ISSUES IN THE FORMATION AND REGULATION OF HEDGE FUNDS

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I. STRUCTURE

A. Limited Partnership Structure

A hedge fund is usually formed as a limited partnership with a separate limited liability company ("LLC") serving as its general partner ("GP"). The GP entity may also serve as the fund’s investment manager, or the fund sponsor may form a separate LLC for this purpose. An investment manager that is a separate entity from the GP typically enters into an investment management agreement with the fund (or the GP) to act as the investment adviser or manager of the fund.

If the fund entity is structured as a limited partnership, the investors purchase limited partnership interests in the fund entity and their money is a contribution of capital to the fund entity. The investment gains and losses (including certain operational costs paid by the fund entity) are allocated to the investors’ capital accounts on a pro rata basis, subject to an incentive allocation payable to the GP. The incentive allocation (also called “carried interest”) is an allocation of a share (typically 20 percent) of the income and gain from the fund’s investment and trading activities.

A limited partnership structure for the fund entity offers tax efficiencies and limited liability protection against certain third parties to both the investors and the individual founders. From a tax perspective, a limited partnership is attractive because there is no tax at the entity level. Rather, partners are taxed currently on their allocable shares of partnership income or loss, whether distributed or not. The character of partnership income passes through to the partners. Accordingly, investors in a partnership hedge fund receive the same tax treatment as they would if they invested in the same securities directly. Additionally, the partnership structure allows for compensation in the form of an incentive allocation because partnerships have flexibility in how they allocate items of income and loss to their partners and, in particular, because profits can be divided among the partners without regard to the capital contributions of the partners.

In addition, limited partnerships offer limited liability to their limited partners. This means that limited partners owners are generally not liable for the debts or liabilities of the partnership in excess of their direct investment in the entity. A limited partnership does not offer the same protection to the GP, but the same limited liability can be obtained in effect if each GP is structured as an LLC.

For tax reasons, funds are frequently organized with two separate entities at the management level, one serving as the GP and the other serving under a contract as the investment manager. This structure is useful for funds operating in New York City, which imposes an Unincorporated Business Tax (the “UBT”) on the taxable income of non-corporate entities (such as partnerships and LLCs) from a trade or business carried on in whole or in part in New York City. The UBT provides for a broad “trading for your own account” safe harbor, whereby purchasing and selling property (including but not limited to stock, securities and commodities) for one’s own account is not, by itself, a trade or business. The fund generally does not earn any income other than income from trading for its own account. The “trading for your own account” safe harbor also applies to a GP’s incentive allocation, or “carried interest” in the fund. The fee on assets under
management ("management fee") is outside the scope of the exception. Funds planning to operate in New York City can avoid the UBT on the incentive allocation by segregating the incentive allocation from the management fee. Specifically, two management entities can be formed: (1) the GP, which will trade only for the account of the fund and will receive the incentive allocation, and (2) the investment manager, which will be retained by the fund to provide advice on investments and be compensated for such service with the management fee. The investment manager will not have an equity interest in the fund, and all its income will be subject to the UBT.

If the GP/investment manager is an LLC, there is also the added benefit that the founders of the fund have flexibility to offer equity interests in the entity to employees, advisers and other affiliates of the fund. In addition, LLCs are generally taxed as partnerships and are not subject to entity-level tax. Therefore, the owners of GP and investment manager entities that are structured as LLCs are not subject to two levels of tax on their equity interests.

**B. Onshore and Offshore Funds**

The preceding paragraphs assume that the fund structure will be entirely “onshore,” meaning that all the entities will be U.S. domestic entities, likely formed in the state of Delaware.

If the fund founders have a significant number of potential investors outside the United States and/or U.S.-based tax-exempt investors, an offshore fund may be the best structure. The advantage of an offshore fund is that the investors in the fund would generally not be subject to U.S. taxation as long as the fund meets certain IRS requirements. Formation and operation of an offshore fund can be more expensive and administratively burdensome than a domestic fund entity. The founder will need to engage local counsel and the jurisdiction may require the fund to, among other things, have independent directors, maintain a third-party administrator licensed in that jurisdiction, and file its offering documents and subsequent amendments with the local monetary authority. The cost of each of these items varies based on the jurisdiction, the entity type and the complexity of the fund.

A “master-feeder” structure is one in which U.S. investors and offshore investors are able to indirectly invest in the same “master fund” that serves as the investment vehicle. The master fund is typically structured as a limited partnership or similar structure that is treated as a pass-through entity for U.S. federal income tax purposes. Ordinarily, U.S. taxable investors investing in a master-feeder structure invest directly in a limited partnership organized in the United States. This limited partnership is referred to as the “domestic feeder.” The domestic feeder invests its assets in the master fund. The offshore investors and U.S. tax-exempt organizations (e.g., IRAs) invest directly in an offshore corporation. This offshore corporation is referred to as the “offshore feeder.” The offshore feeder also invests its assets in the master fund. The master fund is often formed in the same jurisdiction as the offshore feeder.

Master-feeder structures may provide significant benefits for money managers, including, among other things, having one investment entity instead of multiple entities, allowing the feeder funds to aggregate their assets at the master fund level in order to participate in certain private placements in which each individual feeder fund could not have otherwise participated, and allowing the founder to take an incentive allocation at the master fund level rather than a
performance-based fee at the feeder fund level, which may be more favorable to the founder from a tax perspective. Master funds may, however, raise issues under U.S. securities laws and limit the ability to differentiate strategies among the various feeder funds. In addition, the structure may be cost-prohibitive for start-up funds. The desirability of a master-feeder structure will depend on the strategy and goals of the individual founder as well as the overall fund structure.

II. COMPENSATION

A fund GP/investment manager is often compensated in a manner commonly called “1 and 20” or “2 and 20.” The “20” refers to an incentive allocation (also known as carried interest, carry or incentive allocation) that is usually a set percentage (typically 20 percent) of the net profits, counting both realized and unrealized gains and losses and made on a partner-by-partner basis. In addition, the fund pays management fees to the investment manager, pursuant to the investment management agreement, for employing the investment professionals, evaluating potential investment opportunities and providing other investment advisory services. The management fee is generally an annual amount equal to 1 to 2 percent of the net asset value of the fund.

Important to note is that if the investment manager is registered with the U.S. Securities and Exchange Commission (the “SEC”), the investment manager is prohibited from collecting incentive allocations from investors that do not meet certain net-worth tests, subject to certain exceptions. Section 205(a)(1) of the Investment Advisers Act of 1940 (the “Advisers Act”) prohibits an investment adviser from entering into an investment advisory contract that provides for compensation to the adviser based on a share of capital gains on, or capital appreciation of, the funds of a client (such as performance fees or carried interest).

However, SEC-registered investment advisers may collect incentive allocations from private funds that are excepted from the definition of an investment company under Section 3(c)(7) of the Investment Company Act of 1940 (the “Investment Company Act”). If a fund is relying on the Investment Company Act Section 3(c)(7) exception from the definition of investment company, all of the fund’s investors must be qualified purchasers. “Qualified purchasers” are investors that meet certain requirements regarding the total amount of investments owned, generally individuals owning at least $5 million of investments or entities with at least $25 million of investments. In addition, SEC-registered investment advisers may collect incentive allocations from investors who are “qualified clients.” See Advisers Act Rule 205-3. In certain circumstances, “knowledgeable employees” of the fund and the investment manager will be qualified clients.

While investment advisers that are not required to register with the SEC may charge incentive allocations to investors who are not qualified clients, certain states impose restrictions similar to Section 205(a)(1). Registered investment advisers that act as advisers to offshore funds may charge incentive allocations to all non-U.S. investors.

III. LIMITATIONS ON INCENTIVE ALLOCATIONS

The GP’s incentive allocation is typically limited for the protection and benefit of the investors. Three common limitations set forth in fund documents are described below.
There is typically a loss carryforward provision, commonly referred to as the “high-water mark,” which carries forward any losses previously allocated to a partner until the loss has been completely absorbed. In effect, if the previous high of investment performance is not exceeded during the current calendar year (or other incentive allocation period), then the GP does not receive any incentive allocation for that year (or other period).

There are potential variations on this limitation. Under the conventional high-water mark, a GP might be inclined to shut the fund down after a period of losses because, without any performance compensation until the fund reaches the prior high-water mark, the GP may be working for “free” and may be unable to retain some of its key employees (despite the management fee paid to the investment manager).

Additionally, sometimes the GP’s incentive allocation does not begin until the limited partners have achieved a minimum specified return (often called a “hurdle rate”). Under this limitation, there is typically a “catch up” concept whereby the GP receives its full 20 percent incentive allocation with respect to all net profits during each year as long as the limited partners receive at least the hurdle rate for that year.

Finally, funds may feature a “clawback” whereby the investors are able to recoup some portion of the earlier-paid incentive allocation if the fund experiences a downturn.

IV. SOLICITING INVESTORS

The GP must adhere to certain regulatory requirements when selling interests in the fund through a private placement.

A. Accredited Investors

First and foremost, unless the GP is prepared to undertake the verification and other requirements of making a general solicitation pursuant to Rule 506(c), the GP must ensure that only accredited investors (discussed below) receive the fund’s offering memoranda. While Rule 506(b) permits sales to a limited number of non-accredited investors, the number of non-accredited investors may not exceed 35, and if the offering is made to non-accredited investors, the disclosure requirements are significantly more stringent. Thus, practically speaking, hedge funds are offered only to accredited investors. In-depth disclosure similar to a registration statement is required even if only one non-accredited investor invests in the fund. It is generally a good idea for the GP/investment manager to have a substantive pre-existing relationship with every potential initial investor in the fund in order to avoid an inadvertent general solicitation.

The federal securities laws define the term “accredited investor” in Rule 501 of SEC Regulation D to include:

- a corporation, partnership, employee benefit plan or charitable organization with assets exceeding $5 million;
- a natural person who has individual net worth, or joint net worth with the person’s spouse, that exceeds $1 million at the time of the purchase, excluding the value of the primary residence of such person;
- a natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year; or

- a trust with assets in excess of $5 million with sophisticated trustees.

The thresholds pertaining to natural persons are widely viewed as outdated. The SEC is authorized to review the accredited investor standard in 2014 (four years after the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”)) and every four years thereafter, and, if appropriate, to adjust the standard for the protection of investors, in the public interest and in light of the economy.

B. Solicitation of Potential Investors

Most offerings in the United States by private funds are made pursuant to the Rule 506(b) exemption from registration. Issuers relying on this exemption are prohibited from using any form of general solicitation or general advertising to market the fund interests. The recently enacted Rule 506(c) establishes an additional exemption, which differs from Rule 506(b) in that general solicitation and general advertising are permitted, so long as (i) all purchasers are accredited investors and (ii) reasonable steps are taken by issuers to verify that the purchasers are accredited investors. Additionally, issuers are required to check a box on their Form D filing, indicating that they are relying on Rule 506(c) to make general solicitations.

The reasonableness of such steps must be determined objectively by the issuer in the context of the particular facts and circumstances. The nature of the purchaser, the type of general solicitation used and the size of the investment are some of the factors that the SEC has noted may be relevant in determining the reasonableness of the issuer’s verification methods.

In conjunction with lifting the general solicitation ban, the SEC proposed rules regarding Regulation D offerings (the “Proposed Reg D Amendments”). The Proposed Reg D Amendments would require, among other things: (i) an advance Form D filing 15 days prior to any general solicitation in addition to a Form D filing at the closing of an offering, (ii) additional disclosure on Form D, and (iii) the filing of general solicitation material with the SEC for a period of two years. Importantly, the proposals include, for issuers that fail to comply with the Form D filing requirements, a one-year ban from making any offering pursuant to Regulation D, subject to a cure period.

Many private funds take advantage of Rule 506 to issue securities. With the removal of the ban on general solicitations, these funds do not have to rely solely on existing relationships for funding. A wider audience of investors can be reached via the Internet, seminars and other venues. Additionally, placement agents and finders can also use Rule 506(c) to advertise securities through a diverse range of media. The Proposed Reg D Amendments are still pending. If approved by the SEC in their current form, the Proposed Reg D Amendments could have a significant impact on a fund’s decision to employ general solicitation. Many issuers are waiting until final rules are published before they engage in general solicitation in order to fully understand the risks and burdens of these new regulations.
Funds intending to use general solicitation should investigate the securities laws of other jurisdictions in which they intend to conduct their offering, notably in Europe where increased marketing restrictions and regulations have recently been imposed by the Alternative Investment Fund Managers Directive (the “AIFMD”; described below).

C. Private Placement Memorandum

Most funds solicit potential investors through use of an offering document (often called a “private placement memorandum,” or “PPM”). Although the federal securities laws do not require that PPMs be delivered to accredited investors and qualified institutional buyers in connection with private offerings of fund securities, the PPM protects the fund and its management from potential liability by warning potential investors of the risks of the investment. Regulation D governs the extensive information requirements for non-accredited investors in connection with a private offering of fund interests. Delivery of a PPM in strict compliance with Rule 506 of Regulation D is essential if the offering is being extended to non-accredited investors.

D. Pension Plan Investors

Funds may allow pension plans to invest; however, most funds limit participation by pension plans to no more than 25 percent of the value of the fund (or any class thereof) in order to avoid subjecting the fund itself to the U.S. Employee Retirement Income Security Act of 1974 (“ERISA”). In this context, we are using “pension plans” to mean employee benefit plan investors, such as ERISA plans, IRAs and 401(k) plans. Important to note is that the presence of IRA and 401(k) plan investors in a fund does not itself cause the fund to become subject to ERISA. However, if there are ERISA plan investors in the fund, all types of benefit plans are counted for purposes of the 25 percent limit. Those fund managers that wish to take more than the 25 percent threshold may qualify as a “qualified professional asset manager” (“QPAM”) under a Department of Labor exemption if the manager, among other things, is federally registered and has client assets under management in excess of $85 million and the manager itself has net capital (equity) in excess of $1 million. If qualified as a QPAM, the fund manager is exempt from compliance with certain “prohibited transaction rules” under ERISA, that, without the exemption, typically make the operation of a fund entity not practical.

Due to important tax consequences, pension plans that invest in a fund that trades on margin or that makes certain kinds of investments may want to invest in the fund through a “blocker corporation,” which is often accomplished through a master-feeder structure (discussed above).

E. Selling Through Third Parties

Many funds use third parties (placement agents) to market and sell interests in the fund. However, under both federal and most state laws, a person soliciting a securities transaction must be registered as a broker-dealer, except in very limited circumstances. The SEC has long viewed compensation that depends on the outcome or size of the securities transaction — in other words, transaction-based compensation, also referred to as a “salesman’s stake” in a securities transaction— to be the hallmark of being a broker.
The SEC is cracking down on private fund managers for not using registered broker-dealers for fundraising. In March 2013, the SEC brought an enforcement action against a private equity fund and a senior fund employee for paying transaction-based compensation to a third-party consultant who was not registered with the SEC as a broker-dealer. In addition to charging the third-party consultant with violating the Securities Exchange Act of 1934 (the “Exchange Act”) by acting as an unregistered broker-dealer, the SEC charged the fund with causing such violations and charged the fund employee with aiding and abetting such violations. Notably, the SEC did not allege that fraud was committed against the investors. This appears to be a novel SEC enforcement action in that it is focused on penalizing the private fund manager and its marketing personnel as well as the unregistered broker-dealer. If a fund has used an unregistered broker to raise capital, the investors could possibly have a rescission right to unwind the investment and receive a return of their capital.

The fund’s relationship with the placement agent may be subject to certain disclosure requirements under the Advisers Act. The SEC and most state securities bureaus closely monitor the use of third-party solicitors in private placements by requiring specific disclosures on the Form D.

V. REGULATORY ISSUES

A. Securities Act of 1933

The U.S. Securities Act of 1933 (the “Securities Act”) and state blue-sky laws regulate securities offerings in the United States, but funds may be able to rely on various exemptions to avoid some or all of the registration and other requirements. The fund typically can rely on the private placement “safe harbor” provisions of Regulation D for offerings to investors in the United States. For offerings outside the United States, the fund can generally rely on the safe harbor contained in Regulation S.

Certain “bad actors” are prohibited from making private offerings in reliance on Rule 506 of Regulation D of the Securities Act (the “Bad Actor Rule”) if the issuer or any other person covered by the Bad Actor Rule (including officers and directors of the issuer who participate in the offering) had a “disqualifying event.” Disqualifying events include, among others, certain criminal convictions, certain court injunctions and restraining orders, and a variety of disciplinary actions and orders. The disqualification is limited to events that occur after the Bad Actor Rule became effective, although pre-existing events are subject to mandatory disclosure. There is an exception that allows an issuer to rely on Rule 506 to the extent that the issuer had no knowledge of the disqualifying event and through the exercise of reasonable care could not have known of such event. Funds will need to vet the disciplinary history of their employees, placement agents and potentially certain large investors to identify “bad actors,” because a bad actor’s involvement in an offering will preclude the fund from relying on the Regulation D private placement exemption.

B. State Blue Sky Laws

Under current law, states are prohibited from imposing their blue-sky laws relating to registration or qualification of securities with respect to securities offered in a private placement pursuant to
Rule 506 of Regulation D. States are still permitted to require blue-sky notice filings, which are similar to the Form D that is filed with the SEC pursuant to Regulation D, and collect filing fees. Many of these filings must now be made through the SEC’s electronic filing system.

C. Recent European Legislation

On July 22, 2013, the Alternative Investment Fund Managers Directive took effect in the European Union (“EU”). The AIFMD overhauls private placement rules on a country-by-country basis and impacts fund managers based in the EU, U.S. managers seeking to manage funds established in the EU and funds marketing in the EU, regardless of where such funds are domiciled. U.S. funds marketing in the EU will be subject to additional disclosure and reporting obligations and perhaps more onerous obligations that EU member states may create as a result of this new legislation.

D. Investment Advisers Act

Recent changes to federal law have changed the landscape of both federal and state regulation of investment advisers to pooled investment vehicles.

Federal Investment Adviser Registration and Regulation. The Dodd-Frank Act amended the Advisers Act to eliminate the private investment adviser exemption, requiring advisers to funds to register with the SEC as investment advisers unless they can rely on an alternative registration exemption. The Dodd-Frank Act significantly expanded the number of fund managers that are subject to SEC regulation. Advisers whose sole clients are private funds and have total assets under management in the United States of less than $150 million are exempt from SEC registration but may be subject to certain record-retention requirements and must provide certain reports required by the SEC. As a result of the Dodd-Frank Act, most fund managers with assets under management of $150 million or greater must register with the SEC as investment advisers.

State Investment Adviser Registration and Regulation. Managers of funds with assets under management of $100 million or less may be required to register with state authorities, absent a state exemption from registration.

E. Investment Company Act

Hedge funds are typically not subject to the Investment Company Act pursuant to one of the following exclusions:

- **3(c)(1) Fund.** A “3(c)(1) Fund” is a fund that is excluded from registration as an investment company pursuant to Section 3(c)(1) of the Investment Company Act (the “Investment Company Act”). Entities that register under the Investment Company Act are typically mutual funds. A fund entity may qualify as a 3(c)(1) Fund if its outstanding securities are not owned by more than 100 persons and the fund does not conduct, and does not propose to conduct, any public offering of its securities. Exemption from the Investment Company Act is important for fund entities because registration under and compliance with the Investment Company Act would make operation of a fund entity difficult, if not impossible. Accordingly, fund entities that choose to rely on the exclusion
for 3(c)(1) Funds must closely monitor the number of persons owning interests in the fund entity.

Important to note is that the 100-person limit is subject to special calculations under the SEC rules. In certain circumstances, a fund entity must “look through” an entity investor and count each of the underlying beneficial owners of the entity based on certain percentage tests. Also, certain investors, including “knowledgeable employees,” spouses of owners with jointly held interests, or interests held by one beneficial owner through multiple entities, may be excluded from the count (or may count as only one investor). In addition, separate 3(c)(1) Funds managed by a single fund manager may be treated as a single, integrated fund for purposes of the 100-investor limit if the strategies employed by the funds are not sufficiently distinct.

- **3(c)(7) Fund.** A “3(c)(7) Fund” is a fund that is excluded from registration as an investment company pursuant to Section 3(c)(7) of the Investment Company Act. A fund entity qualifies as a 3(c)(7) Fund if its limited partners are all either (1) individual investors who are “qualified purchasers” owning not less than $5 million in investments; or (2) entities owning not less than $25 million in investments, and the fund does not conduct, and does not propose to conduct, any public offering of its securities. Under certain circumstances, an entity that has less than $25 million in investments may invest in a 3(c)(7) Fund. For a number of tax and regulatory reasons, 3(c)(7) Funds must limit the number of investors to fewer than 2,000.

A fund manager may simultaneously operate both a 3(c)(1) Fund and a 3(c)(7) Fund that are substantially similar to each other. The ability to operate parallel 3(c)(1) and 3(c)(7) Funds may be helpful for a manager of a 3(c)(1) Fund that is approaching the 100-investor limit if some investors are qualified purchasers. The manager may set up a 3(c)(7) Fund with an identical strategy to the 3(c)(1) Fund and direct its more sophisticated investors to the 3(c)(7) Fund. There will generally be no integration when a 3(c)(1) Fund and a 3(c)(7) Fund are operated simultaneously, even if the two funds have similar or identical strategies. The integration doctrine was developed by the SEC staff to prevent abuse of the 100-security-holder restriction on 3(c)(1) Funds. The integration doctrine requires that two 3(c)(1) Funds that are substantially identical be treated as if they were a single fund for purposes of testing whether the 3(c)(1) limitation has been exceeded. The SEC staff will not integrate properly constituted 3(c)(1) Funds and 3(c)(7) Funds. Additionally, the SEC staff normally does not integrate domestic hedge funds and their offshore counterparts.

- **F. CFTC Registration**

If a fund entity trades in futures contracts, options on futures contracts, options on commodities, or “swaps” (which the Dodd-Frank Act defines broadly to include most over-the-counter derivatives contracts, including foreign exchange forwards, interest rate swaps, and total return swaps on broad-based securities indices) or other commodities, the GP of the fund will be deemed a commodity pool operator (“CPO”) and the adviser to the fund will be deemed a commodity trading adviser (“CTA”). Entering into even a single commodity contract, or having the authority to do so, can subject the GP of a fund to regulation under the Commodity Exchange Act and rules promulgated by the CFTC.
Unless it qualifies for an exemption, any CPO or CTA must register with the Commodity Futures Trading Commission ("CFTC") and become a member of the National Futures Association ("NFA").

As a CPO, the GP is subject to various record-keeping, reporting and disclosure requirements under the Commodity Exchange Act and the CFTC regulations. In addition to the registration requirement, the fund entity’s PPM must ordinarily be approved by the NFA prior to its use.

**CPO Exemptions.** CFTC regulations offer several exemptions from CPO registration to investment managers of fund entities. Rule 4.13(a)(3) exempts operators of funds that trade only a de minimis level of commodities interests, are marketed only to accredited investors (as defined for purposes of Regulation D) and certain employees, and are not marketed as a vehicle for trading in commodity interests. To satisfy the Rule 4.13(a)(3) de minimis exemption, a fund must satisfy one of the following tests:

- Its aggregate initial margin, premiums and minimum security deposit required to establish commodity interest positions, determined at the time the most recent position is established, do not exceed 5 percent of the liquidation value of the fund’s portfolio, after taking into account unrealized profits and unrealized losses on any such positions; or

- The aggregate net notional value of such positions, determined at the time the most recent position is established, does not exceed 100 percent of the liquidation value of the fund’s portfolio, after taking into account unrealized profits and unrealized losses on any such positions.

See a discussion in Section X below regarding the CFTC Rule 4.7 "regulation lite" exemption which requires the CPO and the CTA to register with the CFTC but provides relief from certain of the disclosure and reporting requirements.

Private funds that invest in commodity interests and rely on the de minimis exemption from registration may engage in general solicitations in Rule 506(c) offerings or use resellers under SEC Rule 144A without jeopardizing their ability to rely on Rule 4.13(a)(3), in reliance on CFTC Letter 14-116 (Sept. 9, 2014) which provides exemptive relief from the general solicitation restrictions in CFTC Rule 4.7 and 4.13(a)(3) to harmonize the CFTC rules with the SEC rule changes arising from the JOBS Act. CPOs claiming the exemptive relief must file a notice with the CFTC Division of Swap Dealer and Intermediary Oversight.

Funds that do not qualify for an exemption will be subject to full registration as CPOs and must verify whether fund investors are themselves registered CPOs or relying on an exemption. Funds-of-funds are temporarily exempted from registration until the CFTC issues guidance on the application of the de minimis test.

**CTA Exemptions.** Rule 4.14(a)(8) exempts a CTA from registration if the CTA’s commodity interest trading advice is directed solely to, and for the sole use of, a fund for which a CPO has claimed exemption under Rule 4.13(a)(3), provided that the CTA provides commodity interest
trading advice solely incidental to its business of providing securities or investment advice to the commodity pool and is not otherwise holding itself out as a CTA.

- Rule 4.14(a)(10) exempts CTAs that have not provided commodity trading advice to more than 15 persons during the course of the preceding 12 months, and do not hold themselves out generally to the public as a CTA.

- The exemption under Section 4m(3) of the Commodity Exchange Act exempts CTAs that are (i) registered with the SEC as investment advisers, (ii) whose business does not consist primarily of acting as a CTA, and (iii) that do not act as a CTA to any fund engaged primarily in trading commodity interests.

- Seeking an Exemption. All persons seeking registration exemptions under Rules 4.13(a)(3) and 4.14(a)(8) must file a notice of exemption electronically with the NFA, confirm their claims of exemption on an annual basis at the end of each calendar year, and make certain disclosures to investors. The Section 4m(3) and Rule 4.14(a)(10) exemptions are self-executing.

VI. ADDITIONAL TAX CONSIDERATIONS

A. Unrelated Business Taxable Income

Investors that are exempt from federal income taxation under Section 501(a) of the Internal Revenue Code, including qualified pension and profit sharing trusts and individual retirement accounts (“Tax Exempt Investors”), are required to pay federal income tax on their “unrelated business taxable income” (“UBTI”). UBTI generally includes gross income derived by a Tax Exempt Investor from any unrelated trade or business but generally does not include income from dividends, interest, and gains from the sale or exchange of capital assets (unless that income is “debt financed” income discussed below). Because fund entities trade for their own accounts in debt and equity securities, their income will consist almost exclusively of interest, dividends and gains from the sale of capital assets. Consequently, a Tax Exempt Investor’s distributive share of such income of a fund entity will not be UBTI and will not be subject to federal income tax. Tax Exempt Investors will be subject, however, to federal income tax on their distributive share of any other income of a fund entity that is classified as UBTI, as well as the portion of any income and gains that are derived through a fund entity from property with respect to which there is acquisition indebtedness.

Borrowings by a fund entity would give rise to UBTI if the related investment were to generate any income during the taxable year or years in which such borrowing was outstanding or if the related investment were disposed of at a gain within 12 months after such borrowing was repaid. Further, an investment by a fund entity will result in acquisition indebtedness (1) if indebtedness incurred by the fund entity before the investment was made would not have been incurred but for the investment, (2) if the investment is actually made with the use of borrowed funds, or (3) if the investment necessitates future borrowings by the fund entity and this eventuality was foreseeable at the time the investment was made. For example, if a fund entity were to purchase stock in a company and finance one-half of the purchase price with debt and then sell the stock for a gain, the fund entity would have UBTI equal to one-half of the gain,
minus one-half of the net interest cost. A tax-exempt organization will be subject to a tax return filing requirement if it takes into account $1,000 or more of gross income in computing UBTI. The receipt of UBTI by a tax-exempt organization generally will not affect its tax-exempt status if the investment is not otherwise inconsistent with the nature of its tax exemption. Short-sales transactions involving publicly traded securities do not generally give rise to UBTI, but, as in all matters relating to taxes, it is wise to check with a tax adviser.

As a general proposition tax-exempt investors do not like to receive UBTI, principally because it requires them to prepare and file a tax return on Form 990T, which they would not otherwise have to file, and pay taxes on that income at the corporate rate. Therefore, they will generally avoid fund entities that generate UBTI.

B. U.S. Trading Safe Harbor for Offshore Feeder Funds

Section 864(b)(2) of the U.S. Internal Revenue Code provides a safe harbor (the “Trading Safe Harbor”) applicable to a non-U.S. corporation (other than a dealer in securities) that engages in the U.S. in trading securities (including contracts or options to buy or sell securities) for its own account pursuant to which such non-U.S. corporation will not be deemed to be engaged in a U.S. trade or business.

Most offshore feeder funds conduct their businesses in a manner so as to meet the requirements of the Trading Safe Harbor. Thus, an offshore feeder fund’s securities trading activities should not constitute a U.S. trade or business, and, except in the limited circumstances discussed below, the offshore feeder fund should not be subject to the regular U.S. income tax on any of its or the master fund’s trading profits. However, if certain of the offshore feeder fund’s or the master fund’s activities are determined not to be of the type described in the Trading Safe Harbor, the company’s or the master fund’s activities may constitute a U.S. trade or business, in which case the company would be subject to U.S. income and branch profits tax on the income and gain from those activities.

Gains realized from the sale or disposition of stock or securities (other than debt instruments with no equity component) of U.S. real property holding corporations (as defined in Section 897 of the IRC; “USRPHCs”), including stock or securities of certain real estate investment trusts, will generally be subject to U.S. income tax on a net basis. However, a principal exception to this rule would apply if such USRPHC has a class of stock that is regularly traded on an established securities market and the offshore feeder fund generally did not hold (and was not deemed to hold under certain attribution rules) more than 5 percent of the value of such stock at any time during the five-year period ending on the date of disposition. Moreover, if the offshore feeder fund or the master fund were deemed to be engaged in a U.S. trade or business as a result of owning a limited partnership interest in a U.S. partnership, income and gain realized from that investment would be subject to U.S. income and branch profits tax.

C. Foreign Account Tax Compliance

Legislation commonly referred to as the Foreign Account Tax Compliance Act, or FATCA, generally imposes a 30 percent U.S. withholding tax on certain payments by issuers of U.S. securities to foreign entities and on the proceeds of sale of U.S. securities by foreign entities, regardless of whether the foreign entity is the beneficial owner or an intermediary, unless the
foreign entity furnishes tax reporting information concerning its U.S. account holders or U.S. owners to the IRS. Exemptions from this withholding tax may apply. Current guidance from the IRS indicates that withholding under FATCA will be phased in beginning on July 1, 2014 and continuing through 2017.

VII. PARTICIPATION IN NEW ISSUES

A fund generally will require that certain types of investors (as described in rules set forth by the Financial Industry Regulatory Authority ("FINRA")) be restricted from participating in allocations of profit and loss attributable to investments by the fund in securities that are part of an initial public offering of an equity security made pursuant to a registration statement or offering circular (a “New Issue”). The categories of “restricted persons” under FINRA Rule 5130 are FINRA members or other broker-dealers, broker-dealer personnel, finders and fiduciaries, portfolio managers, and persons owning a broker-dealer. In the absence of such a provision in its fund documents, the fund can choose either to (1) not participate in New Issues or (2) not accept FINRA-restricted persons as investors. A fund may permit “restricted persons” to participate in New Issues provided that the aggregate participation in the fund by restricted persons does not exceed 10 percent of the fund’s capital.

FINRA’s anti-spinning rule (Rule 5131) prohibits a FINRA member or associated person from allocating New Issues to any account in which certain “covered persons” have a beneficial interest (an executive officer or director of a U.S. public reporting company or certain non-public companies, or a person “materially supported” by such an executive officer or director), if the FINRA member has certain investment banking relationships with the company in question. If a fund’s investors are “covered persons,” Rule 5131 may preclude the fund from participating in New Issues. However, funds may invest in New Issues so long as the beneficial interests of covered persons do not exceed 25 percent of the fund.

Funds seeking to invest in New Issues will be required to make certain representations about their investors and provide relevant information to their broker-dealer and would be advised to add questions relating to company-specific information to their subscription documents or investor questionnaires. FINRA recently adopted an amendment to Rule 5131 to make it easier for a fund to comply with certain information-gathering requirements with respect to the allocation of New Issues to third-party investors that are funds of funds managed by an unaffiliated investment manager. Pursuant to the new exemption, the fund’s manager is not required to “look through” to the beneficial owners of any unaffiliated private fund invested in the account and thus is not required to collect company-specific information of any such beneficial owners (except with respect to beneficial owners who are “control persons” of the investment adviser to the fund). This amendment should ease the burden on funds with respect to the collection of certain company-specific information regarding the underlying investors of a fund of funds.

VIII. ANTI-MONEY LAUNDERING

Funds are required to comply with trade sanction regulations adopted through the Department of Treasury’s Office of Foreign Assets Control (“OFAC”). As part of its sanctions program, OFAC publishes lists of sanctioned countries and persons, with whom U.S. persons cannot do
business. Funds are restricted from accepting subscriptions from entities and persons on the OFAC list.

The U.S. Treasury Department’s Financial Crimes Enforcement Network (“FinCEN”) does not currently require private funds and their investment advisers to implement anti-money laundering (AML) compliance programs, it is best practice for funds and their advisors to put in place AML programs that comply with the Bank Secrecy Act (BSA) and Patriot Act requirements. Among other things, funds are advised to take measures to verify the identities of existing and prospective investors and to identify the source of funds invested in the fund. In addition, funds should develop internal policies, procedures and controls designed to detect and prevent money laundering. The Treasury Department has indicated that it may soon require private funds to comply with the BSA/Patriot Act requirements. Offshore jurisdictions also typically have anti-money laundering laws and regulations that will apply to offshore investment funds.

IX. CUSTODY

Fund managers and advisers that are registered as investment advisers with the SEC are required to comply with the SEC’s “Custody Rule,” which generally requires that all client assets, other than certain privately offered securities, be held by a qualified custodian, which is typically a bank or other financial institution. The Custody Rule also requires that the investment adviser inform its clients of the identity of the custodian.

In addition, fund advisers are generally required by the Custody Rule (1) to undergo an annual surprise examination by an independent public accountant registered with the Public Company Accounting Oversight Board (“PCAOB”) to verify client assets and (2) to have a reasonable belief after due inquiry that any qualified custodian maintaining client assets sends account statements directly to advisory clients. An exemption from the annual surprise audit and the requirement to provide quarterly account statements to clients is available for advisers to pooled investment vehicles such as fund entities if the adviser delivers to clients an audited annual financial statement prepared by a PCAOB-registered accountant within 120 days of the end of the fiscal year or within 180 days of the end of the fiscal year for hedge funds of funds.

If the adviser or a related person acts as “qualified custodian” of client assets, the adviser is required to obtain or receive, from the related person, a report on internal controls relating to the custody of client assets prepared by an independent PCAOB-registered public accountant.

X. FILING REQUIREMENTS

Annual. Investment advisers to funds are required to update certain information on an annual basis: Form D amendments, state blue-sky filings, New-Issue certifications, Form ADV information and privacy policies.

- Form D amendments. All funds engaged in a continuing offering are required to file an annual amendment to their Form Ds on the electronic form on or before the first anniversary of the filing of the notice of sales on Form D or the filing of the most recent amendment to the notice of sales on Form D, if the offering is continuing at that time.
- State blue-sky filings. Funds’ advisers should consider whether there are any state blue-sky filing obligations in connection with the offering or sale of interests in the funds. The applicable state laws of most jurisdictions require blue-sky filings for the sale of fund interests. The deadline for such filings is generally 15 days after the date of the first sale of interests in any particular jurisdiction (with a few limited exceptions, such as New York and Idaho, that may require presale filings). State blue-sky filings typically consist of a Form D and some combination of a Form U-2 and payment of a filing fee. New York requires an additional disclosure document (Form 99). A few states have no blue-sky filing requirements, while others have exemptions from blue-sky filing requirements for certain categories of investors, such as institutional accredited investors. Some states require final notice when the offering of fund interests ceases in the specific state.

- New-Issue certifications. Pursuant to FINRA Rule 5130, a member of FINRA is prohibited from selling a New Issue — defined to include many securities sold pursuant to an initial public offering — to any fund, unless such member has received a representation from the fund within the previous 12 months that (i) the fund is not a “restricted person” and (i) restricted persons do not have more than a de minimis ownership in the fund. To comply with the annual representation requirements in good faith, fund entity advisers should reconfirm that the “restricted person” status of all fund investors has not changed since the certification made in the subscription documents. This annual certification may be obtained through “negative consent” letters. For fund investors that are funds of funds managed by an unaffiliated investment manager, the fund may need to obtain certain information from the underlying investors with regard to the status of such investors as restricted persons under FINRA Rule 5130. Funds will need to take similar steps to reconfirm that the “covered person” status of all fund investors has not changed for purposes of FINRA Rule 5131.

- Privacy policy. Investment advisers, CPOs and CTAs, whether registered or not, are subject to SEC, CFTC and/or Federal Trade Commission regulations governing the privacy of certain confidential information. Advisers should deliver their privacy policy, along with subscription materials, to each new investor and update the policy as necessary. Additionally, advisers must distribute the policy at least once during each 12-month period.

- 13F reports. If the adviser holds or has investment power over long positions in certain U.S. publicly traded equity securities valued at more than $100 million, the adviser is required to file a Schedule 13F with the SEC on a quarterly basis. The Schedule 13F lists portfolio holdings. Although the 13F regulations permit confidential filings, in practice, confidential treatment requests are often rejected by the SEC absent compelling reasons.

- 13D or 13G filing obligations. Funds may be required to make a filing on Schedule 13D or Schedule 13G with the SEC (and send copies of the filing to the principal exchange on which the securities are registered and to the issuer of the securities) if the fund acquires 5 percent or more of the outstanding securities of any class of a publicly traded company. The Schedule 13D or 13G provides information with respect to the acquiring entity and the purpose of the acquisition. An amendment to a Schedule 13D must be filed if there is a material change in investment intention of the fund entity or if the percentage of outstanding securities of the issuer held by the filer changes by more than 1 percent.
Registered investment advisers holding securities in the ordinary course of business and other investment advisers that hold less than 20 percent of the securities of an issuer on a strictly passive basis are exempt from the Schedule 13D filing obligations and, instead, are generally allowed to file a short-form Schedule 13G. An amendment to a Schedule 13G must be filed at the end of each year in which there is any change in the ownership of the securities and generally if the percentage of outstanding securities of the issuer held by the filer changes by more than 5 percent or exceeds 10 percent of the outstanding shares. Each of these filings must be made through the SEC’s electronic filing system.

- **Form 144.** Advisers to fund entities may have to file a Form 144. A Form 144 should be filed as notice of a proposed sale of restricted securities or securities held by an affiliate of the issuer in reliance on Rule 144 of the Securities Act when the amount sold during any three-month period exceeds 5,000 shares or units or has an aggregate sales price in excess of $50,000. The form is filed with the SEC and the principal national securities exchange, if any, on which such security is traded and is publicly available.

- **Forms 3, 4 or 5.** Advisers may also have to file a Form 3, 4 or 5. These are statements of ownership filed by directors, officers or owners of more than 10 percent of a class of equity securities of a public company. The initial filing is on Form 3 and changes are reported on Form 4. The annual statement of beneficial ownership of securities is on Form 5. The statements contain information on a reporting person’s relationship to the company and on purchases and sales of the company’s equity securities.

  Form 3 reporting is triggered (1) when more than 10 percent of the equity securities of a public company is acquired; (2) when the reporting person becomes a director or officer; or (3) if a reporting person is a 10 percent owner, when the equity securities become publicly traded, as the case may be. Form 4 reporting is triggered by any open market purchase, any sale or an exercise of options of those reporting under Form 3. Form 5 reporting is required annually for those insiders having exempt transactions not reported on Form 4. These statements are filed with the SEC and are publicly available.

- **Form PF.** Advisers Act Rule 204(b)-1 requires SEC-registered investment advisers with at least $150 million in private fund AUM to periodically file Form PF with the SEC to report extensive information regarding the private funds they advise, including risk exposure statistics regarding the type and size of assets held by such private funds. To determine whether an adviser meets the $150 million AUM threshold for purposes of Form PF, advisers must aggregate (1) assets of managed accounts advised by the firm that pursue substantially the same investment objective and strategy and invest in substantially the same positions as private funds advised by the firm, unless the value of those accounts exceeds the value of the private funds with which they are managed and (2) assets of private funds advised by any of the adviser’s “related persons” other than related persons that are separately operated. Advisers having at least $1.5 billion in regulatory assets under management attributable to hedge funds must file Form PF within 60 days of the end of each fiscal quarter. Smaller private fund advisers are required to file Form PF annually, within 120 days of the end of the adviser’s fiscal year.
• **Hart-Scott-Rodino Antitrust Improvements Act of 1976.** A Hart-Scott-Rodino ("HSR") Notice is filed prior to the consummation of certain mergers, acquisitions, joint ventures or acquisitions of more than a certain value of assets or voting securities (currently $66 million). The notification includes information about the transaction and the participants in the transaction. As a general matter, both the acquiring person and the acquired person must file notifications when either the acquiring person or the acquired person is engaged in U.S. commerce or any activity affecting U.S. commerce and either of the two threshold tests is met.

Acquisitions of voting securities are exempt from HSR filing if they are made “solely for the purpose of investment” and if, as a result of the acquisition, the securities held do not exceed 10 percent of the outstanding voting securities of the issuer. Securities are acquired solely for investment purposes if the person acquiring the securities has no intention of participating in the formulation, determination or direction of the basic business decisions of the issuer.

• **CPO and CTA Registration Forms 7-R and 8-R.** If required to register with the CFTC as a CPO or CTA, the fund must submit (1) a completed Form 7-R (which provides CPO or CTA information); (2) a completed Form 8-R (which provides biographical data) and fingerprint card for each principal (defined to include executive officers, directors and 10 percent owners), branch office manager and associated person (defined to include persons soliciting fund interests or accounts or supervising persons so engaged) and proof of passage of the Series 3 exam for each associated person; and (3) proof of passage of the Series 3 and futures branch office manager exams for each branch office manager. After a fund is registered with the NFA as a CPO or CTA, it will be required to provide regular reports to its investors.

CPOs and CTAs to commodity pools that principally trade in commodity futures or security futures may rely on the exemption in CFTC Regulation 4.7, which requires the CPO and the CTA to register with the CFTC but provides relief from certain of the disclosure and reporting requirements so long as the interests in the fund are only offered to “qualified eligible persons” consisting of certain securities and commodities industry participants and persons who satisfy certain investment ownership, net asset or net income thresholds. However, a CPO may only claim an exemption pursuant to Rule 4.7(b) if the pool interests are offered or sold without marketing to the public. Many of the qualified eligible persons that are not industry participants or qualified purchasers must also meet a portfolio requirement, i.e., a minimum securities or commodities ownership threshold.

If CPOs or CTAs qualify for the Regulation 4.7 exemption, they will be exempt from the extensive periodic reporting requirements. Instead, they will be required to prepare and distribute a quarterly report to investors regarding the commodity pool’s net asset value within 30 days of the end of each fiscal quarter and an annual report within 90 calendar days of the end of the fiscal year. The quarterly report must reflect (1) the net asset value of the pool as of the end of the relevant period; (2) the change in net asset value from the end of the previous reporting period; and (3) either the net asset value per unit as of the end of the relevant period or the total value of the investor’s interest or share, all computed in accordance with Generally accepted accounting principles (GAAP) or International
Finance Reporting Standards (IFRS), as appropriate. If the fund consists of series structured with a limitation to liability, the CPO may present information for only that series.

The annual report must include a statement of operations for the relevant year in compliance with GAAP or IFRS, as appropriate, including footnote disclosures. As with periodic reports, the fund may provide information with respect to a specific series only if it is isolated from other series. The annual report also must include a legend on the cover page that the CPO or CTA has made a claim for exemption, an affirmation by a person authorized to bind the CPO, and either a certificate by an independent public accountant or an offer to provide a certified audit upon the request of a majority in interest of the unaffiliated limited partners of the fund entity.

Although CPOs and CTAs relying on Regulation 4.7 are exempt from certain reporting requirements, they must maintain all books and records prepared in connection with the fund, including records relating to the qualifications of qualified eligible persons and substantiating any performance claims. They must also maintain the periodic and annual reports described above. The time frame and method of retaining such records are specifically set forth in the CFTC regulations.

Funds seeking to make general solicitations pursuant to Rule 506(c) may not be able to take advantage of the exemption from certain record-keeping, reporting and disclosure requirements, as Regulation 4.7 requires that interests in the fund be offered or sold without marketing to the public.

- Speculative position limit exemption. Exchanges generally have speculative position limits for physical commodities and stock index contracts, and the CFTC has limited speculative positions for certain agricultural commodities. Exemptions from such limits are generally available for hedging transactions. Financial contracts, such as interest rate contracts, generally have “position accountability” levels rather than strict position limits. Accounts or account controllers exceeding position accountability levels must justify their positions to an exchange or the CFTC upon request. Generally, an application for any speculative position limit exemption must show that such position is a bona fide hedging, risk management, arbitrage or spread position. The filing is made with the appropriate exchange in the case of physical commodities and stock index contracts and with the CFTC in the case of certain agricultural commodities. A separate related exemption applies for a CTA for a commodity pool for which it is also a CPO.

XI. FUND MANAGEMENT AND OPERATIONS

Written policies and procedures. SEC-registered investment advisers are required to adopt written policies and procedures reasonably designed to ensure compliance with the Advisers Act and SEC rules by the adviser and its supervised persons. In addition, the investment adviser should have a code of ethics setting forth the standards of conduct for employees, particularly with respect to their personal trading and insider trading. Such policies and procedures and their effectiveness must be internally reviewed at least annually. The adviser should develop a procedure to ensure that employees understand and accept the code of ethics. An investment
adviser is also required to designate a chief compliance officer responsible for the administration of the adopted policies and procedures.

**Investor privacy concerns.** The investment manager is required to adopt policies and procedures designed to maintain and protect from inappropriate disclosures to third parties the information it obtains concerning its investors (Regulation S-P). The investment manager is prohibited from providing non-public personal information about an investor to an unaffiliated third party without providing prospective and existing investors with initial and annual notices describing its policies and procedures for protecting investor information. In addition, many states have rules and regulations concerning treatment of investors’ non-public personal information.

**Record-keeping requirements.** The SEC imposes extensive record-keeping requirements on registered investment advisers. Rule 204-2 of the Advisers Act requires an adviser to maintain two types of records: (1) typical business accounting records and (2) certain records regarding the adviser’s business that the SEC believes an adviser should keep in light of the special fiduciary nature of its business, including copies of all written communications (including e-mails) relating to any advice or recommendations given or proposed to be given to clients; any receipts; records of the disbursement or delivery of funds or securities; records regarding the placing or execution of any order to purchase or sell any security; policies and procedures; and records related to the code of ethics. The records required to be maintained under Rule 204-2 must be maintained in an easily accessible place for at least five years from the end of the adviser’s fiscal year during which the last entry was made, with the first two years being in the office of the adviser. These requirements survive the termination or discontinuance of the adviser. In addition, the records are subject to reasonable periodic or special examinations by the SEC. It is recommended that all registered investment advisers develop a comprehensive record-keeping policy, including provisions for e-mail retention.

The Dodd-Frank Act permitted the SEC to create additional reporting and record-keeping requirements applicable to registered investment advisers to private funds. These advisers must maintain records pertaining to (1) the amount of AUM; (2) the use of leverage, including off-balance-sheet leverage; (3) counterparty credit risk exposure; (4) trading and investment positions; (5) valuation policies and procedures; (6) types of assets held; (7) side arrangements or side letters; (8) trading practices; and (9) such other information the SEC deems necessary or appropriate in the public interest for the protection of investors or for the assessment of systemic risk.