14TH ANNUAL

Investment Management Regulatory University

WEBINAR SERIES

September 2, 2020

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OCIE Risk Alert Regarding Private Fund Advisers — Exam Observations

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September 2, 2020

Overview

- In June, OCIE published a risk alert summarizing a number of compliance issues that OCIE staff observed in examinations of registered investment advisers that manage private equity funds or hedge funds (“private fund advisers”).
- OCIE pointed out that many compliance issues “may” have:
  - caused private fund investors to pay more in fees and expenses than they should have; or
  - resulted in investors not being informed of relevant conflicts of interest concerning the private fund adviser and the fund.
- Among other disclaimers, the alert states that it “has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person.”

Overview — Continued

- On the heels of this statement, the alert points out that the SEC has brought enforcement actions on a number of the issues discussed in the alert, and that OCIE continues to observe some of these practices during examinations.
- And the alert concluded with the following sentiments from OCIE:
  - OCIE examinations of private fund advisers have resulted in a range of actions, including no-comment letters, deficiency letters and, where appropriate, enforcement referrals.
  - In response to these observations, many of the examined advisers modified their practices to address the issues identified by OCIE staff.
  - OCIE encourages private fund advisers to review their practices and written policies and procedures, including implementation of those policies and procedures, to address the issues discussed in the alert.

The risk alert focused on three areas of deficiencies, none of which are surprising:

- Conflicts of interest
- Fees and expenses
- Policies and procedures relating to material non-public information (“MNPI”) and codes of ethics.

Conflicts of Interest

Background

Citing Section 206 of the Advisers Act, the alert restates what the SEC said in the 2019 fiduciary interpretive release:

- The Advisers Act imposes a fiduciary duty on investment advisers, which includes both a duty of care and a duty of loyalty.
- The duty of loyalty requires that an adviser not subordinate its clients' interests to its own (i.e., an investment adviser must not place its own interest ahead of its client's interests).
- To meet its duty of loyalty, an adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship.
- Material facts for this purpose include conflicts of interest that might incline an investment adviser – consciously or unconsciously – to render advice which is not disinterested such that a client can provide informed consent to the conflict.
- In order for disclosure to be full and fair, it should be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent.

Conflicts of Interest — Continued

- The alert also referenced Advisers Act Rule 206(4)-8, which prohibits investment advisers to pooled investment vehicles from:
  - making any untrue statement of a material fact or omitting to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading to any investor or prospective investor in the pooled investment vehicle; and
  - otherwise engaging in any act, practice, or course of business that is fraudulent, deceptive or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.
- OCIE staff observed no less than nine categories of conflicts that “appeared to be” inadequately disclosed and thus are deficiencies under Section 206 or Rule 206(4)-8.

Conflicts of Interest — Continued

Investment Allocations

- Private fund advisers did not provide adequate disclosure about conflicts relating to allocations of investments among clients, including:
  - the adviser's largest private fund clients ("flagship funds")
  - private funds that invest alongside flagship funds in the same investments ("co-investment vehicles")
  - sub-advised mutual funds [interesting, given potential ICA violation]
  - collateralized loan obligation funds and
  - separately managed accounts ("SMAs").

  Examples: Private fund advisers preferentially allocated limited investment opportunities to:
  - new clients
  - higher fee-paying clients and
  - proprietary accounts or proprietary-controlled clients.

  Problem: This deprived certain investors of limited investment opportunities without adequate disclosure.

- Private fund advisers allocated securities at different prices or in apparently inequitable amounts among clients:
  - without providing adequate disclosure about the allocation process or
  - in a manner inconsistent with the allocation process disclosed to investors.

  Problem: This caused certain investors to pay more for investments or not to receive their equitable allocation of investments.

Conflicts of Interest — Continued

Capital Structure Variations

- Inadequate disclosure about conflicts created by causing clients to invest in the same portfolio company at different levels of the capital structure.

- **Example:** One client owns debt and another client owns equity in the same portfolio company.

  - **Problem:** The inadequate disclosure deprives investors of important information related to conflicts associated with their investments.

Financial Relationships Between Investors/Clients and the Adviser

- Inadequate disclosure about economic relationships between the adviser and select investors or clients.
- In some cases, these investors were the initial investors in the adviser's private funds ("seed investors").
- In other cases, these select investors had economic interests in the adviser (e.g., they provided credit facilities or other financing to the adviser or the adviser's private fund clients).

  - **Problem:** The inadequate disclosure deprives other investors of important information related to conflicts associated with their investments.

Conflicts of Interest — Continued

Preferential Liquidity Rights

- Private fund advisers entered into side letters with select investors that established special terms, including preferential liquidity terms.

- The advisers did not provide adequate disclosure about these side letters.

  - **Problem:** As a result, some investors were unaware of the potential harm that could be caused if the selected investors exercised the special terms in the side letters.

- Private fund advisers established undisclosed side-by-side vehicles or SMAs that invested alongside another private fund, but these vehicles/SMAs had preferential liquidity terms.

  - **Problem:** As a result, some investors were unaware of the potential harm that could be caused by selected investors redeeming their investments ahead of other investors, particularly in times of market dislocation or other circumstances where there is a greater likelihood of a financial impact.

Adviser/Personnel Interests in Client Investments

- Private fund advisers had interests in investments recommended to clients, but did not provide adequate disclosure of such conflicts.
- In some instances, adviser principals and employees had undisclosed preexisting ownership interests or other financial interests, such as referral fees or stock options in the investments.

Co-Investments

- Inadequately disclosed conflicts related to investments made by co-investment vehicles and other co-investors, potentially misleading certain investors as to how these co-investments operate.
- **Example:** Adviser disclosed a process for allocating co-investment opportunities among select investors, or among co-investment vehicles and flagship funds, but failed to follow the disclosed process.
- Advisers had agreements with certain investors to provide co-investment opportunities to those investors, but did not provide adequate disclosure about the arrangements to other investors.

  - **Problem:** Investors might not understand the scale of co-investments or the manner in which co-investment opportunities would be allocated among investors.

Conflicts of Interest — Continued

Service Providers

- Portfolio companies controlled by advisers' private fund clients entered into service agreements with entities controlled by the adviser, its affiliates, or family members of principals without adequately disclosing the conflicts.
- Advisers had financial incentives for portfolio companies to use certain service providers, such as incentive payments from discount programs, but failed to disclose the incentives and conflicts to investors adequately.
- Advisers did not have in place procedures to ensure that they followed their disclosures related to affiliated service providers.
- Advisers represented to investors that services provided to the private funds or portfolio companies by affiliates would be provided on terms no less favorable than those that could be obtained from unaffiliated third parties. *However, the advisers did not have procedures or support to establish whether comparable services could be obtained from an unaffiliated third party on better terms, including at a lower cost.*

Conflicts of Interest — Continued

Fund Restructurings and Stapled Secondary Transactions

- Background
  - Fund restructurings are transactions where a private fund adviser arranges the sale of an existing private fund or the fund's portfolio to a purchaser.
  - In a restructuring, the purchaser often offers the existing investors the option to sell their interests or roll their interests into a new, restructured private fund.
  - A "stapled secondary transaction" combines the purchase of a private fund portfolio with an agreement by the purchaser to commit capital to the adviser's future private fund.

- Advisers purchased fund interests from investors at discounts during restructurings without adequate disclosure regarding the value of the fund interests.
- Advisers did not provide adequate disclosure about investor options during restructurings, potentially impacting the decisions made by investors.
- Advisers did not provide adequate information in communications with investors about fund restructurings.
- Advisers required any potential purchaser of investor interests to agree to a stapled secondary transaction or provide other economic benefits to the adviser without adequate disclosure about the conflict to investors.

Cross-Transactions

- Advisers established the price at which securities would be transferred between client accounts in a way that disadvantaged either the selling or purchasing client without adequate disclosure.

Fees and Expenses

OCIE staff observed four categories of fee and expense issues that “appeared to be” deficiencies under Section 206 or Rule 206(4)-8:

- Allocation issues
- Operating partner issues
- Valuation issues
- Portfolio company fee issues

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Fees and Expenses — Continued

Allocation Issues

- Private fund advisers inaccurately allocated fees and expenses.
- **Examples:**
  - Advisers allocated shared expenses, such as broken-deal, due diligence, annual meeting, consultants, and insurance costs, among the adviser and its clients (including private fund clients, employee funds, and co-investment vehicles) in a manner that was inconsistent with disclosures to investors or with the adviser's policies and procedures.

    Problem: Adviser caused certain investors to overpay expenses.

  - Advisers charged private fund clients for expenses that were not permitted by the relevant fund operating agreements. These included adviser-related expenses, such as:
    - ✓ Salaries of adviser personnel
    - ✓ Compliance
    - ✓ Regulatory filings
    - ✓ Office expenses

    Problem: Adviser caused investors to overpay expenses.

  - Advisers failed to comply with contractual limits on certain expenses that could be charged to investors (e.g., legal fees or placement agent fees).

    Problem: Adviser caused investors to overpay expenses.

  - Advisers failed to follow their own travel and entertainment expense policies,

    Problem: This potentially resulted in investors overpaying for such expenses.

Fees and Expenses — Continued

Operating Partner Issues

- Private fund advisers did not provide adequate disclosure regarding the role and compensation of individuals that may provide services to the private fund or portfolio companies, but are not adviser employees (i.e., "operating partners").
- **Problems:** This potentially mislead investors about who would bear the costs associated with the operating partners' services and potentially caused investors to overpay expenses.

Valuation Issues

- Private fund advisers did not value client assets in accordance with their valuation processes or in accordance with disclosures to clients (e.g., "the assets would be valued in accordance with GAAP").
- In some cases, this led to *overcharging* management fees and carried interest because such fees were based on inappropriately *overvalued* holdings.

Fees and Expenses — Continued

Monitoring/Board/Deal Fees; Fee Offsets

- Private fund advisers had “issues” with respect to the receipt of fees from portfolio companies, such as monitoring fees, board fees, or deal fees (collectively “portfolio company fees”).
- **Examples:**
  - Advisers failed to apply or calculate management fee offsets in accordance with disclosures. **Problem:** Adviser caused investors to overpay management fees.
    - ✓ In some instances, advisers incorrectly allocated portfolio company fees across fund clients, including private fund clients that paid no management fees.
    - ✓ In other instances, advisers failed to offset portfolio company fees paid to advisory affiliates when these fees were required to be offset against management fees.
  - Advisers disclosed management fee offsets, but did not have adequate policies and procedures to track the receipt of portfolio company fees (including compensation that their operating professionals may have received from portfolio companies). **Problem:** Adviser potentially caused investors to overpay management fees.
  - Advisers negotiated long-term monitoring agreements with portfolio companies they controlled and then accelerated the related monitoring fees upon the sale of the portfolio company, but did not adequately disclose the arrangement to investors.

MNPI/Code of Ethics

<u>Background</u>

- Section 204A of the Advisers Act requires investment advisers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI by the adviser or any of its associated persons.

- Advisers Act Rule 204A-1 (“Code of Ethics Rule”) requires a registered investment adviser to adopt and maintain a code of ethics.

- The code must set forth standards of conduct expected of advisory personnel and address conflicts that arise from personal trading by advisory personnel.

- The Code of Ethics Rule also imposes personal trading restrictions and reporting requirements on certain advisory personnel.

OCIE staff observed three issues that “appeared to be” deficiencies under Section 204A and three apparent deficiencies under the Code of Ethics Rule.

MNPI/Code of Ethics — Continued

MNPI and Section 204A Issues

- Private fund advisers failed to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI as required by Section 204A.

- **Examples:**

  - *Employee Interactions* -- Advisers did not address risks posed by their employees interacting with:
    - ✓ insiders of publicly traded companies
    - ✓ outside consultants arranged by "expert network" firms
    - ✓ "value added investors" (e.g., corporate executives or financial professional investors that have information about investments).

  In these cases, advisers did not assess whether MNPI could have been exchanged through these interactions and, in some cases, the advisers did not enforce policies and procedures addressing these risks.

  - *Access to Offices/Systems* -- Advisers did not address risks posed by their employees who could obtain MNPI through their ability to access office space or systems of the adviser or its affiliates that possessed MNPI.

  - *Periodic or Intermittent MNPI Access* -- Advisers did not address risks posed by their employees who periodically had access to MNPI about issuers of public securities (e.g., in connection with a private investment in public equity).

MNPI/Code of Ethics — Continued

Code of Ethics Issues

- Private fund advisers failed to establish, maintain, and enforce provisions in their code of ethics reasonably designed to prevent the misuse of MNPI.
- **Examples:**
  - Advisers did not enforce trading restrictions on securities that had been placed on the adviser's "restricted list."
  - Advisers that had codes of ethics that provided for the use of restricted lists did not have defined policies and procedures for adding securities to, or removing securities from, such lists.
  - Advisers failed to enforce requirements in their code of ethics relating to employees' receipt of gifts and entertainment from third parties.
  - Advisers failed to require access persons to submit transactions and holdings reports timely or to submit certain personal securities transactions for preclearance as required by their policies or the Code of Ethics Rule, as applicable.
  - Advisers failed to identify correctly certain individuals as "access persons" under their code of ethics for purposes of reviewing personal securities transactions.

1 Advertising in the age of COVID

2 Volcker Rule Revisions

3 SEC Rulemaking

Presented by Adam Kanter

September 2, 2020

Advertising in the Age of COVID

- COVID carve-outs
- Pandemic-inspired past specific recommendations
- So Q2 performance wasn’t great … but what if COVID *hadn’t* happened?
- Stale data?

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Volcker Rule Revisions

- New exclusions for credit funds, VC funds, customer facilitation funds, and family wealth management entities
- Broadened availability of the Loan Securitization Exclusion and the Foreign Public Fund exclusion
- Codified foreign excluded relief for non-U.S. banking entities
- Incorporated certain 23A exemptions into “Super 23A”

SEC Rulemaking

- Accredited Investor amendments
- Form CRS
- Proxy voting

1 Derivatives Law Overview

2 Jurisdiction of the CFTC and Exchanges

3 CTA Registration and Exemptions

4 CTA Marketing Considerations

Presented by Matthew Kluchenek

September 2, 2020

U.S. Derivatives Law/Regulatory Authorities

Commodity Exchange Act of 1936

- Dodd-Frank Act (Title VII - Swaps)

US Derivatives Regulators:

- Commodity Futures Trading Commission (CFTC)
  - Administers the CEA
  - Key Divisions: DOE / DSIO / DMO
- Futures Exchanges (CME Group and ICE Futures)
  - Administer exchange rules
- National Futures Association (NFA)
  - Administers its rules / examines CFTC registrants
- U.S. Attorney's Office / Department of Justice—Criminal Authority

Jurisdiction—CFTC

- **Scope:** To determine whether the CFTC has jurisdiction over a commodity interest transaction under the CEA, we generally examine two factors:
  - whether the transaction involves a "**commodity interest**," and
  - the **location** of the parties to, and the execution of, the transaction.
- **Commodity interests:** Futures, options on futures, swaps and retail commodity transactions (among others).
- **Non-Commodity interests:** Spot transactions, forward contracts, physically-delivered FX swaps and FX forwards, securities, security-based swaps and listed equity option contracts (among others).
  - But, the CFTC has anti-fraud and anti-manipulation authority with respect to cash (physical) commodity transactions (such as Bitcoin and crude oil).
- **Location:** If a US person is involved or the transaction is executed, arranged or booked in the US, then regulation generally follows.

Jurisdiction—Futures Exchanges

- **Deemed Consent**
  - Any person "initiating or executing a Transaction on or subject to the Rules of the Exchange directly or through an intermediary . . . expressly consents to the jurisdiction of the Exchange and agrees to be bound by and comply with the Rules of the Exchange," including rules requiring cooperation and participation in investigatory and disciplinary processes."
- **Remedy for Non-Cooperation?**
  - May terminate market access.
- **Supervision Requirement**
  - Exchange rules impose **duties to supervise**, so policies and procedures are strongly recommended.

What Is a CTA?

- Commodity trading advisors (CTAs) provide advice to clients with respect to the value or advisability of trading *commodity interests*.
- CEA §1a(12)(A) defines a CTA as 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 "compensation or profit" element is very broad. Can mean a business benefit.
- CEA § 4m(1) makes it unlawful to engage in the business of providing commodity trading advice without registering as a CTA with the CFTC.

When Is a CTA Exempt from Registration?

1. **CEA §4m(1) / CFTC Rule 4.14(a)(10)**: Small advisors (15 or fewer clients and no holding)
2. **CEA §4m(3):** SEC-registered investment advisers
3. **CFTC Rule 3.10(c)(3):** Foreign advisors with non-US clients
4. **CFTC Rule 4.6(a):** Otherwise regulated entities
5. **CFTC Rule 4.6(a)(3):** CFTC-registered swap dealers
6. **CFTC Rule 4.14(a)(1)**: Cash market transactions
7. **CFTC Rule 4.14(a)(2):** Non-profits
8. **CFTC Rule 4.14(a)(3):** APs
9. **CFTC Rule 4.14(a)(4):** CFTC-registered CPOs
10. **CFTC Rule 4.14(a)(5):** Exempt CPOs
11. **CFTC Rule 4.14(a)(6):** IBs
12. **CFTC Rule 4.14(a)(7):** RFEDs
13. **CFTC Rule 4.14(a)(8)**: Investment advisers (registered and exempt)
14. **CFTC Rule 4.14(a)(9):** Publishers

Exemptions Commonly Relied Upon by Investment Advisers—CEA §4m(1)

- **Small Adviser Exemption.** A manager who, in the preceding 12 months, has not furnished commodity trading advice to more than 15 persons and "who does not hold himself out generally to the public" as a CTA is exempt from CTA registration.
- Thus, two elements:
  - Not more than 15 persons; and
  - Does not "hold himself out generally to the public" as a CTA.

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Exemptions Commonly Relied Upon by Investment Advisers—CEA §4m(1)

- CFTC staff has stated that the "hold himself out" factor includes "such conduct as promoting advisory services through mailings, directory listings, and stationery, or otherwise initiating contacts with prospective clients."
- Thus, "unless the CTA restricts his or her clients to family, friends, and existing business associates, a CTA will generally be viewed as holding himself or herself out to the public."
- Moreover, according to CFTC staff, a CTA that identifies itself as a CTA or otherwise refers to its advisory services or history on a "public electronic forum such as portions of the Internet or a proprietary on-line service" may not avail itself of the exemption under CEA §4m(1).

Exemptions Commonly Relied Upon by Investment Advisers—CEA §4m(3)

- An exemption from CTA registration under CEA §4(m)(3)(A) is available for a manager:
  - who is registered with the SEC as an investment adviser;
  - whose business does not consist primarily of acting as a CTA; and
  - who does not act as a CTA to any commodity pool that is engaged primarily in trading commodity interests.

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Exemptions Relied Upon by Investment Advisers—CEA §4m(3)

- A CTA or a commodity pool is considered to be "engaged primarily" in the business of being a CTA if it 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.
- While the "holding out" element appears in other CTA registration exemptions (*e.g.*, CEA §4(m)(1) above), they are used in different contexts, which substantially changes their meaning.
- Thus, the CFTC's broad interpretation of the phrase "hold himself out generally to the public" in CEA §4m(1) would not apply in the case of CEA §4m(3), which has a more limited "holding out" restriction.
- For commodity pools, we need to examine whether the pool is "primarily engaged".

Exemptions Relied Upon by Investment Advisers—CFTC Rule 4.14.(a)(8)

- An exemption from CTA registration under CFTC Rule 4.14(a)(8) is available for an investment adviser—**registered or exempt**—where:
  - the adviser provides advice to:
    - “qualifying entities” (*i.e.*, investment companies, separate accounts, trusts and pension plans),
    - collective investment vehicles excluded from the definition of commodity pool under Rule 4.5(a)(4) (*i.e.*, certain pension plans),
    - commodity pools that are organized and operated outside of the U.S., and
    - commodity pools exempt under Rule 4.13(a)(3);
  - such trading advice is **solely incidental** to its securities advice; and
  - the manager does **not otherwise hold itself** out as a CTA.

Exemptions Relied Upon by Investment Advisers—CFTC Rule 4.14.(a)(8)

- CFTC staff has stated that, in construing the term "solely incidental," the term is "not meant to denote a numerical standard but rather, must be construed in the context of the business concerned and the factual situation in which the services are rendered."
- *In re Summit Energy Services, Inc.*, the CFTC addressed the "solely incidental" factor in the context of an advisor that provided commodity interest hedging advice in connection with physical purchases and sales.
- According to the CFTC, "[t]hrough its website and public brochures, Summit Energy publicly offered prospective clients 'risk management' services which included advising its clients as to the value of or the advisability of trading in natural gas swaps and futures. Summit Energy's commodity trading advice was part of, and not solely incidental to, its business."

CTA Registration Process

- To register with the CFTC as a CTA, the CTA must have at least one associated person ("AP") who has passed the Series 3 exam, and all principals and APs of the CTA must provide their fingerprints to the NFA for a background check.
- The CTA is subject to a one-time requirement to file Form 7-R (for the entity) and Form 8-R for each principal and associated person with NFA.
- Employees of the CTA who engage in swaps activity are subject to NFA's Swaps Proficiency Requirements.

Registration “Lite”

- If a CTA satisfies specified eligibility criteria, the CTA may register under CFTC Rule 4.7, which offers an exemption from many of the more onerous requirements associated with registration as a CTA.
- Registration under Rule 4.7—which is often referred to as “registration lite”—provides an exemption from certain **disclosure, reporting and recordkeeping** requirements for registered CTAs.
- To qualify as a CTA under Rule 4.7, the person must:
  - be registered with the CFTC as a CTA;
  - file a Rule 4.7 notice of exemption through NFA’s Exemption System;
  - accept only clients that satisfy the definition of “qualified eligible person,” or “QEP,” in Rule 4.7; and
  - ensure that disclosure document (or other documentation) contains the required CFTC disclaimer.

Marketing Considerations—Exempt and Registered CTAs

- CTAs that are exempt from registration are nonetheless subject to certain regulatory requirements that apply to all CTAs.
- For example, a CTA **(whether registered or unregistered)**:
  - may **not refer to any testimonial or to any simulated or hypothetical performance of the CTA or any of its principals, unless certain disclosures are made** in accordance with the rules;
  - may **not solicit or accept client funds or other property (or extend credit in lieu thereof) to purchase, margin, guarantee or secure any commodity interest** of the client,
  - may **not represent or imply that it has been recommended or approved, or that their abilities or qualifications have been passed upon by, the CFTC**,

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Marketing Considerations—Registered CTAs

- **Key Rules:** Part 4 of the CFTC's rules and NFA rules 2-29 and 2-36
- **Focus on "Promotional Material":**
  - Except for day-to-day communications with clients, most communications with the public are considered promotional material.
    - Sales or educational literature distributed to the public;
    - Seminar presentations and any related advertising of those;
    - Advertising in newspapers, magazines, radio, television, websites, etc.;
    - Standardized phone solicitations, including cold calls;
    - Newsletters, reports, circulars, etc.;
    - A prepared sale script, whether used or just for training;
    - Audio or video recordings used on the Web or other media; and
    - Hotlines.

Materials, Statements and Opinions

- **Promotional Material**
  - Must not be deceptive or misleading;
  - Must not use high-pressure sales tactics;
  - Must not say or imply that trading is appropriate for everyone.
- **Factual Statements**
  - Must be true **and** supported; and
- **Statements of Opinion**
  - Must be identifiable as opinions;
  - Must have a reasonable basis in fact;
  - If there are good and bad testimonials, cannot only show the good ones.

Possibility of Profit

– Must analyze an overall promotional piece for balance. Items to consider include:
  - Font size of the risk disclaimer vs. font size of the remainder of the text;
  - The number of times profit is addressed vs. the number of times risk of loss is addressed;
  - The manner in which risk is addressed – a risk disclaimer must address the **significant risk of loss** that is unique to the futures industry.

Disclaimers

- **"Commodity Trading Involves Substantial Risk of Loss“**
  - is an appropriate disclaimer.
- **"All Trading Involves Risk"**
  - is **not** an appropriate disclaimer, as it fails to address the risk of loss that is unique to the futures industry.
- **"Commodity trading involves substantial risk of loss. However, it is less risky than investing in swaps."**
  - is **not** acceptable, as any discussion addressing risk should stand alone and should not include qualifiers.

Websites and Social Media

- Any communication related to a commodity interest transaction that is posted by or on behalf of a CTA member on a website, social media page or another internet-based forum that can be viewed by the general public or a closed community that includes current and potential customers, falls within the definition of promotional material and is subject to the requirements of NFA rules.
- CTAs must implement written supervisory procedures governing the use of websites, social media and other internet-based forums that are designed to achieve compliance with the requirements of NFA rules, including NFA Rules 2-10 and 2-29.

Use of Leads

- If a NFA member firm does not have direct knowledge of the source of leads, then the NFA member has a **duty to inquire** as to the source of leads.
- If a Member firm purchases leads from a third-party, then the NFA member must ensure—prior to soliciting any customer with the leads—that the advertisement used by the lead provider complied with NFA Rule 2-29.

Performance Results

- With the exception of proprietary trading results, a non-Rule 4.7 CTA must disclose the actual performance of all accounts directed by the CTA and each of its trading principals.
  - Detailed disclosures apply.
- All required performance information must be presented for the most recent five years and year-to-date, or for the life of the trading program or account if in existence less than five years.
- If the CTA or its trading principals previously have not directed any accounts, the CTA must prominently disclose this fact.
- Proprietary trading results may not be included in unless it is **clearly labeled** as "Proprietary" and set forth separately after all other disclosures, together with a discussion of any differences between such performance and the performance of the offered trading program.

- Hypothetical performance results are any performance results derived with the benefit of hindsight.
- Cannot be presented for any trading program that has at least three months of actual client or proprietary trading results;
- Must be accompanied by prescribed statements / disclaimers regarding hypothetical or simulated performance results;

Department of Labor: Definition of Investment Advice and Proposed New Class Exemption

Presented by: Erika Gosker

September 2, 2020

Who Is an ERISA Fiduciary?

A “fiduciary” under ERISA includes:

- any person who renders investment advice to a plan for a fee (direct or indirect) and
- any person who has discretionary authority or control respecting the management or disposition of plan assets

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- 1975 - the Department of Labor first adopted a regulation defining “investment advice”
- 2010 - a proposal to amend the long-standing regulation
- 2016 - an amendment that became applicable in 2017 (the “2016 Fiduciary Rule”)
- 2018 - the U.S. Court of Appeals for the Fifth Circuit vacates the 2016 Fiduciary Rule

2016 Fiduciary Rule

In connection with the expanded scope of fiduciary status, the Department of Labor

- revoked Interpretive Bulletin 96-1 regarding participant investment education,
- adopted two new prohibited transaction exemptions, and
- amended various existing Prohibited Transaction Class Exemptions (collectively, the "Amended PTEs").

Field Assistance Bulletin 2018-02

- Issued in response to the Fifth Circuit ruling vacating the 2016 Fiduciary Rule
- Policy of non-enforcement of prohibited transaction claims against investment advice fiduciaries who worked diligently and in good faith to comply with the “Impartial Conduct Standards” for transactions that would have been exempted in the new exemptions adopted in connection with the 2016 Fiduciary Rule

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Technical Amendment by the Department of Labor

Conform the text of the regulation in the CFR regarding the definition of "investment advice" and the Amended PTEs in light of the Fifth Circuit's decision vacating the 2016 Fiduciary Rule

1975 Regulation: 5-Part Test

- A person is an ERISA fiduciary to a plan if it gives "investment advice" for a fee or other compensation (direct or indirect) with respect to the assets of a plan
- A person is only considered to give "investment advice" if:
  - The person renders advice as to the value of securities or other property or makes recommendations regarding the advisability of buying, selling or retaining securities or other property
  - On a regular basis
  - Pursuant to a mutual agreement or understanding
  - That serves as a primary basis for the investment decision
  - Which is individualized for the plan

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Interpretive Bulletin 96-1

Guidance with respect to participant investment education

- Revoked in connection with the 2016 Fiduciary Rule
- Reinstated by technical amendment

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- Advice to take an otherwise permissible plan distribution, even when that advice is combined with a recommendation as to how the distribution should be invested, does not constitute “investment advice”
- The Department of Labor retracts the views expressed in Advisory Opinion 2005-23A

Improving Investment Advice for Workers & Retirees – The Proposed Exemption

A proposed prohibited transaction class exemption (the “Proposed Exemption”) based on Field Assistance Bulletin 2018-02.

- Allows the receipt of otherwise prohibited compensation
- Permits riskless principal transactions and certain other principal transactions (Covered Principal Transactions)

Improving Investment Advice for Workers & Retirees – The Proposed Exemption

Who may rely on the Proposed Exemption?

- "Financial Institutions"
- "Investment Professionals"

Conditions of the Proposed Exemption – Impartial Conduct Standards

- “Best Interest” standard
- “Reasonable” compensation
- “Best execution”
- Statements are not materially misleading

Conditions of the Proposed Exemption –Written Disclosure, Policies and Reports

- Acknowledge the applicable fiduciary status
- Describe the services to be provided and the material "Conflicts of Interest"
- Adopt policies and procedures prudently designed to ensure compliance with the Impartial Conduct Standards
- Conduct a retrospective review, at least annually, of compliance with the Impartial Conduct Standards and the policies and procedures

Exclusions – The Proposed Exemption Does Not Apply

- if the plan is subject to Title I of ERISA and the investment advice fiduciary or an affiliate is the employer of the employees covered by such plan or is a named fiduciary or plan administrator with respect to such plan and was selected to provide advice to such plan by a fiduciary who is not independent of such investment advice fiduciary and its affiliates
- if the investment advice is generated solely from computer models or applications
- if the Investment Professional is acting in a fiduciary capacity other than as an investment advice fiduciary

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Private Equity Hot Issues

The Pandemic and Its Aftermath: The Impact on Private Equity

Presented by James M. Schell

September 2, 2020

- Market Uncertainty Lowers Portfolio Valuations Both for Specific Companies and Generally
- Portfolio Company Exits Suffer Material Contraction
- Some Portfolio Companies Suffer Severe Revenue and Cash Flow Contraction
- Private Equity Fund Distributions Contract, Impacting Large Investor Portfolio Management
  - Alternative Asset Allocations Require Excess Commitments to Achieve Target Deployment
  - Many Investors Rely Substantially on PE Fund Distributions to Fund Commitments

Medium Term

- Central Bank Policies Expected to Continue Low Fixed Income Environment
- Large Investors, Especially Public and Private Pension Funds, React to Lower Fixed Income Expectations
  - Pressure Rises to Increase Alternative Asset Allocation
  - Increased Focus on Controlled Staging of Capital Calls, Quicker Distributions and Secondary Market Liquidity
- Distinguishing Pandemic Zombies from Short-Term Distress
  - Sales and Revenue Shortfalls Prove Fatal to Some
  - Indirect Victims: Landlords and Suppliers Confront Longer Term Contraction of Demand

Longer Term

- Duration of Low Fixed Income Environment
- Economic and Political Developments Diminish Support for Cross Border Mobility of Goods, Services and Capital
- Distinguishing Temporary Disruption From Long Term Change
  - International Supply Chains
  - “Just in Time” Inventory Management
  - Retail Distribution
  - Telecommuting

Potential Market Responses

- Traditional Secondary Players Increase Capital and Transaction Capacity
- Institutional Investors Attempt Structured Sales of a Percentage of a Pool of PE Funds, Balancing Liquidity Needs with Retained Equity Upside
- Sponsors Pursue Liquidity Alternatives
  - Fund level borrowing to achieve partial liquidity
  - Form controlled, leveraged fund to purchase some or all of primary fund portfolio investments
    - Agency cross rules and conflicts
    - Valuation risk and disclosure
    - Impact on portfolio companies