Questionnaire, the firm’s current procedures are adequate to meet its supervisory responsibilities. Copies of these signed Questionnaires must be kept as part of a firm’s records and, for the first two years, the copies must be kept in an easily accessible place. Member firms are required to provide their completed Questionnaires to the NFA for inspection upon request.

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40. Generally speaking, a “qualified purchaser” is an individual or family-owned company that owns at least $5 million in investments or institutional purchaser or other company that in the aggregate owns and invests at least $25 million in investments. See Section 2(a)(51) of the 1940 Act. A “knowledgeable employee” is generally considered to be any individual closely involved in the management of the fund or similar operations, but excludes an employee performing solely clerical, secretarial, or administrative functions. See Rule 3c-5 under the 1940 Act.

41. In general, a “non-United States person” is a natural person who is not a resident of the United States or a partnership, corporation or other business entity, organized under the laws of a non-U.S. jurisdiction and which has its principal place of business in a non-U.S. jurisdiction. See CFTC Rule 4.7(a)(1)(iv).

42. See NFA Compliance Rule 2-9; NFA Interpretive Notice 9020 (rev. Apr. 8, 2011).

43. For a copy of the Self-Examination Questionnaire and for other related information, see http://www.nfa.futures.org/NFA-compliance/publication-library/self-exam-questionnaire.HTML.
PART C
REGISTRATION AND FILING REQUIREMENTS FOR PRINCIPALS AND ASSOCIATED PERSONS

This Part of the outline discusses in general terms the application and licensing requirements applicable to personnel of registered CPOs and CTAs. Personnel fall into two general categories — principals and associated persons. Of course, it is often the case that a person may be both a principal and an associated person.

I. Principal Status.

Definition of Principal. NFA Registration Rule 101 defines the term “principal” in relevant part as:

(1) an individual who is:
   (A) a proprietor of a firm that is a sole proprietorship;
   (B) a general partner of a firm organized as a partnership;
   (C) a director, president, chief executive officer, chief operating officer, chief financial officer, or chief compliance officer of a corporation, or a person in charge of a business unit, division or function subject to regulation by the CFTC (e.g., business units involved in trading commodity interests); or
   (D) a director, the president, chief executive officer, chief operating officer, chief financial officer, chief compliance officer, manager, or managing member of a limited liability company or limited liability partnership or those members of a limited liability company or limited liability partnership vested with the management authority for the entity, and any person in charge of a principal business unit, division or function subject to regulation by the CFTC; or

(2) an individual who directly or indirectly, through agreement, holding companies, nominees, trusts or otherwise:
   (A) is the owner of 10% or more of the outstanding shares of any class of a firm’s voting stock;
   (B) is entitled to vote 10% or more of any class of a firm’s voting securities;
   (C) has the power to sell or direct the sale of 10% or more of any class of a firm’s voting securities;
   (D) has contributed 10% or more of a firm’s capital;
   (E) is entitled to receive 10% or more of a firm’s net profits; or
   (F) has the power to exercise a controlling influence over a firm’s activities that are subject to regulation by the CFTC. 44

An individual’s status as a principal is determined by his ability to control the entity’s business activities, his formal title or position with the entity, or his financial or ownership interest in the entity. An individual who, through his conduct or activity, directly or indirectly controls an entity is a principal, regardless of his formal title or financial interest in the entity. An individual who holds a specific position or has a specific title is also a principal, regardless of his ability to control the entity’s business.

44. See CFTC Rule 3.1(a).
The definition of “principal” also includes certain entities. Further information on principal status, including examples of personnel and entities who may be required to register as principals, is available on the NFA website.45

**Principal Filing Requirements.** Firm personnel who fall within the definition of “principal” must complete the following steps in connection with their firm registering as a CPO or a CTA:46

- Complete online Form 8-R, the Individual Application;47
- Submit fingerprint cards;
- Complete the verification of the person’s Form 8-R; and
- Pay a non-refundable application fee of $85.00.

A person need not pay the application fee if he is registered with the CFTC/NFA in any capacity or is listed as a principal of a current CFTC registrant.

II. **Associated Person Status.**

**Definition of Associated Person.** An individual will be considered an “associated person” of a CPO or a CTA if that person is associated with the firm in any capacity as a partner, officer, employee, consultant, or agent (or who has a similar status or performs similar functions), and is involved in the solicitation of funds, securities, or property for a participation in a commodity pool. In addition, a person will be considered an associated person if he supervises any person engaged in those solicitations.48 In this regard, the NFA has indicated that the “associated person” designation generally applies to any person in the “supervisory chain-of-command” and not just the direct supervisor of a person soliciting funds, securities, or property.49

**Associated Person Registration Process.** Firm personnel who fall within the definition of “associated person” must register with the NFA by completing the following steps:50

- Complete online Form 8-R, the Individual Application;
- Submit fingerprint cards;
- Satisfy the NFA’s Proficiency Requirements (described below);
- Complete the verification of the person’s Form 8-R; and
- Pay a non-refundable application fee of $85.00.

A person need not pay the application fee if he is registered with the CFTC/NFA in any capacity or is listed as a principal of a current CFTC registrant.

The CFTC’s regulations contain certain exemptions from the registration requirement for associated persons.51 A firm should consider those exemptions in evaluating whether certain of its personnel who

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46. Technically speaking, “principal” is not a separate class of persons required to register with the NFA. Nonetheless, people falling within that definition are subject to certain NFA requirements.
48. See CFTC Rule 1.3(aa)(3).
50. Unlike “principal” status, “associated person” is a separate class of persons who must register with the CFTC.
51. See generally CFTC Rule 3.12(h).
otherwise fall within the “associated person” definition are nonetheless exempt. In this regard, two exemptions may be of particular interest:

- The CFTC’s regulations provide an exemption for individuals who are licensed as registered or limited representatives or principals of a FINRA-licensed firm (i.e., a broker-dealer) and who restrict their activities as associated persons to selling shares of commodity pools. This exemption may be particularly helpful for CPOs that are sponsors of registered investment company commodity pools, since distribution of those pools is generally conducted exclusively through a FINRA-licensed firm (i.e., a captive or affiliated broker-dealer that serves as the pools’ distributor).

- The CFTC’s regulations provide a separate exemption for individuals in the “supervisory chain-of-command” of other associated persons but are effectively removed from the supervisory process. This exemption requires the adoption of governance resolutions by the firm to reflect that removal and the designation of another associated person to assume that role. Those resolutions must be filed with the NFA as designee for the CFTC. (Special Note: The NFA tends to read this exemption narrowly, which firms may wish to consider in evaluating whether they may seeks to rely on it.)

Proiciency Requirements for Associated Persons. An individual seeking to register as an associated person of a CPO or a CTA must satisfy the NFA’s proficiency requirements. Generally speaking, an individual must have passed the National Commodity Futures Examination, also known as the Series 3 Exam, within the two years preceding his application.

To take the Series 3 Exam, an individual must complete the online testing application form, known as Form U10, that is available on the FINRA website. An individual who is currently licensed with FINRA would instead seek to amend his Form U4 with FINRA rather than complete Form U10. FINRA typically informs the NFA whether an individual has passed the Series 3 Exam.

The NFA has indicated that an individual may not be required to take the Series 3 Exam if he has passed the examination that he intends to use to satisfy the proficiency requirements either:

- Within two years of the date the application is filed; or
- More than two years prior to the filing date and, since that date, there has not been a period of two consecutive years during which the person was not registered as an associated person (or floor broker) or was not an approved principal of a registered firm.

Substitute Examinations, Waivers, and Exemptions from the Series 3 Requirement. The NFA has indicated that, subject to certain conditions, a person may rely on passing an exam other than the Series 3 Exam to satisfy the proficiency requirements (e.g., the Series 31 Futures Managed Funds Examination or the Series 32 Limited Futures Examination).

The NFA may also determine, upon request pursuant to Registration Rule 402, to waive the examination requirement for certain individuals associated with a CPO. The NFA’s Director of Compliance may waive the examination requirement in either of the following two cases:

- The CPO or the commodity pool is subject to regulation by a federal or state regulator (e.g., the SEC, federal bank regulators, or state insurance agencies) or the pool is privately offered pursuant to an exemption from the registration under the 1933 Act and the CPO limits its activities for which registration is required to operating a commodity pool that: (a) engages principally in securities transactions; (b) commits only a small percentage of its assets as
initial margin deposits and premiums for futures and options on futures; and (c) uses futures transactions and options on futures only for hedging or risk management purposes.

- The individual requesting the waiver is a general partner of a CPO or of a commodity pool that is primarily involved with securities investments; there is at least one registered general partner of the CPO or pool who has taken and passed the Series 3 examination; and the individual requesting the waiver is not involved in soliciting or accepting pool participations, trading futures or options on futures, handling client funds, supervising any of the above activities, or engaging in any other activity that is integral to the operation of the fund as a pool.

The NFA may also determine, upon request pursuant to Registration Rule 402, to waive the examination requirement for certain individuals associated with a CTA who are required to register solely because their advisory services include advice on the use of futures and options for risk management purposes. The NFA’s Director of Compliance may waive the examination requirement if:

- the CTA is subject to regulation by a federal or state regulator;
- for each client for whom the CTA provides futures trading advice, that advice is incidental to the securities advisory services the CTA provides to the client; and
- the futures trading advice offered by the CTA is for hedging or risk management purposes.

The individual or firm requesting a waiver must provide a written description of the facts that form the basis for qualifying the individual for the waiver.55

In addition, the NFA has adopted an exemption that applies to associated persons of firms that:

- conduct solely swaps-related activities; or
- limit their activities in futures and other commodity interests besides swaps to the restrictions set forth in CFTC Rule 4.13(a)(3) (for private fund CPOs) or CFTC Rule 4.5 (for registered investment company CPOs) and obtain waivers of the Series 3 requirement from the NFA.56

The basis for this relief is that the Series 3 Exam focuses on futures trading requirements. The NFA has determined that testing on those requirements is not necessary for associated persons of firms that do not trade futures or that only do so in a limited fashion.

An associated person will automatically receive a waiver of the testing requirement if his Form 8-R indicates his activities will involve swaps only. If that is not the case — meaning his activities will involve futures or other commodity interests besides swaps on a limited basis — the associated person must submit a written request for a waiver. Those waivers are generally granted as a matter of course.57

The NFA’s website contains additional information regarding these examinations and the possibility of exam waivers.58

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56. See NFA Registration Rule 401(e).
58. See http://www.nfa.futures.org/NFA-registration/proficiency-requirements.HTML.
PART D
KEY EXEMPTIONS FROM CPO AND CTA REGISTRATION

This Part briefly describes certain key exemptions from CPO and CTA registration that may be available to firms that sponsor or advise private funds. Whether a particular firm may rely on a specific exemption will largely depend upon the nature and scope of the firm’s activities as they pertain to commodity interest trading for client accounts. Accordingly, firms should not rely upon the following summaries of the various key exemptions as a basis for concluding that they are exempt from CPO or CTA registration.

Section I below identifies the key exemption from CPO registration, and Section II describes key current exemptions from CTA registration. Section III identifies exemptions from both CPO and CTA registration available solely to certain non-U.S. firms.

I. CPO Exemptions

CFTC Rule 4.13(a)(3) — Ille Minimis Exemption for Private Fund Sponsors. Under Rule 4.13(a)(3), a firm is not required to register with the CFTC as a CPO with respect to a private fund if the fund engages in limited trading of commodity interests. Pursuant to the Rule, a fund must satisfy at least one of the following limits:

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

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

For further guidance on the Rule 4.13(a)(3) portfolio tests, please see Annex D.

To make use of this exemption, each fund investor must be: (i) an “accredited investor,” as that term is defined in Rule 501(a) of the 1933 Act; (ii) a trust formed by an accredited investor for the benefit of a family member; (iii) a “knowledgeable employee,” as that term is defined in Rule 3c-5 under the 1940 Act; or (iv) a “qualified eligible person” as defined in CFTC Rule 4.7. In addition, in relying on this exemption a firm cannot market the fund as a vehicle for trading in commodity interests.

Notice Filing and Annual Update. A firm relying on this exemption must file a notice of exemption with the NFA and must affirm at the end of each calendar year that it is conducting its activities in accordance with the terms of the exemption. If it cannot do so, the firm must withdraw its claim of exemption.

CFTC Rule 4.5 — De Minimis Exemption for Registered Fund Sponsors. Under Rule 4.5, a firm is not required to register with the CFTC as a CPO with respect to a registered investment company if the investment company engages in limited trading of commodity interests. The limitations on exposure to commodity interests are substantially the same as the Initial Margin Limit and the Aggregate Net Notional Value Limit in Rule 4.13(a)(3), which are discussed above and summarized further in Annex D. It should

59. CFTC Rule 4.13 contains additional exemptions from CPO registration besides the exemption provided in paragraph (a)(3). Those exemptions are unlikely to be useful for the vast majority of firms, and thus are not summarized in this outline

60. Rule 4.13(a)(3) also provides that a commodity pool for which a CPO claims the exemption cannot be “offered and sold without marketing to the public in the United States.” This language is generally regarded as precluding a CPO from offering a pool by means of general solicitation permitted under Rule 506(c) of SEC Regulation D, as amended pursuant to the JOBS Act. However, the CFTC staff has issued an exemption that is intended to enable CPOs relying on Rule 4.13(a)(3) to offer commodity pools by means of general solicitation as permitted under Regulation D. See CFTC Letter 14-116 (Sept. 9, 2014).
be noted that, unlike Rule 4.13(a)(3), Rule 4.5 permits a firm to exclude positions held by a registered investment company for bona fide hedging purposes, although generally speaking this carve-out is of little practical use.61 The CFTC has indicated, for instance, that bona fide hedging does include portfolio hedging for risk management purposes.62

Marketing Restriction. Like Rule 4.13(a)(3), Rule 4.5 includes a marketing restriction. In adopting amendments to Rule 4.5 in 2012, the CFTC articulated the following as relevant to assessing whether a commodity pool has been marketed as a vehicle for trading commodity interests:

- The name of the fund.
- Whether the fund’s primary investment objective is tied to a commodity index.
- Whether the fund makes use of a controlled foreign corporation for its derivatives trading.
- Whether the fund’s marketing materials, including its prospectus or disclosure document, refer to the benefits of the use of derivatives in a portfolio or make comparisons to a derivatives index.
- Whether, during the course of normal trading activities, the fund or an entity on its behalf has a net short speculative exposure to any commodity through a direct or indirect investment in other derivatives.
- Whether the futures/options/swaps transactions engaged in by the fund or on behalf of the fund will directly or indirectly be its primary source of potential gains and losses.
- Whether the fund is explicitly offering a managed futures strategy.

The CFTC has stressed that these factors are merely “instructive,” and “that no single factor is dispositive.” At the same time, however, the CFTC indicated that it “will give more weight to the final factor” listed above in considering “whether a registered investment company is a de facto commodity pool.” In addition, the CFTC explained that the fact a fund includes “futures” or “derivatives” in its name “will not be considered a dispositive factor, but rather one of many” it will consider in determining whether the fund has violated the marketing restriction. The CFTC also indicated that it “will not consider the mere disclosure to investors or potential investors that the registered investment company may engage in derivatives trading incidental to its main investment strategy and the risks associated therewith as being violative of the marketing restriction.”63

Notice Filing and Annual Update. A firm relying on this exemption must file a notice of exemption with the NFA and must affirm at the end of each calendar year that it is conducting its activities in accordance with the terms of the exemption. If it cannot do so, the firm must withdraw its claim of exemption.

Application of CFTC Rules 4.5 and 4.13(a)(3) in the Funds-of-Funds Context. In 2003, the CFTC published guidance regarding how the Initial Margin Limit and the Net Notional Value Limit would apply in the context of funds-of-funds (i.e., on a look-through basis, whether alone or in concert with direct holdings of commodity interests). This guidance appeared as Appendix A to the CFTC’s Part 4 regulations until it was effectively withdrawn as part of the amendments to Rules 4.5, 4.13(a)(3), and related regulations in April 2012.

The CFTC has yet to issue new guidance to replace the guidance in former Appendix A. However, the CFTC staff has issued a no-action letter that would allow a firm to claim relief from CPO registration as a consequence of sponsoring a fund-of-funds that has exposure to commodity interests (either indirectly or

61. See CFTC Rule 1.3(z) (general definition of bona fide hedging).
63. 77 Fed. Reg. at 11259.
both directly and indirectly). A firm must submit a claim of relief to the CFTC and remain in compliance with the following criteria:

- The firm must structure its operations in whole or in part as a sponsor of one or more funds-of-funds;
- The amount of commodity interest positions to which a fund-of-funds is directly exposed must not exceed the Initial Margin Limit or the Net Notional Value Limit specified in Rule 4.5 or Rule 4.13(a)(3);
- The CPO does not know and could not have reasonably known that the fund-of-fund’s indirect exposure to commodity interests derived from contributions to underlying funds exceeds the Initial Margin Limit or the Net Notional Value Limit, either calculated directly or through the use of Appendix A; and
- The commodity pool for which the CPO seeks relief is either a registered investment company or a private fund that complies in all other respects with Rule 4.13(a)(3).

This relief will expire within six months of the CFTC adopting new funds-of-funds guidance.64 No new guidance has been adopted yet.

II. CTA Exemptions

CEA Section 4m(1) and CFTC Rule 4.14(a)(10) — 15 or Fewer Clients. Section 4m(1) of the CEA provides that a person need not register as a CTA if, during the course of the preceding 12 months, the person has not furnished commodity trading advice to more than 15 persons. In addition, the person must not hold itself out generally to the public as a CTA.

Rule 4.14(a)(10) provides additional guidance regarding how a person relying on this exemption would count clients toward the 15-client limit. In particular, non-U.S. firms need only count U.S.-resident clients towards the 15-client limit.65 In addition, the Rule provides that a person shall not be deemed to hold itself out generally to the public for purposes of Section 4m(1) solely because the person participates in a non-public offering of interests in a collective vehicle (e.g., a private offering of securities exempt from registration under the 1933 Act).

We understand that the CFTC tends to take an expansive view of those activities that would constitute “holding oneself out” generally to the public as a CTA.

CEA Section 4m(3) — Certain SEC-Registered Investment Advisers. Section 4m(3) of the CEA provides that a person need not register as a CTA if that person is registered with the SEC as an investment adviser under the Investment Advisers Act of 1940, provided that the person’s business does not consist “primarily” of acting as a CTA and does not act as a CTA to any commodity pool that is engaged primarily in trading commodity interests. For this purpose, the CEA provides that a CTA or a commodity pool shall be considered to be “engaged primarily” in the business of being a CTA or commodity pool if it is or holds itself out to the public as being engaged primarily, or proposes to engage primarily, in the business of advising on commodity interests or investing, reinvesting, owning, holding, or trading in commodity interests, respectively.66

64. See CFTC Letter 12-38 (Nov. 29, 2012).
65. Any corporation, general partnership, limited partnership, limited liability company, trust (except as otherwise set forth in the CFTC Rules), and any other legal organization will be counted as one client for purposes of the 15-client limit if such entity receives commodity trading advice based on its investment objectives rather than the individual investment objectives of its shareholders, partners, limited partners, members, or beneficiaries.
66. CEA Section 4m(3) also provides that, for purposes of this exemption, the term “commodity interests” includes the categories of instruments discussed in this outline as well as “any monies held in an account used for trading commodity interests.”
CFTC Rule 4.14(a)(8) — Certain SEC- or State-Registered Investment Advisers; Exempt and Excluded Investment Advisers. Rule 4.14(a)(8) provides that an SEC- or state-registered investment adviser, an investment adviser exempt from SEC registration, or an investment adviser excluded from SEC registration need not register as a CTA, provided that:

- The firm's commodity trading advice is directed solely to, and for the sole use of, one or more:
  - “qualifying entities” for which a notice of eligibility for the Rule 4.5 exclusion has been filed with the NFA;  
  - collective investment vehicles excluded from the definition of “commodity pool;”  
  - certain non-U.S. commodity pools;  
  - a CPO claiming the exemption from CPO registration under Rule 4.13(a)(3); or  
  - a registered CPO that may treat each pool it operates that meets the criteria of Rule 4.13(a)(3) as if it were not so registered;

- The firm provides commodity trading advice “solely incidental” to its business of providing securities or other investment advice to the aforementioned clients;

- The firm does not otherwise hold itself out as a CTA;

- The firm files an exemption with the NFA and affirms at the end of each calendar year that it is conducting its activities in accordance with the terms of the exemption (if it cannot do so, the firm must withdraw its claim of exemption); and

- The firm must make and keep certain books and records prepared in connection with its commodity trading advice.

CFTC Rule 4.14(a)(4) — Registered CPOs. Under CFTC Rule 4.14(a)(4), a firm registered as a CPO need not register as a CTA if the firm's commodity trading advice is directed solely to, and for the sole use of, the pool or pools for which it is so registered.

CFTC Rule 4.14(a)(5) — Exempt CPOs. Under CFTC Rule 4.14(a)(5), a firm exempt from registration as a CPO need not register as a CTA if the firm's commodity trading advice is directed solely to, and for the sole use of, the pool or pools for which it is so exempt.

III. CPO/CTA Exemptions for Non-U.S. Firms

While non-U.S. firms may rely on the exemptions outlined in Sections I and II above to the extent they meet the conditions of those exemptions, there are additional exemptions available to non-U.S. firms. We discuss key exemptions for non-U.S. firms below.

CFTC Rule 30.5 — Exemption for Non-U.S. Firms Effecting Commodity Interest Transactions Solely in Non-U.S. Markets. CFTC Rule 30.5 provides an exemption from CPO and CTA registration for persons that are not located in the United States and that only deal in, or advise on, futures on or subject to the rules of non-U.S. commodity exchanges or boards of trade. In order to claim this exemption, a non-U.S. firm must file with the NFA a form that includes appointment of the NFA as an agent for service of process in the United States. This filing is made online, and a small filing fee applies.

67. Generally speaking, under Rule 4.5(b) “qualifying entities” include SEC-registered investment companies, insurance company separate accounts, bank custodial accounts and trust accounts, and ERISA pension plans.

68. Under Rule 4.5(a)(4), these vehicles include, in general terms, certain noncontributory plans, contributory defined benefit plans, governmental plans, employee welfare benefit plans, and church plans.
While this exemption is subject to confirmation by the NFA, we understand that this confirmation is routinely provided for firms that appear to qualify for the exemption. A non-U.S. firm that deals in, or advises on, futures contracts and options on futures contracts on or subject to the rules of U.S. exchanges may not rely on this exemption.

**CFTC Rule 3.10(c)(3)(i) — Exemption for Non-U.S. Firms Effecting Commodity Interest Transactions in U.S. Markets.** CFTC Rule 3.10(c)(3)(i) provides that a non-U.S. person engaged in the activity of a CPO or CTA in connection with any commodity interest transaction executed bilaterally or made on or subject to the rules of any designated contract market or swap execution facility only on behalf of persons located outside the United States, its territories, or possessions is not required to register with the CFTC as such. Based on prior CFTC no-action guidance from which this exemption evolved, a firm seeking to rely on the exemption may do so only if no fund investor is a resident or citizen of the United States and if none of the funds or other capital contributed to the fund comes from U.S. sources.69

In addition, each commodity interest transaction must be submitted for clearing through a futures commission merchant registered with the CFTC. The clearing condition has raised interpretive questions for firms that may wish to rely on the exemption but trade instruments that are not cleared — most notably swaps that are not currently subject to a clearing requirement under the CEA, as amended by the

69. See CFTC Staff Letter 76-21 (Aug. 15, 1976); see also, e.g., CFTC Staff Letter 01-62 (June 13, 2001) (noting that, in addition to the absence of U.S. investors and U.S. sources of funds, no affiliates of the commodity pools would market those pools in a way that would solicit participation from U.S. persons or would market the pools from the United States).
ANNEX A
OVERVIEW OF MAJOR COMMODITY INTERESTS CATEGORIES

I. Commodity Interests Generally

Generally speaking, commodity futures and commodity options are commodity interests subject to CFTC jurisdiction, along with certain other categories discussed throughout this outline. A commodity future or commodity option can have as a reference many different sources of value, including for example:

* **Commodities generally** such as wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Irish potatoes, wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions and motion picture box office receipts (or any index, measure, value, or data related to such receipts), and all services, rights, and interests (except motion picture box office receipts, or any index, measure, value or data related to such receipts) in which contracts for future delivery are presently or in the future dealt in.

* **Agricultural commodities** such as:
  o Wheat, cotton, etc. as noted above;
  o All other commodities that are, or once were, or are derived from, living organisms, including plant, animal and aquatic life, which are generally fungible, within their respective classes, and are used primarily for human food, shelter, animal feed or natural fiber;
  o Tobacco, products of horticulture, and such other commodities used or consumed by animals or humans as the CFTC may designate; and
  o Commodity-based indexes based wholly or principally on underlying agricultural commodities.

* **Excluded commodities** such as:
  o An interest rate, exchange rate, currency, security, security index, credit risk or measure, debt or equity instrument, index or measure of inflation, or other macroeconomic index or measure;
  o Any other rate, differential, index, or measure of economic or commercial risk, return, or value that is not based in substantial part on the value of a narrow group of commodities not described above or based solely on one or more commodities that have no cash market;
  o Any economic or commercial index based on prices, rates, values, or levels that are not within the control of any party to the relevant contract, agreement, or transaction; or
  o An occurrence, extent of an occurrence, or contingency (other than a change in the price, rate, value, or level of a commodity not described in the first sub-bullet) that is beyond the control of the parties to the relevant contract, agreement, or transaction and associated with a financial, commercial, or economic consequence.

* **Exempt commodities** — i.e., a commodity that is not an agricultural commodity or an excluded commodity.

II. Security Futures Products; Futures on Broad-Based Securities Indexes

The term “security futures product” includes both futures on a single security (called single stock futures) and futures on narrow-based security indexes. A put, call, straddle, option, or privilege on any security future is also a security futures product.
Broad-based security index futures are not considered security futures products but are subject to CFTC jurisdiction.

III. Swaps as Defined under Dodd-Frank

The following table identifies in general terms the categories of instruments that fall within the definition of “swap” in the Commodity Exchange Act, as further clarified in a joint release by the CFTC and the SEC. Please note that “swap” is broadly defined in the statute and could include many types of instruments not specifically identified below.70

<table>
<thead>
<tr>
<th>Instrument Type</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Rate Swaps</td>
<td>Cross-Currency Rate Swaps Rate Floors Rate Caps Rate Collars</td>
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<tr>
<td>Currency Swaps</td>
<td>Cross-Currency Swaps</td>
</tr>
<tr>
<td>Non-Deliverable Currency Forwards</td>
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</tr>
<tr>
<td>Total Return Swaps</td>
<td>Generally speaking, would be a security-based swap if the reference is a narrow-based security index, a single loan, or a single security. Otherwise, would be a swap. In addition, would be a swap if the underlying security is a government security other than a municipal security.</td>
</tr>
<tr>
<td>Credit Default Swaps</td>
<td>Generally speaking, would be a security-based swap if the reference is a narrow-based security index, a single loan, or a single security; swaps on some loan indexes may also be considered security-based swaps as specified in SEC rules. Otherwise, would be a swap.</td>
</tr>
<tr>
<td>Equity / Equity Index Swaps Debt / Debt Index Swaps</td>
<td>Generally speaking, would be a security-based swap if the reference is a narrow-based security index, a single loan, or a single security. Otherwise, would be a swap.</td>
</tr>
<tr>
<td>Monetary Rate Swaps</td>
<td>Includes, for example, swaps on LIBOR, Euribor, TIBOR, money market rates, government target rates, general lending rates, constant maturity rates, rates derived from a rate index, and monetary rates (e.g., CPI). In addition, would include swaps referencing a yield.</td>
</tr>
<tr>
<td>Options on Rates (e.g., interest or currency exchange rates)</td>
<td>Includes puts, calls, floors, and collars, and any similar options.</td>
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</table>

70. For more specific information, see 77 Fed. Reg. 48208 (Aug. 13, 2012) (CFTC and SEC release further defining swap and security-based swap). In general, a security-based swap is defined in the Securities Exchange Act of 1934 (as amended by Dodd-Frank) as any swap based on narrow-based security index, a single loan, or a single security. As noted in the discussion of credit default swaps, swaps on some loan indexes may be covered.
## IV. Retail Forex Transactions

In essence, a “retail forex transaction” is an off-exchange foreign currency transaction in which one party is not an eligible contract participant (“ECP”). This category generally includes off-exchange futures and options on foreign currency, as well as other transactions that are offered or entered into on a leveraged or margined basis or financed on a similar basis by the counterparty or a person acting in concert with the counterparty. Retail forex transactions do not include transactions that are effectively actual spot trades — i.e., transactions that either (a) result in actual delivery within two days or (b) create an enforceable obligation to deliver between parties who are capable of making and taking delivery in connection with their line of business.

The Treasury Department has issued a final determination that exempts both foreign exchange swaps and foreign exchange forwards from the swap definition. It is nonetheless possible that these exempted foreign exchange products could be considered retail foreign exchange transactions. If it can be established that the party entering into a forex transaction is an ECP, however, then the transaction

<table>
<thead>
<tr>
<th>Instrument Type</th>
<th>Notes</th>
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<tbody>
<tr>
<td>Basis Swaps</td>
<td>Intended to be a limited category of instruments with attributes of swaps and security-based swaps — e.g., an instrument in which the underlying references are the value of an oil company stock and the price of oil. General speaking, a mixed swap would count as a swap under CFTC jurisdiction absent some determination to the contrary.</td>
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<tr>
<td>Correlation Swaps</td>
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<td>Credit Spreads</td>
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<td>Credit Swaps</td>
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<tr>
<td>Commodity Swaps</td>
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<td>Agricultural Swaps</td>
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<td>Emissions Swaps</td>
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<td>Energy Swaps</td>
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<td>Metal Swaps</td>
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<td>Weather Swaps</td>
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<tr>
<td>Mixed Swaps</td>
<td>Intended to be a limited category of instruments with attributes of swaps and security-based swaps — e.g., an instrument in which the underlying references are the value of an oil company stock and the price of oil. General speaking, a mixed swap would count as a swap under CFTC jurisdiction absent some determination to the contrary.</td>
</tr>
<tr>
<td>Commodity Interest Options</td>
<td>Includes puts, calls, caps, floors and collars, and any similar options on commodity interests (i.e., non-securities). Includes foreign currency options that are not traded on a national securities exchange.</td>
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<tr>
<td>Swaptions</td>
<td>Includes options on the foregoing instruments.</td>
</tr>
</tbody>
</table>

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71. A “foreign exchange swap” is defined as a transaction that provides for (i) an actual exchange of two different currencies on a specific date at a fixed rate that is agreed at the inception of the contract, and (ii) an actual reverse exchange of those same two currencies at a later date at a fixed rate agreed upon at inception of the contract.

72. A “foreign exchange forward” is defined as a transaction that solely involves the actual exchange of two different currencies on a specific future date at a fixed rate agreed at the inception of the contract.
would not be considered retail forex. A further discussion of retail forex transactions relevant to commodity pools is included in Annex D.

V. Leverage Transactions; Leverage Commodities; Retail Commodity Transactions

The CFTC has jurisdiction over leverage transactions, i.e., the purchase or sale of any leverage contract, the repurchase or resale of any leverage contract, the delivery of the leverage commodity, or the liquidation or rescission of any leverage contract. A leverage contract is a standardized agreement for the long-term (ten years or longer) purchase or sale of a leverage commodity. The definition of leverage commodity includes a commodity (gold bullion, silver bullion, bulk gold coins, bulk silver coins, or platinum) which is the subject of a leverage contract offered by a leverage transaction merchant, the value of which is reflected in a widely accepted and broadly disseminated commercial or retail cash price series for cash market transactions. Leverage commodities are defined by reference to certain criteria specified in the CFTC's rules. The CFTC also has jurisdiction over retail commodity transactions, which include any agreement, contract, or transaction in any commodity that is entered into with, or offered to, a non-ECP or non-eligible commercial entity.
# Annex B

## Overview of CFTC Substituted Compliance Release & Related No-Action Relief

<table>
<thead>
<tr>
<th>Rule / Letter</th>
<th>Summary of Amendment / No-Action Relief</th>
<th>Required Filing</th>
<th>Effective / Compliance Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.12(c)(3)(i)</td>
<td><strong>Registered Fund CPOs — Exemption from Disclosure Document Requirements.</strong> Must provide related performance for a pool with less than three years of operating history, and pool’s disclosure must comply with applicable securities law requirements.</td>
<td>See Rule 4.12(d) below.</td>
<td>9/23/2013 11/22/2013</td>
</tr>
<tr>
<td>4.12(c)(3)(ii)</td>
<td><strong>Registered Fund CPOs — Exemption from Account Statement Requirements.</strong> CPO must make the pool’s current NAV per share available to investors and must disclose that it is available and where it may be found (including a website address, if applicable).</td>
<td>See Rule 4.12(d) below.</td>
<td>9/23/2013 10/22/2013</td>
</tr>
<tr>
<td>4.12(c)(3)(iii)</td>
<td><strong>Registered Fund CPOs — Exemption from Books and Records Inspection Requirement</strong></td>
<td>See Rule 4.12(d) below.</td>
<td>9/23/2013 10/22/2013</td>
</tr>
<tr>
<td>4.12(d)</td>
<td><strong>Registered Fund CPOs — Exemption Filing.</strong> A CPO must make a filing in order to claim the relief specified above.</td>
<td>NFA Filing. Must be made through the NFA’s electronic exemption filing system.</td>
<td></td>
</tr>
<tr>
<td>4.22(c) Letter 13-51</td>
<td><strong>Registered Fund CPOs — CFCs — Audited Financial Statement Requirements.</strong> Separate audited financial statements are not required under Rule 4.22 for a “controlled foreign corporation” or “CFC” of a registered fund that is itself a commodity pool.</td>
<td>CFTC Filing. Must be sent by email to the CFTC staff.</td>
<td>Upon filing notice with the CFTC.</td>
</tr>
<tr>
<td>4.23(c) Letter 14-114</td>
<td>CPOs Generally — Recordkeeping Relief Records may be kept at a location other than the CPO’s main business office. Records may instead be held by the pool’s administrator, distributor, or custodian, or by a bank or registered broker-dealer acting in a similar capacity with respect to the pool. Subsidiary ledger requirement may be satisfied by records held at the pool’s transfer agent or through a list of intermediaries where shares are held in an omnibus account or through intermediaries. Under a 2014 CFTC staff letter, records may be held by a service provider not included in the preceding list, provided that the CPO remains able to maintain timely access to all records that are required to be kept and the proper filings are made with the NFA.</td>
<td>NFA Filings. Must file a statement from the CPO by the later of the time the CPO registers with the CFTC or delegates its recordkeeping obligations. Must file a statement electronically from each person who keeps required books and records.</td>
<td>9/23/2013 11/22/2013</td>
</tr>
<tr>
<td>Rule / Letter</td>
<td>Summary of Amendment / No-Action Relief</td>
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<tr>
<td>4.26</td>
<td><strong>CPOs Generally — Renewal of Disclosure Document.</strong> Disclosure document may not be used if it is dated more than 12 months prior to date of proposed use.</td>
<td>N/A</td>
<td>9/23/2013</td>
</tr>
<tr>
<td>4.27(c) Letter 13-51</td>
<td>Registered Fund CPOs — CFCs — Form CPO-PQR Filing Requirement. A separate report on Form CPO-PQR is not required to be filed with respect to a “controlled foreign corporation” of a registered fund that is itself a commodity pool. The CPO must provide a consolidated annual report for the registered fund that includes the data that the CFC would otherwise report separately. The CPO must also currently consolidate the financial statements of the registered fund or be in the process of converting to consolidation. In the latter case, the CPO must operate at least one other registered fund and CFC that currently consolidate and will report on Form CPO-PQR for the next applicable reporting period.</td>
<td>CFTC Filing. Must be sent by email to the CFTC staff.</td>
<td>Upon filing notice with the CFTC.</td>
</tr>
<tr>
<td>4.7(b)(4) Letter 14-114</td>
<td><strong>CPOs Eligible for CFTC Lite — Recordkeeping Relief.</strong> Records may be kept at a location other than the CPO’s main business office. Records may instead be held by the pool’s administrator, distributor, or custodian, or by a bank or registered broker-dealer acting in a similar capacity with respect to the pool. Under a 2014 CFTC staff letter, records may be held by a service provider not included in the preceding list, provided that the CPO remains able to maintain timely access to all records that are required to be kept and the proper filings are made with the NFA.</td>
<td>• Must file a statement from the CPO by the later of the time the CPO registers with the CFTC or delegates its recordkeeping obligations. • Must file a statement electronically from each person who keeps required books and records.</td>
<td>9/23/2013 11/22/2013</td>
</tr>
<tr>
<td>4.36</td>
<td><strong>CTAs Generally — Renewal of Disclosure Document.</strong> Disclosure document may not be used if it is dated more than 12 months prior to date of proposed use.</td>
<td>N/A</td>
<td>9/23/2013</td>
</tr>
</tbody>
</table>
## Content of Required Filings

<table>
<thead>
<tr>
<th>Rule 4.12(d)</th>
<th>Rule 4.22(c), under Letter 13-51 Rule 4.27(c), under Letter 13-51</th>
<th>Rule 4.23(c) (CPOs Generally) Rule 4.7(b)(4) (CFTC Lite Pools) CPO Notice</th>
<th>Rule 4.23(c) (CPOs Generally) Rule 4.7(b)(4) (CFTC Lite Pools) Recordkeeper Notice</th>
</tr>
</thead>
</table>
| Specific language will be provided in the NFA’s electronic exemption filing system. | The claim must:  
1. State the CPO’s name, address, and main telephone number;  
2. Provide the capacity of the party claiming relief (CPO);  
3. Identify each CFC covered; and  
4. Be signed by the CPO (PDF will suffice).  
The claim must be sent by email to dairobiaction@cftc.gov, with the subject line CFTC Letter 13-51. | The CPO must file a statement that:  
1. Identifies the name, main business address, and main business telephone number of the person(s) who will be keeping required books and records;  
2. Sets forth the name and telephone number of a contact for each person who will be keeping required books and records;  
3. Specifies the books and records that such person will be keeping by reference to the rule; and  
4. Contains representations from the CPO that:  
   a. It will promptly amend the statement if the contact information or location of any of the required books and records changes, by identifying the new location and any other changed information;  
   b. It remains responsible for ensuring that all required books and records are kept in accordance with Rule 1.31;  
   c. Within 48 hours after a request by the CFTC, it will obtain the original books and records from the location at which they are maintained, and will provide them for inspection at the CPO’s main business office (72 hours permitted for materials kept outside the United States); and  
   d. It will disclose in the pool’s “disclosure document” the location of its books and records. | The CPO must file a statement from each person who will be keeping required books and records in lieu of the CPO, in which that person:  
1. Acknowledges that the CPO intends that the person keep and maintain required pool books and records;  
2. Agrees to keep and maintain such records required in accordance with Rule 1.31; and  
3. Agrees to keep such required books and records open to inspection by the CFTC or the Department of Justice in accordance with Rule 1.31, and  
4. [Rule 4.23(c) Only] Agrees to make such required books and records available to pool participants.*  
*Requirement to make books and records available to investors (pool participants) should not apply if the CPO also claims the relief under Rule 4.12(c)(3)(ii). |
Selected NFA Instructions for Filings Under Rules 4.23(c) and 4.7(b)(4):

A separate notice must be filed for each pool for which the records will be maintained at a third party, as well as a separate notice for the CPO if its records will be maintained at a third party.

A CPO that elects to maintain the books and records of a Rule 4.7 exempt pool at a third party, however, must file a notice for that pool under Rule 4.7(b)(4) and a separate notice for the CPO under 4.23(c), if applicable.

## ANNEX C

CPO and CTA Reporting Required on Forms CPO-PQR and CTA-PR\(^73\)

<table>
<thead>
<tr>
<th>Entity Type</th>
<th>Form</th>
<th>When to File?</th>
<th>Contents of Filing?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small CPO</td>
<td>PQR</td>
<td><strong>Quarterly,</strong> within 60 days of the quarters ending March, June, and September.</td>
<td>NFA Form PQR</td>
</tr>
<tr>
<td>AUM of less than $150 million</td>
<td></td>
<td><strong>Annually,</strong> within 90 days of December 31.</td>
<td>CFTC Form PQR: Schedule A + Schedule of Investments</td>
</tr>
<tr>
<td>Mid-Sized CPO</td>
<td>PQR</td>
<td><strong>Quarterly,</strong> within 60 days of the quarters ending March, June, and September.</td>
<td>NFA Form PQR</td>
</tr>
<tr>
<td>AUM of at least $1.5 billion</td>
<td></td>
<td><strong>Annually,</strong> within 90 days of December 31.</td>
<td>CFTC Form PQR: Schedule A + Schedule B (Schedule B includes a Schedule of Investments)</td>
</tr>
<tr>
<td>Large CPO</td>
<td>PQR</td>
<td><strong>Quarterly,</strong> within 60 days of quarter end.</td>
<td>CFTC Form PQR: Schedule A + Schedule B + Schedule C</td>
</tr>
<tr>
<td>AUM of at least $1.5 billion</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CPO also filing Form PF with the SEC</td>
<td>PQR</td>
<td><strong>Quarterly,</strong> within 60 days of the quarters ending March, June, and September.</td>
<td>NFA Form PQR</td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>Annually,</strong> within 60 days (Large CPO) or 90 days (Small or Mid-Sized CPO) of December 31.</td>
<td>CFTC Form PQR: Schedule A + Schedule of Investments</td>
</tr>
</tbody>
</table>

---

<table>
<thead>
<tr>
<th>Entity Type</th>
<th>When to File?</th>
<th>Contents of Filing?</th>
</tr>
</thead>
<tbody>
<tr>
<td>CTA</td>
<td>Quarterly, within 45 days of the quarters ending March, June, and September.</td>
<td>NFA Form PR</td>
</tr>
<tr>
<td></td>
<td>Annually, within 45 days of December 31</td>
<td>CFTC Form PR</td>
</tr>
</tbody>
</table>
ANNEX D:
Outline of PORTFOLIO Limits Under CFTC Rule 4.13(a)(3)

Introduction. This outline describes the steps that we believe a fund manager would be required to take in seeking to determine whether each of its funds satisfied the limits on commodity interest positions that apply under the Rule 4.13(a)(3) exemption from registration as a commodity pool operator (a “CPO”). Broadly speaking, commodity interests include futures, security futures products, swaps, authorized commodity option transactions, authorized leverage transactions, and retail forex or commodity transactions as further defined in the Commodity Exchange Act.

In order to rely on Rule 4.13(a)(3), a fund must pass either the Aggregate Initial Margin Test or the Aggregate Net Notional Value Test specified therein. Under either Test, the calculation must be performed each time that a fund seeks to establish a new commodity interest position. Subject to any different guidance from the CFTC, we believe the Aggregate Initial Margin Test and the Aggregate Net Notional Value Test would apply in the manner described below, as qualified by the Notes that follow:

Aggregate Initial Margin Test. With respect to the commodity interests held by a fund:

1. Add up the aggregate amount of initial margin, premiums, and required minimum security deposit for retail forex transactions required to establish the commodity interest positions in the fund’s portfolio. **Please see Note A for a discussion of retail forex transactions and certain forex transactions that are excluded from the “swap” definition.**

2. Determine the liquidation value of the fund’s portfolio (i.e., net asset value). **Please see Note B for a discussion of liquidation value.**

3. Determine whether the amount in (1) is 5% or less than the amount in (2), after taking into account unrealized losses and gains on the fund’s commodity interest positions. If so, then the fund has passed the Test. If not, then the fund has failed the Test. **Please see Note C regarding the treatment of the “in-the-money amount” on commodity options and options on commodity futures that are in-the-money at the time of purchase.**

Aggregate Net Notional Value Test. With respect to the commodity interests held by a fund:

1. Determine the aggregate net “notional value” of all commodity interest positions in the fund’s portfolio. **Please see Note D for the definition of “notional value” provided by Rule 4.13(a)(3)**

2. Determine the liquidation value of the fund’s portfolio (i.e., net asset value). **Please see Note B for a discussion of liquidation value.**

3. Futures contracts in the same underlying commodity may be netted across designated contract markets and foreign boards of trade, and swaps cleared on the same designated clearing organization also may be netted. **Please see Note E for a further discussion of netting.**

74. This outline discusses the Aggregate Initial Margin Test and the Aggregate Net Notional Value Test in summary fashion. Please note that Rule 4.13(a)(3) contains other conditions that must be taken into consideration when assessing a firm’s ability to rely on the exemption. Other exemptions from CPO registration may be available.


Following any netting permitted by (3), determine whether the amount in (1) exceeds 100% of the amount in (2) after taking into account unrealized losses and gains on the fund’s commodity interest positions. If not, then the fund has passed the Test. If so, then the fund has failed the Test.

Notes. As indicated above, we wish to highlight the following points in connection with the calculations under the Aggregate Initial Margin Test and the Aggregate Net Notional Value Test:

A. Retail Forex Transactions. In essence, a “retail forex transaction” is an off-exchange foreign currency transaction in which one party is not an eligible contract participant (“ECP”). This category generally includes off-exchange futures and options on foreign currency, as well as other transactions that are offered or entered into on a leveraged or margined basis or financed on a similar basis by the counterparty or a person acting in concert with the counterparty. Retail forex transactions do not include transactions that are effectively actual spot trades — i.e., transactions that either (a) result in actual delivery within two days or (b) create an enforceable obligation to deliver between parties who are capable of making and taking delivery in connection with their line of business.

The CFTC has adopted final rules further clarifying ECP status for funds and other persons. “If a fund is an ECP, then a forex transaction into which it enters would not be considered “retail forex” for a variety of purposes under the CEA, including under Rule 4.13(a)(3).

The rules provide that a fund that is the counterparty to retail forex transactions (a “transaction-level pool”) and that has one or more non-ECP participants is not itself an ECP for purposes of the CEA’s provisions governing retail forex transactions. But, to determine whether a fund that is a direct investor in a transaction-level pool (an “investor pool”) is an ECP for purposes of the transaction-level pool’s retail forex transactions, there is no requirement to “look through” to that investor pool’s investors. This relief would not be available, however, if the transaction-level pool, any direct or indirect investor pool, or any commodity pool in which the transaction-level pool holds a direct or indirect interest, has been structured in order to permit non-ECPs to participate in retail forex transactions.

The rules also provide that a commodity pool that enters into a retail forex transaction is an ECP with respect thereto, regardless of whether each participant in the pool is an ECP, if all of the following conditions are satisfied:

1. the pool is not formed for the purpose of evading regulation under the provisions of the CEA and the CFTC rules, regulations, and orders relating to retail forex transactions;

2. the pool has total assets exceeding $10 million; and

3. the pool is formed and operated by a registered CPO or by a CPO who is exempt from registration under Rule 4.13(a)(3).

---

78. CFTC Rule 1.3(m)(5).
79. CFTC Rule 1.3(m)(8).
Information on the exclusion of certain forex transactions from the “swap” definition may be found in Annex A. **If a forex transaction is neither a swap nor retail forex, then — unless it is considered a “commodity interest” on some other basis — it can be excluded from the calculations under Rule 4.13 (a)(3).**

B. Liquidation Value. We are not aware of any formal CFTC guidance indicating that the “liquidation value” of a portfolio would be its net asset value. We understand informally, however, that this is a common approach among hedge funds seeking to comply with Rule 4.13(a)(3).

C. “In the Money Amount” Defined. For purposes of calculating the 5% figure under the Aggregate Initial Margin Test, a fund may exclude the “in-the-money amount” of an option that is in-the-money at the time of purchase. The term “in-the-money amount” is defined in CFTC Rule 190.01(y) as follows:

1. With respect to a call option, the amount by which the value of the physical commodity or the contract for sale of a commodity for future delivery which is the subject of the option exceeds the strike price of the option.

2. With respect to a put option, the amount by which the value of the physical commodity or the contract for sale of a commodity for future delivery which is the subject of the option is exceeded by the strike price of the option.

D. Notional Value. According to Rule 4.13(a)(3), “notional value” is calculated as follows:

1. Futures Positions. Multiply the number of contracts by the size of the contract in contract units (taking into account any multiplier specified in the contract), and then multiply that number by the current market price per unit.

2. Option Positions. Multiply the number of contracts by the size of the contract, adjusted by its delta, in contract units (taking into account any multiplier specified in the contract), and then multiply that number by the strike price per unit.

3. Retail Forex Transactions. Calculate the value in U.S. Dollars of the transaction, at the time the transaction was established, excluding for this purpose the value in U.S. Dollars of offsetting long and short transactions (if any).

4. Cleared Swaps. The notional value is the value determined consistent with the terms of Part 45 of the CFTC’s regulations. The CFTC staff recently published guidance indicating that, for cleared swaps, “the notional value of the swap is the amount reported by the reporting counterparty as the notional amount of the swap under Part 45” of its regulations. Part 45 addresses the swap data recordkeeping and reporting requirements for swap dealers and major swap participants. As relevant here, Part 45 includes an appendix that sets forth “minimum primary economic terms data” to be reported. In certain places, the appendix requires a reporting firm to provide the notional amount of a swap. It therefore appears the notional value that must be assigned to a cleared swap for purposes of Rule 4.13(a)(3) is the notional amount of the instrument.
The CFTC staff’s published guidance also suggests that the notional value of an uncleared swap would be its notional amount as reported under Part 45.

E. **Netting.** Rule 4.13(a)(3) provides that futures and cleared swaps may be netted as described above “where appropriate.” (Arguably, this clause applies only to cleared swaps.) The Rule does not specify when it would be appropriate or inappropriate to do so.
CONTACTS
If you have any questions or would like more information on the issues discussed in this White Paper, please contact any of the following Morgan Lewis lawyers:

**Boston**
- Steven M. Giordano +1.617.951.8205 steven.giordano@morganlewis.com
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- Stephen C. Tirrell +1.617.951.8833 stephen.tirrell@morganlewis.com

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**Washington, D.C.**
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- Steven W. Stone +1.202.739.5453 stone@morganlewis.com

**About Morgan, Lewis & Bockius LLP**

Founded in 1873, Morgan Lewis offers 2,000 lawyers—as well as patent agents, benefits advisers, regulatory scientists, and other specialists—in 28 offices across North America, Europe, Asia, and the Middle East. The firm provides comprehensive litigation, corporate, transactional, regulatory, intellectual property, and labor and employment legal services to clients of all sizes—from globally established industry leaders to just-conceived start-ups. For more information about Morgan Lewis or its practices, please visit us online at www.morganlewis.com.
Michael Elio, Partner
STEPSTONE

Kristine O’Connor, Partner
FRANKLIN PARK

Paul Landi, Director
STEELBRIDGE CONSULTING
Michael Elio, Partner, New York
At StepStone, Mr. Elio is Co-Head of the Middle Market Buyout and Distressed/Turnaround Sector Teams. Mike works closely with clients on constructing portfolios of global private equity funds, secondaries and co-investments.

Prior to StepStone, Mr. Elio was a Managing Director at ILPA, where he led ILPA’s programs around research, standards and industry strategic priorities.

Prior to joining the ILPA he was a Partner and Managing Director at LP Capital Advisors and led the firm’s Boston office where he served as the lead consultant to North American and European institutional investors. Mr. Elio served as the primary consultant for many of the firm’s largest clients including Public and Private Pension plans committing in excess of $5 billion annually. Mr. Elio held several progressive positions in private equity, including Vice President at State Street Corporation and Vice President at Credit Suisse First Boston Private Equity overseeing the Funds Management group.
Kristine A. O'Connor, CPA

Managing Director and Chief Financial Officer

Kristine is Managing Director and Chief Financial Officer of Franklin Park. At Franklin Park, Kristine leads the accounting and reporting functions. She is also actively involved in the firm's compliance efforts. Prior to joining Franklin Park in 2008, Kristine worked with the United States Securities and Exchange Commission, Massachusetts Pension Reserves Investment Management Board and PricewaterhouseCoopers. She is a Certified Public Accountant and a Chartered Alternative Investment Analyst. Kristine received a B.S. in Accounting and Theology from Boston College.
Paul Landi

DIRECTOR, CONSULTING SERVICES

Paul is a Director in the consulting services business practice. He specializes in project management and is responsible for client relationships and direct implementation of SteelBridge client projects. Paul is an expert in overseeing daily accounting operations and producing financial statements; he has 10 years of experience servicing the alternative investment community.

Paul joined SteelBridge in March 2010.

He holds a Bachelor of Science with a Specialization in Finance from Rowan University.

On a personal note

I love digging into a complex distribution model, peeling back the layers and determining how technology can make these sometimes insanely complex models become push-button efficient! I am proud to have worked with some of the most respected investments managers in the world and help them affect real change in their back office. A major component to a successful project is having the right team in place – I draw on my years as a semi-pro hockey player to bring the group together and create the winning team.

ON MY TIME OFF

I played semi-pro hockey in my younger days and now referee and volunteer with a number of youth hockey organizations.
TRACK B – Hedge Fund
Operating an Alternative Fund in the ’40 Act Space

Larry Chiarello, Portfolio Manager & Partner
BPV CAPITAL MANAGEMENT

Nadine K. Haidar, Managing Director, Head of Liquid Alternatives Platform Management
RAMIUS LLC
Experience

Larry recently served as a Partner and Portfolio Manager with Riverview Alternative Investment Advisors. As a Senior Investment Committee member, he was intimately involved in manager sourcing, research, and portfolio management. Before working with Riverview, Larry was the Senior Director of Manager Research & Risk Analysis at Soros Fund Management. There, he directed outside hedge fund manager investments, performed risk analysis, and served as Director of Operations, a position in which he performed daily reconciliations and valuations of funds. Prior to that, Larry worked with Drexel Burnham Lambert in their High Yield & Convertible Bond Department and was a Senior Regulatory Account and Analyst for Merrill Lynch and Drexel Burnham Lambert.

Education

Queens College, BA, Accounting, Magna Cum Laude

New York University, MBA

Series 65 Registered

Expertise

With decades of experience on Wall Street, Larry conducts manager sourcing, research and due diligence in addition to portfolio construction and management. An Investment Management Committee (IMC) member, Larry also manages BPV’s operational due diligence process.
Ms. Haidar is responsible for providing centralized oversight of all of the business aspects related to operating liquid alternative mutual funds and other capabilities at Ramius. She also oversees the development and launch of new liquid alternative investment capabilities. Prior to taking on this role, Ms. Haidar served as Head of Business Due Diligence for Ramius Trading Strategies LLC, Ramius’ managed futures managed account platform, which she helped build when she joined Ramius in 2009.

Previously, she was a Vice President in the Business Due Diligence Group for the Alternative Investment Asset Management Division of Bank of America/Merrill Lynch. Ms. Haidar joined Merrill Lynch from Credit Suisse where she was an operational due diligence analyst in the Hedge Fund Investment Group from 2005 to 2006. Ms. Haidar started her career in 2004 at The Citigroup Private Bank in New York in the Global Manager Selection Team.

She holds a Masters of Science in Financial Engineering from Columbia University and a Bachelors of Engineer in Industrial Engineering from Lebanese American University in Lebanon.
SUMMARY

- Results-oriented executive with over 15 years of experience in the hedge fund and mutual fund industries
- Track record of success in the leadership of accounting, operations, client services and reporting, IT and product development
- Visionary leader with a proven history of building high performance teams
- MBA from Harvard Business School; active CPA license

PROFESSIONAL EXPERIENCE

PAAMCO, LLC, HQ - Irvine, CA 2004-Current

Director, Fund Accounting and Operations

Direct all of fund accounting, financial statement and client reporting preparation, funding and investment operations for a $10 billion institutional fund of hedge fund firm

- Hired, developed and built a team of 8 analysts and CPAs from scratch
- Internally developed a funding system to replace spreadsheets allowing for dynamic, multi-month rebalancing of underlying hedge fund investments
- Converted firm from spreadsheets to Sungard's Investran accounting system and built custom programs to further improve accuracy, enhance analytics and speed processing. Further automation of the system permitted a 30% reduction in staff since 2011.
- Served as PAAMCO's first director on the boards of more than 10 underlying hedge funds, establishing the due diligence standards used by subsequent directors. In 2010, such diligence led to the refund of $1.7 million in erroneous dividend withholding. Simplifying the fund structures to exclude mini-masters has saved investors $1 million.
- Obtained favorable SAS 70/SOC 1 - Type 2 Reports starting with the first report in 2011
- Led an Operational Due Diligence team in the annual review of 8 UK based managers resulting in additional advisory fees of $700,000 since 2010
- Re-negotiated E&O/D&O Policies, resulting in a savings of $2.5 million since 2004
- Wrote the firm's first Compliance Manual as required under SEC Rule 206(4)-7
- Implemented FATCA compliance and led IRS tax reporting for 40 fund of hedge funds
- Led integration of KBC's fund of hedge fund operations into PAAMCO after acquisition
- Actively participated in prospect presentations and in the retention of existing clients with frequent personal interaction, responsive client reporting and operational excellence
- Oversaw the successful wind up of 7 hedge funds liquidated after the 2008 financial crisis, resulting in the repatriation of more than $200 million in formerly illiquid portfolios
- Re-negotiated ISDAs and related agreements for FX Forward Contracts and Swaptions
- Launched dozens of new funds, negotiating legal, compliance and business terms as well as engaging administrators, brokers, attorneys and independent directors.
- Negotiated terms on accounting system which have saved PAAMCO $5 million thus far

EQUISERVE (acquired by Computershare) Jersey City, NJ 2000-2003

Senior Managing Director of Product Management

Directed all of product management for the nation's largest equity & mutual fund transfer agent with 1,400 corporate clients and 27 million shareholder accounts in 2003

- Led a group of 8 product managers who oversaw products with revenues of $325 million
- Coordinated globalization efforts and competitive analysis, and built pricing models
FOLIOfn.com, Vienna, VA 1999-2000

Vice President, Client Services
Developed a customer support division and implemented new systems for a start-up; Firm grew to 250 employees before shifting from a retail brokerage to software development strategy

- Researched, analyzed, purchased, installed and tested new systems, including an IRA record keeping program and email management solution at a savings of $250,000
- Designed the customer service module of an internally developed brokerage system
- Recruited, trained and developed a team of 25 registered (Series 7) representatives

FOUNDERS FUNDS, INC. (Acquired by Mellon Bank), Denver, CO 1993-1998

Vice President, Shareholder Services Division
Directed operations and client services with 50 professionals managing 120,000 accounts totaling $8 billion in mutual fund assets in 1998

- Served on the Firm's Executive Committee and chaired the Operating Committee
- Sales efforts led to revenue increasing from $15 million to $45 million by 1998
- Negotiated a new service contract resulting in cost savings of $500,000 annually
- Directed complicated transfer agency conversion and internalization

T. ROWE PRICE ASSOCIATES, INC., HQ - Baltimore, MD 1988-1993

Vice President, Investment Services, Los Angeles Office (1990-1993)
Directed West Coast telephone sales/service operation for $750 million, mutual fund family

- Managed 100 registered (Series 7) representatives and a $4 million budget
- Directed all day-to-day operational activities for the office, including the call center, HR, compliance, IT, facilities management, telecommunications and vendor relations
- Increased staff by 180% to handle a full 40% of Firm's sales and service calls; efforts instrumental in doubling the Firm's revenue from $150 million to over $300 million


Managed a variety of operational departments in one of the nation's largest banks

Assistant Vice President, Check Processing Division (1986-1988)
On leave of absence from Wells Fargo to attend Harvard Business School (1984-1986)

AVP and Department Manager, Data Center (1980-1984)
Promoted 5 times in 4 years, ending up as the Bank's youngest AVP before leaving for HBS.

EDUCATION

HARVARD BUSINESS SCHOOL, Boston, MA
Masters in Business Administration Degree 1986

UNIVERSITY OF CALIFORNIA, Davis, CA
B.S. Degree in Managerial Economics 1980

LICENSES AND AFFILIATIONS

- Active California CPA license holder since 2009
- Held Series 7, 24 and 63 Licenses from 1988 through 2003 and CFP from 2003 to 2008
Lance R. Taylor  
Chief Financial Officer

Mr. Taylor is the Chief Financial Officer of HGGC.

Prior to joining HGGC, Mr. Taylor served as the CFO and CCO of Calera Capital. Previously, he was the CFO of Legacy Venture and an Audit Senior Manager at Ernst & Young, LLP. Additionally, Mr. Taylor has served as the Director of Finance at Lightspeed Venture Partners and as an Audit Manager at Arthur Andersen.

Mr. Taylor received his B.S. in Accounting and a Master of Accountancy from Brigham Young University. He received his M.B.A. from Duke University.
Vendor Oversight and Due Diligence – Ensuring That You’re Getting the Services that You’re Supposed to be Getting

Marshall Terry, Managing Director, COO and CCO
ROTATION CAPITAL MANAGEMENT LP

Tim Cheu, Principal Consultant
ACA APONIX
CYBERSECURITY AND VENDOR IT RISK

Tim Cheu
Principal Consultant – ACA Aponix

30th July, 2015

ABOUT ACA AAPONIX

Company Background
• Founded in June 2014, acquired by ACA Compliance Group in February 2015
• Staffed by senior financial technologists from investment managers and banks
• Approximately 75 clients currently - primarily hedge funds, asset managers, private equity firms with AUM between $200m and $200bn

About
• Specialists in the assessment of cybersecurity and IT/vendor risk for investment managers
• Apply a balanced and holistic approach to identify and mitigate risk through assessment, remediation, policy, controls and training
• Our objective is to build a robust security posture via a thorough and thoughtful review of business process and technology
AGENDA

- Regulator's Update
- Vendor Diligence Anatomy
- Is Vendor Due Diligence necessary?
- Diligence Approach
- Third-party vendor risks
- Why should you care?
- Keys to reducing vendor risk
- Risk Management Lifecycle
- Best Practices
- Best practices being adopted
- What investor expect from vendors

REGULATORY UPDATE (U.S.)

- SEC – Office of Compliance Inspections and Examinations
  - 2014 – Issued Cybersecurity Risk Alert and undertook first round of sweeps
  - 2015 – released first round sweep results, announced second round of sweeps to take place in Q3:
    - Onsite reviews
    - Focused look at a small number of topics
    - Testing of policies and procedures
    - Key focus on customer information security, access rights, and vendors
  - 2016 and beyond – Regulation?
- FINRA, CFTC, GLBA, PCI, HIPPA,
VENDOR DILIGENCE ANATOMY

• Evaluating how a vendor is financially, operationally and technically sound
• Validation of internal processes, testing and controls
• Ongoing monitoring for performance and resiliency

IS VENDOR DILIGENCE NECESSARY?

• Vendors are an extension of your firm.
  – Understand the types of data they deal with.
• Make sure they are protecting your data.
  – Data access controls and polices should be aligned with your business.
DILIGENCE APPROACH

• Vendor selection & questionnaire approach
  – Assess and determine risk of vendors
    • Scope out questionnaire
• Send questionnaire
• Documentation and questionnaire review
  – Follow up questions/request additional information
  – Identify gaps and risk
• Validation of High Risk Vendors
  – Technical Review
  – Onsite audits

THIRD-PARTY VENDOR RISKS

• How are my third-party vendors protecting my data?
  
  And

• What type of data do my third-party vendors have access to?
WHY SHOULD YOU CARE?

• Risks:
  - Reputational, Compliance/Regulatory Fines, Operational/Business Interruptions, Legal Liability
• Increasing reliance on 3rd party vendors
  - Cloud
  - Outsourced functions

KEYS TO REDUCING VENDOR RISK

• NDAs
• Cyber-security Insurance
• Network monitoring
• Independent risk assessment and pen test
• Employee training
• SLAs / RPOs / RTOs
• Code escrow/vaulting
• Database dumps
BEST PRACTICES

• Third Party Management
  – Due Diligence
    • Evaluating vendor recovery capability and capacity
    • Sub vendors and service providers
    • 3rd party management program
  – Contracts
    • Right to audit, monitor performance standards, default and termination,
      subcontracting (local/foreign), BCP testing, Data governance, security issues
  – Ongoing monitoring
    • Ongoing assessment of performance, resiliency and potential impact to the business
BEST PRACTICES BEING ADOPTED...

- Gap Analysis / Risk Assessment
  - A. Project roadmap / Strategic planning / Budgeting
  - B. Tough decisions
- Vendor Diligence
- Staff Training
- Penetration Testing
- Intrusion Detection / Prevention
- Information Security Policies
- Incident Response Planning
- Cybersecurity Insurance
WHAT INVESTOR EXPECT FROM VENDORS

- Expectations
  - Cybersecurity program
    - Has a framework been adopted?
    - Have policies been created?
    - Are employees properly trained to detect malicious events?
    - Is there a breach protocol established?
  - Who is responsible for overseeing the cybersecurity program?
  - Do you maintain cybersecurity insurance?
  - Who is held accountable in the event of a cybersecurity event?
Managing Funds that are Winding Down

Greg Levy, Partner
KAUFMAN ROSSIN

Michael Belsley, Partner
KIRKLAND & ELLIS
Professional Biography

Gregory M. Levy, CPA
Audit & Financial Services Principal

Gregory M. Levy has been with Kaufman, Rossin & Co. since 1992. He developed expertise in hedge funds, investment advisory firms and securities brokerage firms as a national firm partner in New York and Chicago prior to joining the Firm.

He is a nationally recognized authority on private investment funds (hedge funds), and has authored numerous articles in investment and accounting journals. He is a frequent panelist and speaker at national seminars dealing with hedge fund taxation, accounting and financial reporting, and was a member of the AICPA's Investment Company Expert Panel.

Greg earned his Bachelor's degree in Accounting from Roosevelt University and his MBA with a concentration in Accounting from De Paul University, where he also studied in their graduate tax program. He is licensed as a Certified Public Accountant in Florida and Illinois and is a member of the American Institute of Certified Public Accountants, the Florida Institute of Certified Public Accountants and the Illinois CPA Society.

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Michael D. Belsley - Partner

Professional Profile

Michael Belsley's practice involves structuring, negotiating and documenting complex business transactions, including strategic and leveraged acquisitions, recapitalizations and divestitures, formation and governance of private equity funds (including primary investments in and secondary market sales of private equity fund interests), venture capital investments (start-up and later-stage), mezzanine debt financings, equity financings and corporate governance matters.

Michael regularly represents buyers and sellers, as well as market intermediaries, in their secondary market activities. His secondary market experience includes traditional portfolio sales, structured secondaries, synthetic secondaries (i.e., buy-ins and bundled secondary direct, as well as total return swaps), captive fund spin-outs, stapled secondary offerings, fund recapitalizations and restructurings, follow-on funding secondaries and orphaned asset sales in a variety of asset classes, including the venture capital, leveraged buy-out, special situations and real estate sectors. Michael is a frequent lecturer, speaker, and panel moderator on private equity secondaries.

Michael also frequently represents both private equity fund sponsors (i.e., general partners) and investors in private equity fund formations, fund-level restructurings and governance matters.

Representative buy-side clients include Adams Street Partners, Capital Dynamics, Coller Capital, Landmark Partners, Liquid Realty Partners, Mesirow, Morgan Stanley, Northern Trust Corporation, Pantheon Ventures, Partners Group, Paul Capital Partners, and Virginia Retirement System.

Representative sell-side clients include American Capital, Bank of America, Citigroup, Colgate University, Danske Private Equity, Ewing Kauffman Foundation, confidential Fortune 100 pension plan, confidential Japanese financial institution, confidential Middle Eastern sovereign wealth fund, confidential Pacific-rim sovereign wealth fund, a leading property and casualty insurance company and Virginia Retirement System.

Michael counsels clients on transactions throughout the world, including the United States, Canada, Latin America, Europe and the Pacific-rim.

Memberships & Affiliations

Economic Club of Chicago
Dean's Advisory Board, Northwestern University School of Law

Other Distinctions

Recognized by IFLR1000 as a leading lawyer (2015)


Selected by Super Lawyers magazine as an Illinois Super Lawyer (2010 - 2013)

Chicago Volunteer Legal Services Foundation - 1993 Distinguished Services Award Recipient

Publications


Seminars


Speaker and Panelist, *Tax, Fund Status and Valuation Considerations for Secondary Transactions*, Institute for International Research's 8th Annual Private Equity Tax Practices Conference, Boston,
Massachusetts, June 16, 2009.


Speaker and Panelist, Private Equity Investment in Mexico, Gonzalez Cavillo, S.C. Abogados' Mexico 2007 and Beyond: Challenges and Opportunities Conference, Mexico City, Mexico, June 11, 2007.
Managing Funds that are Winding Down

Michael D. Belsley, Esq.
Partner - Kirkland & Ellis LLP

Gregory M. Levy, CPA
Partner – Kaufman Rossin
Note: Mr. Levy retired from the firm as of June 1, 2015

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Topics Covered

Today’s session will include the following:

• What is the difference among dissolution, wind-up and termination of a fund?
• How do you handle the disposing of assets?
• How are management fees handled?
• What types of votes are required?
• Cash distribution vs. in-kind distribution
• Extending the life – how do you go about this?
• Fund recapitalization and the secondary market
• Zombie funds – how is the industry dealing with the “walking dead”?

In addition, we will cover the distinctive accounting requirements for funds in liquidation.
Dissolution, Wind-up and Termination

- To terminate a Delaware limited partnership, the partnership must first dissolve, then the affairs of the partnership are wound-up and finally, the partnership’s legal existence is terminated.

- Requirements under Cayman Islands law, UK law, Guernsey law and Jersey law different from Delaware law
  - E.g., under Cayman Islands law, shortly after the commencement of the wind-up of a Cayman fund, notice of the wind-up needs to be published

Dissolution, Wind-up and Termination

- No filings are required to dissolve a Delaware limited partnership.
- Delaware limited partnership continues to legally exist during dissolution
- Dissolution of a Delaware limited partnership occurs upon:
  - Time (or other events) specified in the fund agreement (i.e., end of the partnership’s term)
  - Unless otherwise provided in the fund agreement, upon the affirmative vote of the general partner and requisite limited partners
  - In the event of withdrawal of the general partner (unless affirmatively continued in accordance with applicable law)
  - At such time as there are no limited partners (unless affirmatively continued in accordance with applicable law)
  - Upon entry of decree of judicial dissolution
Dissolution, Wind-up and Termination

- Wind-up of a Delaware limited partnership consists of the orderly collection of assets (e.g., “GP clawback” payments), disposition of the partnership’s remaining assets and settlement of the partnership’s liabilities
- Fund’s liquidator is typically its general partner or manager
- Establishment of appropriate reserves for contingent, conditional and/or unmatured claims and liabilities of the partnership
- Provision for satisfaction of unknown claims and for claims that have not arisen but, based on facts known to the partnership, are likely to arise within 10 years of the date of dissolution (consider purchasing “tail” insurance)
- After satisfaction (or reserve) for liabilities, remaining assets can either be sold and/or distributed in-kind (subject to any restrictions on in-kind distributions in the fund agreement)
- No requirement to “fire-sale” assets during the wind-up stage

Dissolution, Wind-up and Termination

- Following the completion of the wind-up a Delaware fund, a certificate of cancellation is filed with the Delaware Secretary of State to terminate the existence of such Delaware fund
- Once the certificate of cancellation is filed, the fund ceases to have a legal existence
- Prior to terminating legal existence, important to make sure that any documents (e.g., tax filings) that require execution by the fund are signed
Disposition of Assets

- Disposition of assets can be conducted in an orderly manner. No “fire sale” required.
- Levels 1 and 2 portfolio holdings should be readily disposable at amounts that approximate fair values.
- Level 3 portfolio holdings may require an extended period to dispose.
- Utilize/continue side-pockets, as is case with traditional hedge funds holding Level 3 items.
- In the case of hedge funds, very important to suspend investor redemptions during liquidation period; also consider suspension when liquidation is being contemplated; only permit pro-rata distributions to partners.
- Very important to hold-back sufficient funds to cover net outlays during liquidation period.

Extension of Life of Fund

- Extension of the term of a Delaware limited partnership
  - During the term of the fund, required vote is typically majority of limited partners (based on capital commitments), or such higher percentage as specified in the fund’s limited partnership agreement.
  - After the term of the fund, may require unanimous vote of all partners to “reconstitute” the partnership and “retroactively” extend the term of the fund.
  - Important to allow enough time for limited partner approval of extension requests.
  - Issues that may be negotiated in connection with extension requests include:
    - Management Fee during extension period
    - Efforts to sell existing investments
    - Time and attention of GP and investment professionals
    - Potential pre-payment (in whole or in part) of “GP clawback”
Restructuring and Recapitalization of Funds

• Restructuring
  – Liquidity opportunity for existing fund investors with the option for such investors to elect to continue to participate in the investments with a longer investment holding period (i.e., not sell)
  – Effectively, a partial sale of assets/non-pro rata redemption of “selling” investors
  – May be structured as a sale to a new investment vehicle (or merger of the existing fund and a new investment fund) or as an admission of new investors into an existing fund
  – General partner/management company typically receives incremental economics, in particular on the new investors’ money.
  – Conflict of interest issues for the fund’s general partner
  – Due diligence and access to information issues

Recapitalization of Funds

• Generally, a fund recapitalization is a fund restructuring that includes incremental capital commitments that are available to be invested
  – Follow-on investments vs new investments
• General partner/management company typically receives incremental economics, in particular on the new investors’ money
  – Calculation of incremental carry on combined basis (cross-collateralized) vs separate waterfalls for secondary assets vs new investments
• “Status quo” option
  – Economic status quo
• Zombie Funds
  – Time and Attention
  – Retention of investment professionals
  – Satisfaction of “GP clawback”
  – Investment exit time table
Accounting for Funds in Liquidation
Overview of FASB ASU 2013-07

• Effective for annual reporting periods beginning after December 15, 2013 (and interim reporting periods therein)

• Requires use of liquidation basis of accounting (as opposed to going-concern GAAP), when liquidation is imminent:
  – A plan for liquidation has been approved by management OR imposed by other forces; it is remote that the plan will be blocked; and it is remote that the entity will return from liquidation
  – Exceptions – Entities that expressly provide for liquidation in their organizational documents (such as private equity) and do not liquidate prematurely; ’40 Act Funds

• Contrast going-concern GAAP and liquidation basis

Accounting for Funds in Liquidation
Overview of FASB ASU 2013-07 (cont.)

• Going-concern GAAP
  – Investment portfolio is carried at fair value, which contemplates an orderly disposition/settlement
  – Income and expenses are recorded as earned or incurred

• Liquidation basis
  – Investment portfolio is carried at amounts expected to be received during dissolution; does not necessarily approximate fair value; may require an adjustment to fair value when liquidation basis is first applied
  – Costs expected to be incurred to sell assets are accrued and presented separately, and not part of the related asset
  – Other costs expected to be incurred (and income earned) through date of liquidation are accrued as of the reporting date to the extent reasonably estimable; examples include legal and audit fees, other administrative fees; management fees may be accruable, incentive fees probably not

  • Note: Funds often suspend or reduce management fees during liquidation.
  • Note: Right to continue to receive management fees while the fund is in wind-up phase is a contractual provision that will be specified in the fund agreement
Accounting for Funds in Liquidation
Overview of FASB ASU 2013-07 (cont.)

• Liquidation basis (cont.)
  – Adjustment to convert going-concern GAAP to liquidation basis is presented as a separate caption; ongoing adjustments are also presented as a separate caption
  – No “leveling” of investment portfolio
  – No presentation of financial highlights
  – Required liquidation basis financial statements
    • Statement of net assets in liquidation
    • Statement of changes in net assets in liquidation (presented from the effective date of liquidation to the end of the reporting period)
    • Note that these financial statements will typically be in addition to going-concern GAAP statements from the beginning of the reporting period to the effective date of liquidation
      – Statement of operations, statement of changes in equity and, as applicable, statement of changes in cash flows
  – Financial statement disclosures would include plan of and accounting for liquidation. Independent auditors’ report would disclose liquidation as emphasis-of-matter
  – Subject to requirements of the Custody Rule for RIAs, consider whether annual audit requirement may be suspended or modified