ANNUAL COMPLIANCE UPDATE

REGULATORY CHANGES & HIGHLIGHTS FROM 2017

Dear Clients and Friends,

With 2018 now upon us, we review our current regulatory climate and highlight compliance obligations for the coming year. In this year's Annual Compliance Update, we cover notable regulatory issues and significant enforcement actions. We also provide a compliance calendar highlighting filings and other action items applicable to many of our clients and investment advisers.

If you have any questions about this year's Annual Compliance Update, please do not hesitate to contact Blue River. Our industry experts are available to assist as needed.

All the best in 2018,

Blue River Partners, LLC

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Blue River Partners, LLC provides a variety of outsourced solutions to Hedge Funds, Private Equity Firms, Registered and Exempt Investment Advisers (IAs), Registered Investment Companies (RICs), Commodity Pool Operators (CPOs), Fund of Funds, Family Offices, and others across the entire spectrum of structures, strategies, and asset classes.

- *Regulatory Compliance Program Design, Implementation, and Ongoing Management*
- *CFO Back-Office Operational Services*
- *Fund Launch Management and Consulting*
- *Private Equity Administration Services*
- *Accounting/CFO/Controller Services for Private Equity Portfolio Companies and Portfolio Assets*
- *Private Equity Tax Advisory & Compliance Services*
- *Information Technology and Cybersecurity Services*

Headquartered in Dallas, with satellite offices in Houston, New York, Chicago, and San Francisco; Blue River is predominantly comprised of experienced Attorneys and CPAs at the management level who have joined us from their prior roles as CCOs, CFOs, COOs, and General Counsel at numerous large and complex alternative and traditional investment entities. To see information about senior management of Blue River Partners, click here.

Contents of Annual Compliance Update

I. Regulatory Examinations, Enforcement Actions, and Guidance

The following section provides an overview of regulatory events and guidance applicable to investment advisers registered under the Investment Advisers Act of 1940 ("RIAs"). This information also serves as a useful tool for exempt reporting advisers ("ERAs") and state registered investment advisers when identifying best practices and obtaining a better understanding of regulatory expectations from the Securities and Exchange Commission (the "SEC"). However, state registered investment advisers must note that state regulations often differ from federal regulations, and such state investment advisers must refer to state rules and regulations for guidance specifically applicable to them.

1. 2017 Examination Highlights

a. Office of Compliance Inspections and Examinations (the "OCIE") Highlights Exam Priorities

The OCIE, which serves as the administrative arm of the SEC's examination and inspection program, publishes an annual Examination Priorities letter to identify areas of focus for regulatory examinations of RIAs. The Examination Priorities letter for 2017, which was issued in January of 2017, was broken into four broad categories: (1) retail investors; (2) senior investors and retirement accounts; (3) market-wide risks; and (4) miscellaneous topics.

Retail Investors

The OCIE is directing its efforts in areas of the financial industry that it perceives provide retail investors with higher risks. Along these lines, the OCIE is reviewing various types of advisory arrangements and specific business models used by RIAs that may impact retail investors. With respect to advisory arrangements, the OCIE is closely reviewing wrap fee programs. In terms of RIAs with certain business models, the OCIE is reviewing never-before examined RIAs—both newly registered advisers and advisers registered for some time, but not yet examined—and multi-branch RIAs, with a specific focus on the continuity of the compliance program throughout geographically separated offices.

Senior Investors and Retirement Accounts

The SEC is working to improve the measurement of potential risks that investors face when entrusting RIAs with their assets—especially assets designated for retirement. The spirit of this goal is captured in the ReTIRE exam initiative. ReTIRE is a program that the SEC started in 2015 as a push to enhance risk assessment for retail investors during examinations that focuses on: (i) exploration of the rationale behind investment recommendations; (ii) detection of conflicts of interest; and (iii) compliance policies and procedures, and the associated implementation, including controls over communications with prospective and current investors.

Market-Wide Risks

As part of the OCIE's market-wide risk initiative, the SEC is reviewing specific areas of RIAs' businesses, such as cybersecurity and risk management. The SEC will continue to scrutinize RIAs' cybersecurity compliance and controls by vetting the success of policy and procedure implementation efforts, and testing these policies and procedures for effectiveness. (Please see the section titled "Cybersecurity" for a discussion of cybersecurity updates.) Further, as a measure to review RIAs' risk management programs, the SEC will focus on RIAs' internal controls over "business units, subsidiaries, and related interconnected infrastructure."

Miscellaneous Areas of Focus

The OCIE provides a list of focus areas that do not fit in the broad categories stated above. This miscellaneous section specifically lists private fund advisers, such as hedge funds and private equity firms, as an area of focus. The letter further explains that during examinations with private fund advisers, the OCIE intends to focus on conflicts of interest—specifically, conflicts perceived to benefit the adviser at the expense of investors and disclosures of such conflicts.

While this list of examination priorities is not exhaustive and does not cover the breadth of topics that are fair game for the SEC, it highlights key risk areas for investment advisers to focus on. Accordingly, it is an excellent jumping-off point for investment advisers critically analyzing their own compliance policies and procedures.

For additional insight on examination priorities and hot-button issues, contact Blue River for assistance.

To read the OCIE Examination Priorities letter released in January of 2017, click here.

b. SEC Issues Guidance on Examination Findings: Problematic Advertising Practices

RIAs are required to comply with Rule 206(4)-1 of the Investment Advisers Act of 1940, which, in addition to other requirements and prohibitions, has the well-established rule that statements contained in marketing materials cannot be false or misleading. In September of 2017, the OCIE provided a list of the most frequently identified compliance issues related to advertising that they have encountered during recent examinations. Some of the more pertinent issues are listed below:

1. RIAs compared their client's performance to benchmarks without disclosing the limitations of such comparison, including that the client may have a materially different strategy from the benchmark(s).
2. RIAs provided hypothetical performance results without providing proper disclosures such as how the results were calculated and other required disclosure information.
3. RIAs provided their best and worst performing securities, but failed to comply with SEC requirements by providing a minimum number of ten securities that contain an *equal* number of best and worst performers.
4. RIAs provided case studies that contain performance information.

This Risk Alert reiterates the importance of having your compliance team review and approve all marketing materials prior to dissemination.

If you have any questions, please contact Blue River for assistance.

To view the 2017 Advertising Risk Alert, click here.

c. SEC Reaches Settlement with an External Chief Compliance Officer ("CCO")

Some compliance consultants use a business model that calls for an employee of the consultant to serve as an outsourced CCO for its investment advisory clients. The SEC has made their view on this approach very clear through a highly critical Risk Alert in late 2015 outlining that there can be serious regulatory issues when a firm engages an external CCO. Despite these warnings, the practice still continues. A recent case concerning an outsourced CCO reiterates the importance of understanding and assessing the regulatory risks inherent in your firm's compliance program.

In August of 2017, David Osunkwo, a consultant that was hired to act as an outsourced CCO for multiple RIAs, reached a settlement with the SEC for alleged violations of the Investment Advisers Act of 1940 that occurred during his tenure as outsourced CCO. Pursuant to service contracts with the RIAs, Mr. Osunkwo was the appointed CCO of each RIA and was responsible for making the RIAs' regulatory filings.

Pursuant to the SEC's findings, Mr. Osunkwo, while serving in the capacity of CCO, (i) failed to file an RIA's Form ADV annual amendment; (ii) failed to timely file a Form ADV-W after an RIA ceased to be in business; and (iii) misrepresented both an RIA's regulatory assets under management ("RAUM") and the number of clients in its late Form ADV annual amendment. The misrepresentations were due to Mr. Osunkwo's failure to take appropriate steps to confirm the RIA's RAUM and number of clients despite signing the Form ADV with the Chief Investment Officer's ("CIO") name (indicating that such figures were approved by the CIO). The SEC imposed fines on Mr. Osunkwo and suspended him from securities-related jobs (including future CCO roles) for one year.

While this settlement serves as an example of the risks associated with an investment adviser using an external CCO, it also reiterates the importance of discussing the structure of your firm's compliance program when working with regulatory compliance experts, with a specific focus on limiting regulatory risk. Mr. Osunkwo's firm used a business model that resulted in him serving as the outsourced CCO for investment advisory clients, which is rife with regulatory risk. Blue River uses a different business model which allows an adviser's CCO to leverage Blue River's resources. This permits Blue River to maintain the daily compliance responsibilities of the business and report up to the CCO with respect to any critical issues or decisions. Under this model, the CCO role is converted from an administrative role to a management role, but with interests and responsibilities aligned between the internal CCO and Blue River, which often leads to a quality compliance program that is less demanding on the CCO. This model has developed into an acceptable approach from a regulatory perspective, as evidenced by the greater than 150 regulatory examinations in which Blue River has participated.

If you have any questions about outsourced CCOs, please contact Blue River for assistance.

To read the Order of Settlement, click here.
To read the OCIE's Risk Alert, click here.

d. The OCIE Continues to Review Compliance with Whistleblower Regulations

As a result of several enforcement actions that took place in a short period of time towards the end of 2016, the OCIE issued a Risk Alert in October of 2016 stating it would be examining RIAs' whistleblower policies and procedures for their compliance with Rule 21F-17 of the Securities Exchange Act of 1934 (the "Whistleblower Rule"), which states, generally, that "no person may take any action to impede an individual from communicating directly with the [SEC] about a possible securities law violation."

The examination program continued throughout 2017 and primarily focused on RIAs' compliance manuals, codes of ethics, employment agreements, and severance agreements. The examination program exposed common pitfalls in RIAs' practices, including: (i) contractual obligations limiting an employee's ability to report potential issues to regulatory bodies and (ii) requiring departing employees to waive all rights to monetary compensation if they report information to regulatory bodies.

As the OCIE's examinations continue, now is an important time for investment advisers to review their compliance manuals, codes of ethics, employment agreements, and severance agreements for compliance with the Whistleblower Rule. In addition to ensuring that these important documents do not include any of the problematic terms discussed above, investment advisers should include language in these documents that either expressly requires employees to disclose potential or actual securities laws violations to an authoritative figure within the organization or, at a minimum, provides employees protection from retaliatory backlash for disclosures of potential violations of securities law made in good faith.

Contact Blue River if you would like to discuss your firm's policies and procedures related to whistleblowing.

To read the OCIE's October 2016 Risk Alert, [click here].

2. Cybersecurity

a. SEC's Risk Alert Includes Cybersecurity Guidance

In April of 2014, the OCIE began its Cybersecurity Initiative, which among other items, subjected advisers to examinations designed to evaluate the adequacy of cybersecurity policies and procedures ("Cybersecurity Programs"). In February of 2015, the SEC issued a Risk Alert summarizing weaknesses in advisers' Cybersecurity Program. The following year, in May of 2016, Mary Jo White, the previous Chairwoman of the SEC, issued a Key Note Address stating that Cybersecurity is "particularly critical" as it is "one of the greatest risks facing the financial services industry." Approximately a year later, in August of 2017, the OCIE produced a Risk Alert providing guidance on important elements of a sufficient Cybersecurity Program. The OCIE's continued guidance and the SEC's public statements on cybersecurity make it clear the SEC is continually reviewing investment advisers' cybersecurity practices.

The August 2017 Risk Alert listed various practices that would assist in establishing a robust Cybersecurity Program:

1. Senior Management should participate in the construction and implementation of the firm's Cybersecurity Program, since their knowledge of the firm's business helps ensure that the policies are as tailored as possible.
2. Employee access rights should be prescribed based on defined criteria via an enforceable use policy, which should include restrictions on employee mobile devices and processes for off-boarding employees when they leave the firm.
3. Investment advisers should establish testing programs, including both technical testing (such as penetration testing and vulnerability scans), and procedural testing (such as conducting exercises designed to review the adequacy of the procedures included in a firm's Cybersecurity Program). These tests provide the firm with relevant feedback about a Cybersecurity Program's effectiveness and areas of weakness. High risk deficiencies discovered should be remediated as soon as possible.
4. Incident reporting and remedial action should be components of the Cybersecurity Program since they are vital for reducing cyberattack damage and preventing spreading.

Since the OCIE provided numerous cybersecurity best practices to consider in the Risk Alert, prudent investment advisers should run a comparison between their current Cybersecurity Program and the OCIE's elements to determine if their current plans are robust enough when viewed under the lens of a regulator.

Self-Assessment

The OCIE's findings revealed that, while most investment advisers have adopted formal Cybersecurity Programs, many still have lingering cybersecurity issues. Drafting a robust Cybersecurity Program is only half the battle, as OCIE examinations revealed investment advisers have generally failed to implement or maintain important aspects of their Cybersecurity Programs. In fact, the OCIE observed that the "vast majority" of investment advisers examined suffered from at least one cybersecurity issue.

As it is incumbent on investment advisers to implement and maintain the Cybersecurity Program they adopt, we have provided a few questions for our friends and clients to consider when evaluating their own Cybersecurity Program:

1. Are there policies in place about when to alert the adviser of a security incident?
2. Can the IT provider produce a copy of its information security policy upon request?
3. Are changes and improvements to the IT security policy applied as needed and documented within a change log?
4. Are full backups performed and tested before applying any major system updates or security patches?
5. Are procedures in place to manage employee remote access? Have steps been taken to ensure remote access is being delivered securely, such as implementing multi-factor authentication?

The questions above provide a small sample of the questions that should be asked to your IT service provider both initially upon engaging the IT provider and periodically thereafter. We recommend compiling a list of probing questions in the form of a due diligence questionnaire designed to assess the effectiveness of your IT Provider's services, which in turn, allows you to assess your Cybersecurity Program as a whole.

If you need any assistance drafting a due diligence questionnaire for your IT service provider, or alternatively, if you have any concerns about your firm's Cybersecurity Program, contact Blue River to learn more about our cybersecurity services.

To read the April 2014 Cybersecurity Initiative, click here.
To read the February 2015 Cybersecurity Risk Alert, click here.
To read Chairwoman Mary Jo White's May 2016 Keynote Address, click here.
To read the August 2017 Cybersecurity Risk Alert, click here.

3. Cryptocurrencies and Blockchain Technology

a. Overview

In 2009, an anonymous person using the pseudonym "Satoshi Nakamoto" designed a distributed ledger technology called Bitcoin. At the time, the technology boasted peer-to-peer transactions with fast speeds and low fees. Although Bitcoin has existed for close to ten years, the alternative asset industry has not paid much attention until 2017, when Bitcoin's value dramatically appreciated which led to considerable investor interest.

Bitcoin is not the only distributed ledger technology; in fact, there are over 1,000 variants of cryptocurrencies available today. At a high level, these distributed ledger technologies can be placed into two broad categories. First, those that have a finite quantity and are designed to provide the transactional benefits of fiat currency. (Prominent examples include Bitcoin and Litecoin.) And second, those that function as platforms to build applications. (Prominent examples include Ethereum and NEO.) The tokens that function as platforms are used by an organization, referred to as a Decentralized Autonomous Organization (or “DAO”), to create a new application that is generally intended as a for-profit enterprise. The new application generates a separate and distinct set of digital tokens controlled by the DAO. When the DAO engages in fundraising by selling its digital tokens, it takes part in what is called an Initial Coin Offering (or “ICO”). Oftentimes, the general public is invited to participate in ICOs by trading valuable cryptocurrencies for the new tokens created by the DAO. Despite the novelty of this process, hundreds of millions of dollars were raised during the numerous ICOs that took place in 2017 alone.

Because this rapid growth has driven enormous sums of money into the burgeoning cryptocurrency asset class, regulators—including the Commodity Futures Trading Commission (“CFTC”), National Futures Association (“NFA”) and SEC—are actively working to assess and identify effective ways to protect U.S. consumers from potential bad actors and other significant risks. In fact, as discussed in more detail below, regulators have already been active in identifying and stopping unlawful ICOs, as well as other activities that run contrary to securities laws and regulations.

b. The Role of the CFTC/NFA

The CFTC and NFA regulate transactions in commodity interests. Generally speaking, commodity interests are products including a derivative where the commodity serves as the underlying asset. Starting in 2015, through a series of enforcement actions and associated communications, the CFTC determined that Bitcoins and some similar cryptocurrencies are commodities. Following this determination, the Commission asserted its jurisdiction over Bitcoin commodity interests.

An important distinction to make is the difference between Bitcoin as a commodity—which generally does not fall under the CFTC or NFA’s jurisdiction—and what constitutes a Bitcoin commodity interest—which is regulated by the CFTC and NFA. For example, an investment fund allocating one million dollars of capital to buy one million dollars’ worth of Bitcoins will not fall under the CFTC’s jurisdiction, since it is considered a transaction in the spot market of that commodity. However, if the Bitcoin transaction includes leverage, margin finance is utilized, or there is optionality in the transaction, the transaction is not a spot market transaction, is considered a commodity interest and is under the jurisdiction of the CFTC. The most obvious and simple example of a Bitcoin commodity interest is the recently launched Bitcoin futures contract, which is listed on derivatives exchanges.

In September, the CFTC exercised its regulatory authority in this area by charging Nicholas Gelfman for allegedly engaging in a Ponzi scheme involving Bitcoin. According to the CFTC’s complaint, Mr. Gelfman raised $600,000 from investors to establish a fund in New York that supposedly used high-frequency, algorithmic trading capable of obtaining monthly profits of 7-9% from Bitcoin investments. In reality, Mr. Gelfman was engaging in a traditional Ponzi scheme and distributing new subscriber income as “profits” to existing investors. As of September 21st, 2017 the CFTC is still seeking restitution, fines and other penalties against Mr. Gelfman.

c. The Role of the SEC

The SEC regulates assets that constitute “securities” as defined by applicable statutes, rules and regulations, meaning that its jurisdiction is limited to cases in which securities are included in the facts and circumstances. Because the CFTC has taken the stance that cryptocurrencies are generally commodities, the SEC’s role in regulating cryptocurrencies was unclear until the SEC published an investigative report in July of 2017. The report concluded that—based on the facts and circumstances—

DAO tokens may fall within the definition of securities and may be subject to the SEC's purview.

The SEC arrived at this conclusion by applying the logic of the Howey test to DAO tokens. The Howey test, which is used to determine whether an asset constitutes a security, requires that the asset is tied to an "investment contract" to be considered a "security." An investment contract has three main components: (1) an investment of money (2) in a common enterprise with a reasonable expectation of profits (3) derived from the entrepreneurial or managerial efforts of others. Analyzing DAO tokens, the SEC concluded that (1) people invested money by contributing valuable cryptocurrencies to the DAO during the ICO, (2) these investors had a reasonable expectation of profit due to the promotional items and publicized for-profit intent behind the ICO, and (3) potential profits would be derived from efforts of the DAO's staff. Accordingly, the DAO's tokens constituted securities subject to the SEC's jurisdiction.

After this investigative report was issued, the SEC has continued to be active in combating abuses in the cryptocurrency market. For instance, in September, the SEC established a Cyber Unit to combat, among other cyber-related topics, violations of securities laws stemming from distributed ledger technology and ICOs. Additionally, in December of 2017, SEC Chairman Jay Clayton issued a statement cautioning investors who may be considering investing in cryptocurrencies. Mr. Clayton specifically referenced the rapid growth, potential illegality of ICOs, substantial risks, and guarantees of excessive profits. This warning may have been motivated by recent events, as one week prior, the SEC took emergency action to halt an "ICO Scam" in which an entity named PlexCorps and its owners were violating securities laws during an ICO. The SEC asserted PlexCorps misappropriated investor funds, engaged in an unregistered offering, and made false and misleading statements in connection with the ICO—including a claim that investors would obtain over 1,000% profits in less than a month.

As the cryptocurrency market is still developing, there are numerous uncertainties on how it will be regulated. Investment advisers looking to invest in cryptocurrencies or their derivatives would be wise to monitor regulatory developments and evaluate how these developments may impact their business.

If you have any questions on how developments in regulations are impacting your business, contact Blue River for assistance.

To read the September 2017 CFTC case, click here.
To read the SEC's July 2017 Report on DAOs and securities, click here.
To read the September 2017 Cyber Unit Announcement, click here.
To read Chairman Jay Clayton's December 2017 statement, click here.
To read the SEC's December 2017 Complaint against PlexCorps, click here.

II. Changing Regulatory Landscape

1. The SEC Implements New Form ADV

The ADV is an investment adviser's primary disclosure document, which is publicly available online at the SEC's website. In general, the ADV requires both RIAs and ERAs to provide varying degrees of information about their businesses' ownership, advisory clients, affiliations, conflicts of interest, and employee disciplinary events. The information disclosed in the ADV is used by the OCIE to prepare for, conduct, and implement risk-based examination programs. It is also used as a source for examiners during examinations, investigations, and enforcement actions.

In May of 2015, the SEC proposed amendments to the ADV, and in August of 2016, the SEC approved many of these amendments. The amendments took effect on October 1, 2017 and established a revised ADV (the "new ADV"). RIAs and other investment advisers will need to complete and file new ADVs before the end of the first quarter of 2018 during their annual ADV update. Due to the significant role of the new ADV as well as the upcoming deadline, steps should be taken to become familiar with new disclosure requirements and gain an understanding of the best ways to approach the new ADV.

A few notable changes to the filing include:

- Investment advisers providing advisory services to separately managed accounts ("SMAs") are required to disclose more information about their SMAs, including the RAUM attributable to each SMA, potential use of borrowings and derivatives for each SMA, and identification of the custodian of each SMA that represents ten percent or more of the adviser's RAUM specifically attributable to SMAs.

- Additional information on the investment advisers and their affiliates is requested, including not only disclosure of an investment adviser's website, but also (i) websites used for social media accounts such as Facebook, LinkedIn, and Twitter; (ii) information on an investment adviser's branch offices, such as the number of employees and activities performed at each office; (iii) whether the CCO is employed by someone other than the investment adviser; and (iv) the RAUM attributable to non-U.S. clients.

- The new ADV is designed to streamline reporting when investment advisers avail themselves of umbrella registration. Even though the previous format of the ADV was not intended to provide information on multiple legal entities, the previous ADV permitted umbrella registration to allow multiple legal entities conducting a single advisory business to file a single ADV on behalf of such entities. One entity (the "filing adviser") is the registrant and the remaining entities rely on the registration of the filing adviser (the "relying advisers"). The new ADV is better designed to accommodate umbrella registration. The new ADV more efficiently discloses information about the relationship among these separate legal entities. For instance, it clarifies whether questions should be answered by only the filing adviser or both the filing adviser and the relying advisers. It also includes a new section, Schedule R, which provides information specifically relating to relying advisers.

An important item to note is that a closely related filing, the Form PF (required for certain advisors of private funds), is also impacted by the new ADV. This is because information from the new ADV carries-over and auto-populates information in the Form PF. Accordingly, consistency in disclosures is necessary between the new ADV and Form PF. For example, RIAs must pay particular attention to the new clarifying client classification questions when filling out the Form ADV, as these answers will directly correlate to the classification of clients on the Form PF. To avoid disclosure issues and clarify any confusion, during 2017, the SEC released an updated list of frequently asked questions on the ADV and Form PF.

Investment advisers should conduct a holistic review of their businesses to ensure they are prepared to provide adequate reporting information. Moreover, the new ADV presents an opportunity for advisers to re-evaluate their compliance program, and for instance, bolster their social media policy, while conducting this full-scale review of their businesses.

If you have any questions about the new ADV, contact Blue River for assistance.

To read the August 2016 Press Release, click here.
To read the October 2016 Final Rule, click here.
To read the September 2017 updated Form ADV FAQ, click here.
To read the January 2017 updated Form PF FAQ, click here.

2. U.S. Department of Labor ("DOL") Extends the Fiduciary Rule's Transition Period

In April of 2016, the DOL issued its final regulation expanding the scope of the regulations potentially applicable to alternative asset managers, including expanding the definition of what constitutes an "investment advice fiduciary" as used in ERISA regulation and the Internal Revenue Code (the "Fiduciary Rule"). The expanded definition likely would have created new fiduciary relationships between advisers and certain clients on its initial effective date in April of 2017. Such fiduciary constraints have the potential to prevent the receipt of any compensation for investment advisory services provided to IRAs, small plans and plan participants without first utilizing a prohibited transaction exemption.

Prior to the Fiduciary Rule's effective date in April of 2017, President Trump issued a memorandum in February urging the DOL to re-evaluate the Rule's projected effects. Consequently, the DOL initially delayed the Rule's effective date by sixty days. The initial delay of the Fiduciary Rule's effective date would prove to be the first of several delays, as the DOL has subsequently extended the Fiduciary Rule's transition period and stalled the implementation of enforcement mechanisms in a series of rules. As it currently stands, investment advisers will not have to begin compliance with the Fiduciary Rule or avail themselves of a prohibited transaction exemption until July 1, 2019.

If you would like to discuss the DOL Fiduciary Rule and how it may apply to your business, contact Blue River for assistance.

To read the DOL's November 2017 extension of the transition period of the Fiduciary Rule, click here.

3. Insider Trading and Material Nonpublic Information ("MNPI")

a. Big Data and Insider Trading Pitfalls

Sparked by the digital age, large data sets, commonly referred to as "Big Data," have reached unprecedented levels in terms of both quantity and quality. As this new data frontier emerges, investment advisers are competing for Big Data in hopes that it will provide a strategic edge. While the concept of analyzing data to make investments is as old as investing itself, investment advisers have begun using new processes to gather Big Data. The automated process of collecting Big Data known as "web scraping" is one such way to access electronically-stored data. Investment advisers have begun engaging third-party data providers, some of which use web scraping to access Big Data, which can have regulatory implications.

Advisers engaging in web scraping must be aware of regulatory risks stemming from MNPI and insider trading concerns. Generally, insider trading occurs when investment advisers make trades while in possession of MNPI. In general, information is MNPI if it is considered to be (i) material to a reasonable investor's decision-making process when making investment decisions and (ii) it has not been effectively communicated throughout the marketplace.

A concern with third-party data provider arrangements is that an investment adviser may inadvertently receive MNPI upon obtaining scraped information (and/or aggregated reports of such information). If an investment adviser obtains MNPI subject to confidentiality obligations and the adviser's receipt of such information violates these obligations of confidentiality—whether the obligation is to the issuer of the security or the information provider—the investment adviser risks violating anti-fraud provisions of the Securities Exchange Act of 1934 under the "misappropriation theory." The misappropriation theory is triggered when an investment adviser breaches a duty owed to the source of confidential information by inappropriately using confidential information for its own gain in a securities transaction. In this case, if the adviser's receipt of scraped data results in a violation of confidentiality obligations, and the adviser uses that data for securities transactions, it may risk the adviser violating anti-fraud provisions pursuant to the misappropriation theory.

Investment advisers must also be aware of how the information is collected, as the manner in which information is collected may impact whether the information constitutes MNPI. In certain contexts, web scraping can be viewed as a deceptive practice under the Securities Exchange Act of 1934. An example of a potentially deceptive practice may include a data provider's use of web scraping to gather information while disregarding or evading a website's security protocols. Investment advisers can be liable for a data provider's deceptive acts if the facts and circumstances surrounding the relationship lead to the appearance that the provider was acting as the investment adviser's agent.

Investment advisers can take steps during the due diligence process to mitigate insider trading concerns when engaging a data provider. The due diligence effort should include an analysis and review of the provider's risk tolerance, industry reputation amongst peers and users, adherence to relevant security protocols when securing information, and the ultimate source of the provider's information. Regarding the information itself, the agreement should prohibit the data provider from disseminating MNPI (or at least identifying information that is MNPI), ensure information received is factual and is not proprietary content, and avoid personal identifying information by having the provider scrub the information prior to dissemination.

b. Expansion of the Personal Benefit Requirement

In August of 2017, the Second Circuit's ruling in *United States v. Martoma*, expanded the personal benefit rule which makes it easier to convict defendants in insider trading cases. In such cases, violations of insider trading laws may occur if a tippee (the party that receives information), trades on information from a tipper (the party supplying the information), and the government can prove the tipper disclosed this information in violation of his fiduciary duty (or duty of loyalty and confidentiality) in exchange for a personal benefit.

For many years, there was a question as to what type of conduct amounted to a personal benefit. In *United States v. Newman*, the Second Circuit answered the question using the valuable personal benefit test, which required a tipper to receive something of pecuniary value or other tangible benefit. However, in December of 2016, the Supreme Court, in *Salman v. United States*, rejected the Second Circuit's valuable personal benefit standard established by *Newman*. Shortly thereafter, the Second Circuit overruled its own valuable personal benefit requirement in *United States v. Martoma*, ruling that no item of pecuniary value is required to meet the personal benefit test. Due to this lower standard, the new rule will make it easier to prosecute an individual who gives someone inside information with the expectation that such information will be traded upon.

c. Hedge Fund Settlement with SEC Reiterates Importance of Establishing MNPI Controls

A hedge fund, Deerfield Management Company, L.P. ("Deerfield"), settled charges with the SEC stemming from the failure to establish, maintain, and enforce policies and procedures reasonably designed to prevent the misuse of MNPI.

Deerfield had policies and procedures for expert networks, but inadequate policies related to research firms. A research firm provided political intelligence information over a three-year period that the SEC alleged constituted MNPI. Deerfield traded on this information and obtained close to $4 million in profits for its clients. The SEC subjected Deerfield to penalties, disgorgement, and interest amounting to over $4 million.

This case reiterates importance of an ongoing evaluation of firm policies and procedures, with a keen eye towards making sure they are tailored to your business and the regulatory risks relevant to your business.

If you have any questions on the sufficiency of your compliance policies and procedures related to material non-public information, contact Blue River for assistance.

To read the August 2017 Martoma case, click here.
To read the August 2017 Deerfield case, click here.

4. SEC Guidance on MiFID II Research Requirements

Effective January 3, 2018, the Markets in Financial Instruments Directive ("MiFID II") issued by the European Union places various requirements on certain investment advisers. On October 26, the SEC provided guidance on how advisers can comply with MiFID II's research requirements in a manner that is consistent with U.S. federal securities laws.

The SEC's guidance provided two items of clarity. First, investment advisers may continue relying on the existing safe harbor for soft dollars located in Section 28(e) of the Securities Exchange Act of 1934. This permits advisers to work with a broker that is not offering the lowest commission rate as long as the manager complies with specific requirements, most notably that the amount of commission is reasonable in relation to the value of services received. Second, investment advisers are permitted to aggregate purchases or sales of securities even when clients pay different amount for research, but clients will continue to receive the same average price for the securities and execution costs.

To read the October 2017 MiFID II Guidance, click here.

5. Tax Law Changes Affecting Investment Advisers

a. Tax Audit Rules/Tax Matters Partner

The Bipartisan Budget Act of 2015 (the "Act"), which became law in 2015, modified future audit procedures for partnerships. These changes went into effect on January 1, 2018.

Under prior law, partnerships were not taxed at the partnership level and instead were taxed at the partner level. However, the Act replaces the partnership audit rules and, as a result, unless an election is available, the new rules will require the determination, assessment, and collection of tax liabilities at the partnership level. Two elections that may eliminate partnership level liability are: (i) the "opt-out" election (which may apply if a partnership has 100 or fewer partners) or (ii) the pass-through election (also known as Section 6226 election or "push-out" election). The opt-out election is unavailable to partnerships containing investors that are partnerships or trusts, and since most private equity and hedge funds have at least one partnership or trust as an investor, the opt-out election is likely unavailable to them.

For this reason, the push-out election will likely be preferable. However, it is important to note that when a partnership uses the pass-through election, the interest rate due to underpayment is 2% higher than the interest rate imposed on those who opt-out or those who do not use any election. As a result, fund documents should include language to determine if these elections will be made. If neither election is used, an indemnification clause should be included to have the partner and/or former partners indemnify the partnership for the applicable shares of any tax liabilities imposed as a result of the new partnership audit rules.

Additionally, the "Tax Matters Partner" concept—in which one partner is appointed to be responsible for representing the partnership in the case of an IRS audit—will be replaced with a concept of a "Partnership Representative." The Partnership Representative will have absolute authority to act for the partnership in the case of an IRS audit, with the notable difference that the Partnership Representative is not required to be a partner of the partnership, and instead only needs to have a "substantial presence in the United States." This is a favorable change for private equity and hedge funds since it allows non-partners, such as management companies, to represent the partnership. However, the new partnership audit rules eliminate the right of the partners to participate or receive notices related to any IRS partnership tax audits. Therefore, fund documents will need to replace "Tax Matters Partner" with "Partnership Representative" and include a clause to provide both notice to and consent from partners prior to binding the partnership.

Please review your partnership agreements to confirm that appropriate language has been incorporated to include push-out provisions and establish a Partnership Representative. If the partnership makes a timely push-out election and furnishes a statement of partner's share of any adjustments to income, gain, loss, deduction, or credit to each partner and Treasury for the reviewed year, the rules requiring partnership level assessment of taxes due will not apply with respect to the underpayment and each partner will be required to make a proportionate adjustment on the partner's individual tax return.

b. Tax Reform

As of December 22, 2017, H.R.1 (the "Tax Cuts and Jobs Act") was signed into law by President Trump. The tax reform primarily focuses on improving the tax environment for businesses in the United States by lowering corporate tax from 35% to 21%, changing from worldwide taxation to a hybrid territorial system, and adding in a new pass-through tax deduction for some eligible non-corporate business entities. Below we discuss three elements of the Tax Cuts and Jobs Act that are especially pertinent to investment advisers: first, the treatment of carried interest, second, pass through treatment of certain entities, and third, changes to miscellaneous itemized deductions.

First, the Tax Cuts and Jobs Act has provisions that potentially impact carried interest. Beginning January 1, 2018, partnership gains due to the sale of an asset held for a period of three years or less may be subject to short-term gains tax treatment. On the other hand, partnership gains derived from assets held for over three years will still retain the preferential long-term tax treatment. Considering the significant difference between short-term and long-term capital gains rates, this aspect of the tax plan could have a substantial impact on both the strategy and profitability of alternative asset managers.

Second, the Tax Cuts and Jobs Act provides a 20% deduction for Qualified Business Income ("QBI") of certain pass through entities for tax years 2018 through 2025. The QBI is defined as all domestic business income other than investment income (e.g., dividends, investment interest income, short-term capital gains, long-term capital gains, commodities gains, foreign currency gains, etc.). Such deductions would be limited to 50% of the taxpayer's allocable or pro-rata share of "W-2 wages" paid by the partnership or S Corporation with respect to the qualified trade or business; or alternatively, the sum of the taxpayer's allocable or pro-rata share of 25% of the "W-2 wages" paid to the qualified trade or business plus 2.5% of the unadjusted basis (determined immediately after an acquisition) of all qualified property. In conjunction with these changes, the cap on the individual tax rate was changed from 39.6% to 37%. These changes have the potential to provide significant tax savings to firms with pass through treatment, such as hedge funds and private equity firms.

Third, the Tax Cuts and Jobs Act repeals all miscellaneous itemized deductions subject to the 2% floor for tax years 2018 through 2025. Previously, taxpayers could deduct certain miscellaneous itemized deductions to the extent they exceed 2% of the taxpayer's adjusted gross income. The miscellaneous itemized deductions subject to the 2% floor include pass-through expenses such as management fees and other investment expenses that have been reported in the Form K-1s from the fund on line 13(k). In turn, these changes may have a notable impact on the tax burden for investment advisers.

As laws related to taxes evolve, investment advisers must take steps to remain compliant not only through modifying their legal agreements but also by the timing of their operations. Staying on top of tax legislation and reform will help investment advisers manage tax liabilities through effective tax planning. Please speak with your tax advisors about updating the tax sections in the Private Placement Memorandum, Limited Partnership/Limited Liability Company Agreements, and any other pertinent documents with the former tax legislation.

If you have any concerns about your firm's compliance with applicable tax laws, contact Blue River to learn more about our tax advisory and compliance services.

For the full text of the Bipartisan Budget Act of 2015, click here.

6. The SEC Amends its Books and Recordkeeping Requirements

The SEC's latest amendment to the books and records rule (the "Recordkeeping Rule") went into effect on October 1, 2017. There are two notable changes from this amendment:

First, prior to this amendment, the Recordkeeping Rule required RIAs to retain all supporting documentation used in the calculation of performance figures included in investor correspondence that was dispersed to *ten or more persons*. The SEC's amendment removes the 10 persons threshold, meaning all supporting documentation used in calculating performance figures must be retained if the figures are provided in a communication *even if the distribution is limited to just one person*.

Second, prior to this amendment, the Recordkeeping Rule required RIAs to maintain original copies of written communications relating to securities recommendations, advice, and transactions. However, these retention requirements have been broadened, and the SEC now requires RIAs to retain original copies of *all* written communications that include *performance figures* related to any managed accounts or securities recommendations.

If you have any questions on the SEC's amendment to the Recordkeeping Rule, contact Blue River for assistance.

To read the October 2016 Final Rule, click here.

7. Revised Hart-Scott-Rodino Act ("HSR Act") Thresholds and New Maximum Civil Penalties

Effective February 27, 2017, the Federal Trade Commission ("FTC") completed its annual adjustment to the filing thresholds under the HSR Act. The new, higher thresholds apply to all transactions which close on or after this date, but before the next round of adjustments take effect in early 2018.

The most significant threshold in determining reportability is the minimum size of transaction threshold. This is often referred to as the "$50 million (as adjusted)" threshold because it started at $50 million and is now adjusted annually. For 2017, that threshold was $80.8 million. As stated above, this threshold will increase in early 2018 and will apply to transactions occurring on or after the new effective date.

To read the FTC's announcement of the new HSR thresholds, click here.

8. Clarification on the Section 16 "RIA Exemption"

Certain managers may take advantage of what is often referred to as the "RIA Exemption" to avoid significant regulatory requirements pursuant to Section 16 of the Securities and Exchange Act of 1934. In general, the Section 16 requirements are triggered when an individual or entity acquires 10% or more beneficial ownership of a class of registered equity securities. Beneficial ownership is interpreted broadly and includes a direct or indirect pecuniary interest in the securities, including the right to receive any profit derived from a transaction in the securities. Due to this broad definition, many investment advisers would be subject to Section 16's requirements, including providing additional ownership disclosures and complying with prohibitions on short-swing profits. However, if the RIA Exemption applies, it removes these requirements. This exemption is available to entities and individuals that hold shares *for the benefit of third parties in the ordinary course of business*, so it generally applies to investment advisers.

A recent case, *Greenfield v. Criterion Capital* sheds new light on the scope of this exemption. In this case, Criterion Capital Management, LLC ("Criterion"), an investment adviser, provided investment advice to private funds that invested in registered equity securities. Criterion and its personnel held ownership interests in the funds—putting them at risk of being classified as beneficial owners of the registered equity securities held by the funds, and in turn, subject to the requirements of Section 16. Since the RIA Exemption hinges on an adviser holding securities for the benefit of third parties, it was unclear whether the RIA exemption could apply when Criterion shared ownership interests in the securities that were being held for third parties. The court ruled that Criterion can avail itself of the RIA Exemption as the exemption does not require that interests in the fund are held *solely* by third parties.

This ruling should provide a level of comfort for advisers who engage in the common practice of investing in their own funds. If you have any questions or would like to discuss the Section 16 RIA Exemption, contact Blue River.

To see the June 2017 Greenfield case, click here.

9. SEC Provides Guidance on Inadvertent Custody

In February 2017, the SEC issued guidance cautioning RIAs who inadvertently obtain custody of client assets and are, in turn, subject to additional regulatory requirements pursuant to Rule 206(4)-2 (the "Custody Rule"). The SEC provided guidance on situations in which an RIA provides advisory services to separately managed account clients and those clients enter into custodial agreements that provide the RIA with greater authority over their clients' assets than permitted in the investment management agreement. This is problematic because custodial agreements govern the breadth of the RIA's control over the account, giving the RIA greater access to its clients' funds despite any limiting language contained in the investment management agreement. Due to the nature of the custodial agreement—being between the account holder and the custodian—RIAs may not even be aware of the additional discretion and authority over client assets pursuant to the custodial agreement. This is notable because, in these cases, RIAs are likely deemed to have custody over such clients' assets and must comply with potentially expensive regulatory obligations, such as surprise examinations.

The SEC recommends that RIAs who are unsure whether they have custody over separately managed accounts send a letter to the custodian limiting the RIA's authority. On its face, this advice appears helpful, but in practice, it may prove less helpful due to unresponsive or uncooperating custodians who are unwilling to take on the additional liability of monitoring the RIA's trading activity on a closer basis. In the end, RIA's with separately managed account clients would be wise to monitor developments and review additional guidance in this area.

If you have any questions on the SEC's guidance regarding custody, contact Blue River for assistance.

To read the February 2017 Guidance Update, click here.

10. Shortened Trade Settlement

In March of 2017, the SEC agreed to quicker settlement periods for securities transactions. Historically, the standard settlement cycle for broker-dealer securities transactions was known as T+3, meaning transactions were settled in three business days. Due to technological advancements and growth in trading volume, the SEC adopted the T+2 settlement cycle, meaning the settlement cycle has been shortened to two business days. T+2 settlement went into effect on September 5, 2017. Investment advisers should make sure they are fully aware of how this timing impact may change their (and their brokers') trading behaviors (e.g. margin payments, trade reporting, valuation practices, shorting practices, etc.).

To read the March 2017 T+2 Settlement Press Release, click here.

11. New Cayman AML Requirements

In October of 2017, the Cayman Islands' Anti-Money Laundering Regulations became effective (the "AML Regulations"). The AML Regulations apply to Cayman-based businesses that constitute "relevant financial business[es]," meaning the businesses are engaged in "investing, administering or managing funds or money on behalf of other persons." As a result, the AML Regulations are applicable to certain investment advisers. Two notable changes due to the AML Regulations are listed below:

- Advisers were previously required to assess customer risks and the adequacy of regulatory disclosures to identify risks related to an adviser's business—this is referred to as a firm's risk-based approach. However, pursuant to the AML Regulations, firms must follow additional procedures when conducting their risk-based approach.

- Advisers must conduct a level of due diligence on their clients to comply with Know Your Customer (or "KYC") policies. The AML Regulations impact this process by splitting adviser's due diligence into two categories: enhanced due diligence and simplified due diligence. If an adviser identifies a client relationship that poses higher risks, it must conduct enhanced due diligence. On the other hand, if a client is deemed to be of lower risk, simplified due diligence is acceptable.

Investment advisers subject to AML Regulations must review their current AML policies and update where necessary to ensure that no gaps have been created by the transition from the old to the new regulatory regime. The review should focus specifically on how current procedures align with new mandatory requirements and how the approach to due diligence should change going forward.

To read the entire text of the AML Regulations, click here.

12. New Model for Audit Reports

In October 2017, the SEC approved the Public Company Accounting Oversight Board's ("PCAOB") newly adopted reporting standard for audited financial statements. The new auditor report now requires auditors to report all "critical audit matters" ("CAMs") and to disclose the number of consecutive years spent serving their audit clients. CAMs are audit items that are deemed material to financial statement reporting and require challenging, subjective, or complex auditor judgment. In the SEC's statement of approval, Chairman Jay Clayton stated that the intended and anticipated effect of the new standard is increased transparency in financial reporting, which should ultimately benefit investors.

To read the entire text of the PCAOB's June 2017 Release, click here.
To read Chairman Clayton's October 2017 Statement of SEC Approval, click here.

III. Requirements Under Specific Circumstances

1. Reminder to File ADV When Updating Registration Status

SEC & State Registration. RIAs who no longer qualify for SEC registration as of the time of filing the annual amendment must withdraw from SEC registration within 180 days after the end of their fiscal year by filing Form ADV-W and should consult their state securities authorities to determine whether they are required to register in one or more states in which they conduct business. In contrast, state registered advisers who are required to register with the SEC as of the end of their fiscal year must register with the SEC within 90 days of filing the annual ADV amendment.

Private Fund Exempt Reporting Advisers ("Private Fund ERAs"). Firms or individuals who no longer meet the definition of a Private Fund ERA will need to submit a final report as an ERA and apply for registration with the SEC or the relevant state securities authority within 90 days after the filing of the annual amendment.

If you have any questions or would like assistance with these filings, contact Blue River.

2. CFTC Form 40

Pursuant to the CFTC's Large Trader Reporting Program, investment advisers who maintain large positions in certain futures contracts or options on futures should be aware of the speculative position limits with respect to these contracts. In the event a position reaches a certain level making the account reportable, the CFTC may request more information about the position from the firm. The Large Trader Program collects certain information on market participants, which is used by the CFTC to help ensure the integrity of futures markets.

For firms which are registered Commodity Pool Operators or Commodity Trading Advisors, once the Futures Commission Merchants ("FCM") account that the manager is controlling maintains positions at or exceeding the reportable thresholds, the FCM is required to report such information to the CFTC. As a result, the CFTC may send a request for the manager to complete and file a Form 40 – Statement of Reporting Trader. The Form 40 is completed via the CFTC's online portal. Reporting Traders will be required to submit information including the individuals responsible for the derivatives trading, parent companies and subsidiaries, information on the clients for which the Reporting Trader controls some or all of the derivatives trading, as well as details pertaining to the Reporting Trader's investment strategy.

If you have any questions on CFTC Form 40, contact Blue River for assistance.

For more information on CFTC Form 40, click here.

3. Form D and Blue Sky Filings

Investment advisers of funds often rely on Regulation D to avoid registration of their securities offerings (most often when offering limited partner interests in funds). Regulation D requires not only an initial filing referred to as the "Form D," but also an annual amendment to the Form D if the fund is still fundraising. As a result, advisers that are fundraising must remember to protect their funds' exemption and file an amended Form D on an annual basis.

States often require notice filings, referred to as blue sky filings, if their residents participate in certain securities offerings. Generally, blue sky filings are filed one time—at the time of the sale of securities to the relevant resident. However, there are a handful of states that have an annual renewal requirement and advisers should be mindful that they may need to make blue sky filings on an annual basis for those states.

IV. Upcoming Compliance Obligations

As you plan the coming months, please keep the following regulatory items in mind:

Date	**Compliance Obligation**
First week of January	Review assets, holdings, and trading activity as of December 31, 2017 to determine filing requirements such as SEC Registration, Schedule 13D/G, Form 13F, Form 13H, Form CTA-PR, Form CPO-PQR, and Form PF.
January 3, 2018	IARD Final Renewal Statements become available and are due on January 18, 2018.
January 30, 2018	Code of Ethics attestations should be completed. These include, but are not limited to, the following: annual securities holding reports and quarterly transaction reports, re-certification of disciplinary events, disclosure of brokerage accounts and political contributions, and disclosures of any outside business activities.
February 15, 2018	Fourth Quarter CTA-PR Due. Schedule 13G Update Due. Form 13F Due. Form 13H “Large Trader” Amendment Due.
March 1, 2018	Deadline for Annual Re-Affirmation of CFTC Exemptions. Fourth Quarter CPO-PQR due for large CPOs (AUM > $1.5 billion).
March 31, 2018	*Form ADV Annual Updating Amendments Due* Once filed, RIAs are required to deliver annually to advisory clients (1) a summary of material changes to the brochure (Part 2A) and offer to provide the client with the updated brochure upon request or (2) deliver a complete updated brochure. In addition, RIAs may also provide any updated Part 2B brochure supplements, if required in the form instructions. *NFA/CFTC Annual Pool Financial Statements Due* CPOs are required to submit to the NFA through the NFA's EasyFile system, and distribute to current participants, a certified Annual Report for each pool. Fourth Quarter CPO-PQR for small (i.e. AUM < $150 million) and mid-size CPOs (i.e. $150 million < AUM < $1.5 billion) are due.
April 30, 2018	*Form ADV Annual Updating Amendments Due* Annual Form PF filings for RIAs managing at least $150 million in

	private fund assets as of December 31, 2017 are due. (Please note, in the case of large hedge fund advisers (i.e. hedge fund advisers with more than $1.5 billion in hedge fund assets), the Form PF must be filed on a more frequent basis.) *Distribution of Audited Fund Financial Statements Due* Required distributions of fund audited financial statements to fund investors for RIAs of pooled investment funds relying on the audit exemption to the SEC's Custody Rule are due.
April 30, 2018 (Recommended Timing)	In addition to the requirement that investment advisers, CPOs and CTAs must deliver a privacy notice and fund subscription materials to each new investor, a privacy policy notice must be distributed to each investor at least once annually (assuming the exception under the Privacy Notice Modernization Act of 2015 does not apply). Investment advisers that trade in new issues (such as IPOs) should obtain annual certifications from all of their investors regarding the relevant investor's status as either a "restricted person" under Rule 5130 or a "covered person" under Rule 5131.

Please keep in mind, this list is not exhaustive. For example, this list does not include information related to U.S. Treasury filings (TIC filings) or Bureau of Economic Analysis filings (BEA filings) among others. Please contact Blue River for any additional assistance related your firm's regulatory compliance obligations.