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Brief

Chair Clayton's Impact at the SEC

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On October 25, 2017, the Hedge Fund Industry Practice team hosted an event at the New York Yacht Club titled "Chair Clayton's Impact at the SEC." Hedge fund professionals, including general counsels, hedge fund principals and chief compliance officers, attended the event, which featured an engaging panel discussion moderated by Marc Powers, national leader of BakerHostetler's Securities Litigation and Regulatory Enforcement and Hedge Fund Industry practices.

The panelists included Walter Van Dorn, Partner, Baker & Hostetler LLP; Simcha David, Partner, EisnerAmper LLP; Jonathan Forman, Counsel, Baker & Hostetler LLP; and Andrew Siegel, Chief Compliance Officer and Chief Regulatory Counsel, Perella Weinberg Partners.

Walter Van Dorn kicked off the panel with a discussion of the Security and Exchange Commission's regulatory impact under Chair Jay Clayton. Van Dorn explained that not a lot had changed at the SEC under Chair Clayton in the first eight to nine months of the Trump administration. Since President Trump took office, Congress has passed no securities legislation. The only significant securities statute it considered was the Choice Act, which had passed in the House of Representatives but had not yet been considered in the Senate and thus has not yet made it to President Trump's desk. The Choice Act, which had been pending under the Obama administration, is deregulatory in a number of ways. One Choice Act provision that affects the fund industry directly would roll back the Dodd-Frank provision requiring more frequent SEC registration of advisers to private equity funds. (Under Dodd-Frank, the thresholds for registration of investment advisers to nonpublic funds can be strict, and the Choice Act, if adopted, would relax this requirement in part.) However, Van Dorn opined that it likely would not gain the traction it needed to pass both houses of Congress, especially with legislation such as the Affordable Care Act and tax reform taking higher priority.

Van Dorn highlighted Chair Clayton's view on the role of the SEC and quoted an excerpt from a speech Clayton gave in June 2017 in New York.

> I believe in the regulatory architecture that has governed the securities market since 1933. It is abundantly clear that wholesale changes to the Commission's fundamental regulatory approach would not make any sense.

> Clayton is not looking to "turn things upside down."
> – Walter Van Dorn

Van Dorn noted, as an example, that Chair Clayton is rumored to be a Democrat despite being appointed by President Trump. He also explained that two of the five commissioners are Democrats and three are Republicans, all of whom appear to be moderate, mainstream individuals.

Various Operating Divisions of the SEC

Van Dorn then provided an overview of the recent developments of the various operating divisions at the SEC, noting that all the divisions – Corporation Finance, Enforcement, Trading and Markets, Investment Management, and the Office of Compliance Inspections and Examinations – were fairly well-staffed, particularly compared with other government agencies, and up and running. Van Dorn noted that the Corporation Finance Division, which regulates capital raising, had proposed substantial overhaul and simplification of Regulation S-K, the basic regulation that dictates the disclosure required for prospectuses and other offering documents and for periodic disclosure by public companies. According to Van Dorn, this revision, the first in a number of years, would have a deregulatory effect, but he noted that most of the proposed changes were quite logical. Van Dorn added that the proposal has been pending since before the presidential election.

> "The Corporation Finance Division's proposed revisions to Regulation S-K, the first in a number of years, would have a deregulatory effect, and the proposed changes are quite logical." – Walter Van Dorn

Next, Van Dorn discussed the SEC's recent activities surrounding cryptocurrencies and initial coin offerings (ICOs), which he noted had been an almost entirely unregulated area that had become quite popular in recent months. The SEC released a statement in July 2017 that addressed the biggest related legal issue of whether a coin, cryptocurrency or token should be treated as a "security" and thus subject to SEC regulation.[1] Van Dorn explained that according to the statement, if the proceeds of the issuance were being used for investment purposes, they were more likely to be classified as a securities offering. But if the transaction had more similarities to an exchange of currencies – for example, exchanging fiat currency, such as dollars, for cryptocurrency, such as bitcoin – it would be more likely to be classified as a currency transaction, which is not regulated by the SEC. If the issuance were subject to SEC regulation, the offer and sale would need to be registered with the SEC or, if not registered with the SEC, then carried out pursuant to a valid exemption from registration, such as a private placement. Van Dorn noted that the determination was very fact specific, but it became evident to the SEC that in the recent so-called ICOs, people were really raising capital, an activity regulated by the SEC. Van Dorn then noted that he believes that cybersecurity is one of the next major areas that the SEC will tackle from a regulatory standpoint.

Updates on SEC Examinations, the OCIE and Compliance

The panel switched gears and provided a brief overview of the SEC's budget and allocation decisions. Last month, Chair Clayton indicated to Congress that there would likely be a 30 percent increase in SEC examinations as compared with those in the previous year. The panel noted that the SEC had a large number of investment advisers to regulate but has limited resources, especially because Chair Clayton had put forward a flat budget for this year. Chair Clayton reasoned that he wanted to see what the SEC could accomplish without having to ask Congress for more money. The audience was advised to monitor the SEC to see where it spends those limited resources.

Attendees were advised not to expect to see significant change from the examiner staff but rather a shift in what gets referred to enforcement.

> "There will be a shift in what examiners refer to the Enforcement Division. An examination will still cover short sale violations or regulation M violations, for example, but this administration likely will not turn it over to enforcement; instead, they will issue a deficiency letter, which in my opinion, is the right result." – Marc Powers

The panel next discussed considerations involved with building a compliance program, and the panelists agreed that there is not a one-size-fits-all model. Nonetheless, firms were urged to verify any statement that they certify to the SEC. For example, personal trading rules require a certification from employees with respect to their quarterly transactions and annually as to their holdings. In this instance, such firms should be prepared to verify the certification and, in the absence of clear guidance, consider obtaining advice from law firms or consulting firms. To that point, the panel acknowledged that compliance is expensive, and Chair Clayton has recognized it.

Chair Clayton also indicated that the SEC may move toward the fiduciary standard. The panel emphasized that the SEC has focused on "Mr./Ms. 401(k)-ing" at length. The panel noted that it has proven difficult for Chair Clayton to step away from the fiduciary rule, despite its controversy and partial implementation, and the SEC likely will take action.

The panel concluded with a prediction that the SEC will issue guidance about the "unbundling of research." The Europe-based Markets in Financial Instruments Directive #2 (MiFID 2) issued a rule effective January 2018 which will affect firms in the United States with UK offices that are

[1] Report, U.S. Sec. & Exch. Comm'n, *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, Rel. No. 81207 (July 25, 2017), https://www.sec.gov/litigation/investreport/34-81207.pdf; *see also* Walter Van Dorn, *SEC Statement on Treatment of Digital Assets under the Federal Securities Laws*, BakerHostetler Exec. Alert (Aug. 3, 2017), https://www.bakerlaw.com/alerts/sec-statement-on-treatment-of-digital-assets-under-the-federal-securities-laws.

subject to MiFID 2 or SCA rules. The panel advised that there would likely be an indirect effect on more firms. The panel identified a major issue under MiFID 2: Fund managers subject to the rules (mostly in Europe but also in the United States) cannot use trading dollars (soft dollars) to pay for their research. The rule will change how firms conduct, develop and pay for research. Currently, broker-dealers typically provide research incidental to their training, because if the broker-dealers accepted fees solely for research, they would be required to register as investment advisers and be subject to an additional set of rules. As a result, most broker-dealers, with the exception of the larger entities that are dual-registered with the Financial Industry Regulatory Authority and the SEC as investment advisers, will avoid regulation as registered investment advisers by declining to accept payments for research unbundled from their trading activities. Chair Clayton recognizes, and the panel acknowledged, that the guidance on the unbundled research issues will have a very global focus. Because present SEC rules conflict with the MIFID2, the SEC likely will act soon.[2]

Tax Considerations Under the Trump Administration

Simcha David outlined plans for tax reform under the Trump administration. The administration initially released just a two-page document with its plans and, as of the date of the event, released a more comprehensive nine-page framework, in conjunction with the House Committee on Ways and Means and the Senate Committee on Finance. David anticipated a draft bill would be released within a week or so of the panel meeting, and he expected that the bill would flesh out the framework. At this point, both a House bill and a Senate bill have been released, with various amendments attached to both. The future status of the bills will depend on the joint committee review. It is currently anticipated that there will be tax legislation passed before the end of the year.

[2] Editor's note: The very next day, the SEC released a no-action letter detailing that where certain stipulated broker-dealers provide research services that constitute investment advice under the Advisers' Act, the SEC's Division of Investment Management would not consider the broker-dealer to be an investment adviser and would not recommend enforcement action. The SEC has adopted this position temporarily, for the period of 30 months following MiFID 2's implementation date. Securities Industry and Financial Markets Association, SEC No-Action Letter (Oct. 26, 2017), https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a.htm.

Tax Issues Surrounding Loan Origination for Funds and Investors

Next, David explained the tax issues of loan origination for funds and investors. He noted that if a fund originates too many loans, the Internal Revenue Service (IRS) will deem it to be in the lending/trading business. When a fund manager purchases securities on the secondary market, from a tax perspective there is a safe harbor. The investing activity is not deemed to be U.S. trade or business activity, and therefore the capital gains generated are sourced to the domicile of the investor (referred to as the "864(b)(2) trading safe harbor"). For a typical hedge fund structure, for example, with a Cayman offshore feeder, the capital gains generated by the sale of securities will be sourced to the domicile of the offshore feeder, which in most structures is the Cayman Islands. As such, there will be no U.S. withholding tax on the capital gains generated and no Cayman Islands tax. When an entity originates loans, it may be deemed to be in the lending trade or business, just like a bank. If a master fund in a hedge fund structure is involved in a lending business, it will have income that is effectively connected to a U.S. trade or business (ECI) flowing up to the Cayman feeder. This means a 35 percent withholding on the income allocable to the offshore feeder and an additional branch profits tax at the offshore feeder, which would mean an approximate 52 to 54 percent effective tax rate on that income. David warns that this could possibly taint the rest of the portfolio, and he advises that "… in the hedge fund arena, businesses should be careful when it comes to lending."

> "In the hedge fund arena, businesses should be careful when it comes to lending." – Simcha David

According to David, more than five loans per year is "too much lending." He referenced a 1997 private letter ruling in which the IRS determined that the income generated by a fund that issued not more than five mortgages per year over a five-year period was not deemed to be trade or business income. David explained that there were several loan origination factors.

Loan origination factors:

- Interaction/negotiation with the borrowers and issuers.
- Solicitation of customers.
- Receipt of fees for lending (fees, not necessarily the interest income, make loan origination so lucrative).
- Performance of services.
- Activity that is considerable, continuous and on a regular basis.

David explained that hedge funds historically have gotten into lending by employing the "season and sell strategy" (a strategy specific to hedge funds that David notes has never been blessed or not blessed); the onshore fund originates the loan (they don't care; they are U.S.-based), they hold it for a period of 60 to 90 days ("seasoning it") and then they sell part of it to the offshore fund. This results in the offshore fund not actually originating but instead purchasing the debt in the secondary market.

Another option is to place a U.S. corporate blocker ("U.S. Blocker") in the structure. The U.S. Blocker would block the lending trade or business income from flowing to the offshore investors. The downside of utilizing a U.S. Blocker is that the income within the U.S. Blocker is taxed, and when money is taken out of the U.S. Blocker, it will be a dividend to the extent that it is not a liquidating distribution. To minimize the amount of income subject to the U.S. corporate income tax, one could use a levered blocker, essentially having the offshore fund lend money to the blocker, so that the blocker will have interest expense to offset the net income otherwise earned by the U.S. Blocker's lending activities. While this method works well from a private equity perspective, it doesn't work well in the hedge fund context because the offshore feeder in a hedge fund structure tends to be a Cayman ***corporation*** rather than a Cayman ***partnership***. If the offshore Cayman corporation feeder lends money to this U.S. Blocker, the interest income that the U.S. Blocker pays to the offshore Cayman corporation feeder will be subject to a 30 percent FDAP withholding. If an entity owns more than 10 percent of the issuer of a debt instrument (in this case, the U.S. Blocker is the issuer and the Cayman offshore feeder corporation is the owner), then the interest income will be subject to withholding. In private equity structures, the Cayman offshore feeder is generally a partnership. Because of this, the ownership test is not done at the partnership level; instead, the IRS will look through the partnership to the owners at the top.

> "Levered blockers don't work very well in the hedge fund context, which is why 'season and sell' is what hedge funds would use, as opposed to private equity funds."
> – Simcha David

Tax Treatment of Cryptocurrencies

David concluded by explaining the IRS's take on cryptocurrencies. He explained that although from the SEC's perspective many ICOs in reality are securities offerings, some cryptocurrencies, such as bitcoin, *would* be a currency, not a security. The IRS does not necessarily share this perspective. Notice 2014-21 specifically states that virtual currency is property and not currency.[3] For example, if someone owns bitcoin and uses it to buy a Pepsi, he or she may incur capital gain or loss, based on the difference in value that the bitcoin has from the time he or she purchased it until the time he or she spends it. David compared the difference here with when a person uses a U.S. dollar, as they don't necessarily think about the fluctuation in currency. David added that using virtual currency to pay a vendor requires an issuance of the 1099 tax form for the fair market value of the bitcoin at the time of payment to the vendor. David indicated that we need to see more guidance from the IRS on whether bitcoins are property more similar to, for example, an umbrella or to a security. Currently, it is unclear how to apply certain tax rules, such as the wash sale rules or the 864(b)(2) trading safe harbor. For example, it is unclear whether, if one is a trader of bitcoins, such activity will fall under the 864(b)(2) trading safe harbor, which applies only to stocks, securities and commodities. It is also unclear whether the wash sale rules will apply.

> "I would love to see more guidance from the IRS on [the appropriate property classification of bitcoins]."
> – Simcha David

[3] Notice, Int. Rev. Serv., No. 2014-21, *https://www.irs.gov/pub/irs-drop/n-14-21.pdf*.

Four Enforcement Developments Under Chair Clayton

Jonathan Forman rounded out the discussion by addressing four SEC enforcement developments under Chair Clayton that affect the investment management industry.

> "Despite the budget decrease and the resulting hiring freeze, enforcement is not going away. The SEC is doing more with less by leveraging its own technology." – Jonathan Forman

1. The SEC is attempting to do more with less.

Forman observed that despite the budget decrease and resulting hiring freeze, enforcement levels for advisers likely will not decrease. Chair Clayton has already shifted 100 exam staffers to the advisory unit, an action that likely will result in more enforcement referrals. The SEC also continues to leverage its own technology. The Division of Economic and Risk Analysis (DERA) has played a prominent role with both the SEC's regulatory and enforcement programs by using its technology national exam analytics tool to quickly process trading information to identify anomalous trades. Forman anticipates that this will continue.

2. The SEC's emphasis of cybersecurity as an enforcement initiative, not just a regulatory initiative.

Next, Forman noted that Chair Clayton recently created a cyber unit and identified two categories of cyber threats that this unit intends to address. The first category of threats is traditional cyber-based threats. For example, market manipulation schemes involving the spread of disinformation through electronic and social media, trading on hacked material nonpublic information, intrusions into retail brokerage to steal personal information and funds, and cyber threats to trading platforms are those previously on the SEC's radar. The second category covers unique cyber-based threats, including violations involving distributed ledger technologies, ICOs and the dark web. The SEC has not traditionally focused on these threats, because they are new and emerging. Given the novelty of these threats, Forman opined that other regulators may join the SEC to address them together.

> "The SEC is attempting to stay ahead of these technological advances and developments to make sure they understand how they may be misused." – Jonathan Forman

3. How the SEC's retail focus will affect advisers.

Chair Clayton also announced the creation of the Retail Strategy Task Force to target pump-and-dump schemes and the sale of unsuitable products. Forman believes that the SEC may, as a result, shift its attention from advisers of private equity funds to those who advise or invest in mutual funds. As an example of this potential shift, he discussed two recent settled orders against advisers that allegedly recommended more expensive share classes of mutual funds when cheaper ones of the same funds were available.[4] And in one of the settled orders, the trailer fees were allegedly paid to the adviser's affiliated broker-dealer without sufficient disclosures to investors. Forman indicated that these enforcement actions illustrate the SEC's emphasis of accurate disclosures regardless of adviser type.

> "Conflicts of interest will continue to be an issue that the SEC focuses on. The SEC wants disclosures to be accurate." – Jonathan Forman

4. A potential pivot from the broken-windows approach of the prior chair.

Forman observed that it remains up for debate whether the SEC will shift away from the broken-windows approach previously adopted by Chair Mary Jo White.

[4] Order, *In the Matter of Envoy Advisory, Inc.*, No. 3-18164 (Sept. 8, 2017), https://www.sec.gov/litigation/admin/2017/ia-4764.pdf; Press Release, U.S. Sec. & Exch. Comm'n, *SunTrust Charged with Improperly Recommending Higher-Fee Mutual Funds*, No. 2017-165 (Sept. 14, 2017), https://www.sec.gov/news/press-release/2017-165.

Chair Clayton's recent remarks cast doubt on whether he will continue this aggressive approach to enforcement and instead indicated his focus on rooting out fraud and considering proportionality with respect to enforcement. Powers added that from a historical perspective, most prior chairs typically did not bring enforcement actions for minor violations, opting instead to issue deficiency letters.

Predictions for the Coming Year

Forman predicted that conflicts of interest will continue to be an issue that the SEC will focus on as it brings enforcement actions. Forman also predicted a cybersecurity enforcement action against an adviser in the coming year given the increasing risk and heightened regulatory focus. Taking into account the SEC's concerns with its own breach, it faces considerable pressure to respond and act responsibly and to ensure that regulated entities dedicate the appropriate amount of resources to combating cybersecurity issues.

> "The SEC likely will be emboldened to bring more insider trading cases." – Jonathan Forman

Forman added that insider trading will also play a prominent role in the SEC's enforcement program going forward. As a result of the *Salman* and *Martoma* decisions, which effectively removed the close personal relationship requirement, and the SEC's focus on fraud cases, the SEC will be emboldened to bring more insider trading cases.[5] At the same time, the Supreme Court's decisions in *Gabelli* and *Kokesh* will likely force the Division of Enforcement to move faster.[6] Those decisions effectively limited civil penalties and disgorgement that the SEC can go after to a strict five-year statute of limitations. Forman predicts that the SEC will lean on its own technology more to identify unusual activity and to move its investigations and enforcement actions forward. Forman pointed to the *SEC v. Rivas* case from August 2017, where data analysis uncovered an alleged insider trading network that used encrypted self-destructing text messages, shell companies and code words to share and trade on information obtained from an information technology employee of a global bank.[7] Forman highlighted the overlap between the SEC's insider trading initiative and its cybersecurity initiative, and he noted that he expects these initiatives to continue to converge over the next year.

Powers concluded the panel by agreeing that cybersecurity will continue to hold the SEC's attention as a significant area of focus, cryptocurrencies will likely gain traction as an area to regulate and that Chair Clayton may revert to strategies employed before the changes made by his predecessor.

Prepared by Camille C. Bent

[5] *Salman v. United States*, 136 S. Ct. 899 (Jan. 19, 2016); *United States v. Martoma*, 869 F.3d 58 (2d Cir. 2017).

[6] *Gabelli v. S.E.C.*, 568 U.S. 442 (2013); *Kokesh v. S.E.C.*, 137 S. Ct. 1635 (2017).

[7] Press Release, U.S. Sec. & Exch. Comm'n, *SEC Uncovers Wide-Reaching Insider Trading Scheme*, Rel. No. 23911 (Aug. 16, 2017), https://www.sec.gov/litigation/litreleases/2017/lr23911.htm.

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