*Waterside Enterprises, LLC*

# Second Annual Report to JPMorgan Chase Bank, N.A. On Activities Related to Securities Act Rule 506 of Regulation D

## December 13, 2017

**Respectfully Submitted:**
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**Second Annual Report to JPMorgan Chase Bank, N.A.**
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Waterside Enterprises, LLC, the Independent Compliance Consultant ("Waterside" or "ICC") engaged pursuant to a waiver of disqualification granted by the Securities and Exchange Commission ("SEC" or "Commission") in 2015,[1] hereby submits the second annual review of the JPMorgan Chase Bank, N.A. ("JPMCB" or "Bank") and its subsidiaries, the "Rule 506 Entities,"[2] activities with regard to transactions entered into in accordance with Rule 506 of Regulation D under the Securities Act of 1933 ("Securities Act").[3]

Waterside conducted the second annual comprehensive review of the JPMorgan Wealth Management platform policies and procedures applicable to compliance with Rule 506, reviewing those policies and procedures in place in 2016 and testing a statistically valid random sampling of transactions conducted in 2016 in reliance on Rule 506 of Regulation D.

In order to accomplish the ICC work as required by the SEC Order, Waterside reviewed:

- Business processes applicable to private placement activity relying on Rule 506 of Regulation D;
- Offerings relevant to the Order;
- Requirements of Regulation D; and
- Written policies and procedures pertaining to the requirements of Regulation D.[4]

The Rule 506 Entities act as investment manager, placement agent or issuer in offering hedge funds, private equity funds and structured notes that rely on the Rule 506 of Regulation D exemption from registration.

[1] Securities Act of 1933, Release No. 9993, December 18, 2015 ("Order").
[2] The "Rule 506 Entities" are JPMorgan Chase Bank, N.A. including the Singapore, Hong Kong and Paris Branches and the following of its subsidiaries or affiliates: J.P. Morgan International Bank, Ltd., J.P. Morgan (Suisse) S.A. and J.P. Morgan Securities (Far East) Limited, Seoul Branch. J.P. Morgan Securities LLC (a U.S. registered broker/dealer) is not a Rule 506 Entity; therefore its Regulation D placements are out of scope for this review. In addition, placements relying on an exemption from registration offered by Regulation S of the Securities Act are not in scope for this review.
[3] For additional background information on the Order and the ICC review, ***See,*** Appendix A, attached.
[4] Waterside conducted the annual review of the Wealth Management platform business processes, written policies and procedures and transactions closing in 2016. During the course of the review, the Asset Management or institutional platform of the Far East Rule 506 Entity identified four additional private equity and real estate funds, with a total of six client transactions that were also in scope for this review. As noted below, Waterside was able to review two transactional files from Asset Management.

## I. Background

Under the federal securities laws, a company or private fund may not offer or sell securities unless the transaction has been registered with the SEC or an exemption from registration is available. Rule 506 of Regulation D is considered a "safe harbor" for the private offering exemption of Section 4(a)(2) of the Securities Act. Companies relying on the Rule 506 exemption can raise an unlimited amount of money and under Rule 506(b), a company can be assured it is within the Section 4(a)(2) exemption by satisfying the following five standards:

1. Companies must decide what information to give to "accredited investors," as long as the information does not violate the antifraud prohibitions of the federal securities laws;[5]
2. The company may sell its securities to an unlimited number of accredited investors and up to 35 other purchasers;[6]
3. The company may not use general solicitation or advertising to market the securities;[7]
4. Companies relying on the Rule 506 exemption must file an electronic "Form D" containing certain sales information with the SEC after they first sell their securities;[8] and
5. Companies must disclose certain regulatory actions and exercise reasonable care that no "Bad Actor" is participating in the Rule 506 offering by, among other things, monitoring the level of client holdings in the offering.[9]

## II. Process of the Review

In 2017, Waterside met with several members of Compliance, Legal and business department management in order to refresh our familiarity with business processes relevant to the private placement businesses of the Rule 506 Entities. The transactions in scope for the review were private placement offerings relying on the Rule 506 of Regulation D exemption from registering including: private equity funds, hedge funds (including the Global Access Portfolio or "GAP" funds) and structured notes. We reviewed background information for Rule 506 Entities

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[5] Unlike offerings registered with the SEC in which certain information is required to be disclosed, companies and private funds engaging in exempt offerings to "accredited investors" do not have to make prescribed disclosures. Clients in private placement offerings generally are made aware of information and risks through offering memoranda such as private placement memoranda and marketing documents. The company must be available to answer questions by prospective purchasers and must make financial statements available to potential investors.

[6] According to the SEC, one principal purpose of the accredited investor concept is to identify persons who can bear the economic risk of investing in unregistered securities. An *accredited investor*, in the context of a natural person, includes: anyone who has earned income that exceeded $200,000 (or $300,000 together with a spouse) in each of the prior two years, and reasonably expects the same for the current year, or has a net worth over $1 million, either alone or together with a spouse (excluding the value of the person's primary residence).

[7] In 2013, the SEC adopted amendments to Rule 506 of Regulation D (Release No. 33-9415; No. 34-69959; No. IA-3624; File No. S7-07-12) that, among other things, allow general solicitation of the private placement as long as the issuer takes reasonable steps to verify that the purchasers are accredited investors (Rule 506(c) of Regulation D). None of the funds within the scope of this review relied on Rule 506(c) of Regulation D.

[8] Form D is a brief notice that includes the names and addresses of the company's promoters, executive officers and directors, and some details about the offering, but contains little other information about the company.

[9] Adopted in 2013, this requirement is referred to as the "Bad Actor" provision of Regulation D. ***See***, Release No. 33-9415; No. 34-69959; No. IA-3624; File No. S7-07-12.

including process schematics outlining private equity and hedge fund business and supervisory processes for pre-offering approval, marketing and subscription activities.

Waterside examined written policies and procedures, guidelines, training materials, subscriber forms and "Frequently Asked Questions" relating to:

- Marketing Guidelines and Review Procedures
- Alternative Investment Procedures, including onboarding and offering funds
- Alternative Investments Middle Office Procedures, including processing and reconciling client transactions
- Accredited Investor Attestations, including Subscriber Information Forms, Instructions to Subscribe and Accredited Investor/Qualified Purchaser forms for Discretionary Accounts
- Procedures for the Global Access Portfolio
- Procedures and Intermediary Agreements for Structured Notes issuance
- Investment Manager/Discretionary Account Guidelines
- Supervisory Management Overview Procedures and additional procedures.[10]

Waterside reviewed written policies and procedures relevant to the scope of the Order that were in effect during our sample test period of calendar year 2016.[11]

During the course of the review, Waterside interviewed business management, supervisors and staff as well as Compliance and Legal management and staff focusing on the Rule 506 of Regulation D private placement business. We met with one of the outside law firms responsible for reviewing subscription documents for private equity funds and reviewed their internal procedures for reconciling transactions. Waterside observed the application of various processes used by the Rule 506 Entities as well as control points, supervisory review practices, and systems used.

Waterside conducted testing, as required by the Order and described more fully in Appendix B, of a statistically valid random sampling of private equity transactions and all hedge fund transactions in scope that closed in 2016 to help ascertain whether the policies and procedures were reasonably designed to achieve their stated purpose, namely, compliance with Rule 506 of Regulation D.

The private placements relying on Rule 506 of Regulation D in scope for this review include:

**Private Equity** – The Rule 506 Entities served as placement agent for 21 private equity offerings that closed in 2016 from the Wealth Management platform. From the 21 funds,

[10] Additional procedures include Terms and Conditions of the E-signature program, and Monitoring Compliance with the Bad Actor Rule.
[11] Waterside was also made aware of relevant new and amended 2017 policies and procedures during the course of the review.

Waterside determined that 1,321[12] private equity transactions would be subject to the statistical sampling methods described in Appendix B. From that sampling methodology, Waterside requested 392 sample transactional files. Waterside reviewed an additional 17 private equity files bringing the total reviewed to 409.[13] Waterside also reviewed two institutional placements from a Rule 506 Entity.[14]

**Hedge Funds** – The hedge funds offered in 2016 within the scope of the Order were developed by non-affiliated hedge fund managers and offered by Rule 506 Entities serving as placement agents. During 2016, the Rule 506 Entities had four hedge fund offerings that were made in reliance on Rule 506 of Regulation D in which 193 client transactions closed. Due to the small number of transactions, Waterside reviewed information for each of the 193 transaction files, which were in both brokerage accounts and in managed or discretionary accounts. Written policies, procedures and paperwork requirements differ with regard to brokerage and discretionary accounts.

**Global Access Portfolio funds** – This Rule 506 private placement offering consists of a variety of hedge funds or funds of funds designed to meet broad investment criteria for accredited investors depending on their investment risk tolerance. In 2016, there were seven Global Access Portfolio funds, with 94 transactions that closed for the Global Access funds. For these offerings, JPMCB served as Investment Manager, so these offerings are in scope for the review of selected policies and procedures such as marketing guidelines. However, these offerings were made either to U.S. persons residing in the U.S. via J.P. Morgan Securities LLC, an entity outside the scope of the Order, or to non U.S. persons outside the U.S. under Regulation S, so no client transaction files were in scope for this review.

**Structured Notes** – Generally, structured bank notes are securities whose returns are based on, among other things, an index or indices based on the market performance of a basket of equity securities, interest rates, commodities, and/or foreign currencies. The investment's return is

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[12] For 18 private equity transactions that closed in 2016, clients were directed to submit subscription agreements and other information directly to the fund administrator, thus bypassing internal subscription processing by the Rule 506 Entities. Upon review, three of these direct investment subscriptions representing one of the 21 funds had been made in reliance on Regulation S, thus making the transactions and the fund out of scope for this review, reducing the overall number of private equity funds to 20 and reducing the number of direct investments to 15. Waterside was able to review marketing information as well as client attestations regarding accredited investor status for each direct investment transaction.

[13] We were originally provided a list of 1,339 private equity transactions, but as noted above, three were made in reliance on Regulation S and pulled from the population. After selecting the statistically valid random sample, Waterside added two files that represented small funds and added back the 15 direct investments to review. ***See***, Appendix B.

[14] Two Asset Management, or institutional, transaction files were made available for our review, out of a total of six transactions. As to the other four transactions, Waterside was provided a memo stating that the Far East branch had general knowledge that the four investors were regulated entities that made institutional investments in the funds ranging from $20 million to $150 million that clearly exceeded the accredited investor requirements of Rule 506 of Regulation D. In addition, the memo contained a chart that listed the institutional clients and the amounts of their investments and stated that based on general knowledge, the Korean branch had a reasonable belief that each of these investors had assets of at least $5 million, and therefore was an accredited investor. The most recent publicly available statements confirm that each entity had asset levels of at least $5 million.

linked to the performance of a reference asset or index. In 2015, the Bank issued over 100 structured notes, but in 2016 the bulk of the structured note business consisted of registered products so the Rule 506 Entities issued only 12 structured notes in reliance on Rule 506 of Regulation D. The notes were developed for and marketed by intermediaries that were not Rule 506 Entities.

For each of the 12 structured products in 2016, JPMCB served as issuer only, not as placement agent; therefore, Waterside reviewed product offering information as well as intermediary agreements, but did no review of client transaction information since the Rule 506 Entities did not act as placement agent for the products.

## III. Findings/Conclusions/Recommendations

As discussed above, requirements of Rule 506 of Regulation D relevant to this review briefly include:

- Complying with the anti-fraud requirements of the Securities Act;
- Limiting sales of unregistered products to accredited investors;
- Not engaging in general solicitations of sales for the unregistered products;
- Filing a Form D when sales commence and periodically thereafter; and
- Complying with the Bad Actor provisions of the Rule.

### A. Complying with the Anti-fraud Requirements of the Securities Act

Waterside reviewed Private Placement offering memoranda and marketing documents describing private equity, hedge funds, Global Access Portfolio funds and structured notes for compliance with the anti-fraud prohibitions of the Securities Act. The funds were routinely described as speculative with a high degree of risk, such as counter-party risk, credit risk, and market risk. Further, each subscription and marketing document made it clear there was no assurance that the investment objectives of the fund would be met. The offering documents also explained that the funds and structured notes had not been registered with the SEC and that they were being offered as unregistered private placements, in reliance on Regulation D.

We reviewed written policies, procedures and guidelines outlining requirements for marketing documents, as well as onboarding procedures. We interviewed due diligence department management about initial and maintenance due diligence procedures for fund issuers and met with structuring department management about on-boarding procedures as well. Accordingly, Waterside was satisfied that marketing, onboarding and offering policies, procedures and guidelines were designed to ensure compliance with Rule 506 of Regulation D.

### B. Limiting Sales of Unregistered Products to Accredited Investors

Key to compliance with the requirements of Rule 506 of Regulation D is developing and following procedures to establish a reasonable belief that clients subscribing to the unregistered offerings are accredited investors. For private equity funds, the Rule 506 Entities served as placement agent and Waterside reviewed 409 client transaction files of the 1,339 transactions that closed in 2016.[15]

For private equity brokerage account transactions, policies generally require a valid Subscriber Information Form ("SIF")[16] or similar document and a Subscriber Agreement that includes certain attestations, representations and warranties by authorized persons, whether individuals or authorized representatives of legal entities. In our first annual review of transaction taking place in 2015, Waterside reviewed approximately 400 private equity transactions and had questions on 17, which questions were all resolved with further feedback from the Rule 506 Entities.

In this second annual review, Waterside reviewed 409 private equity transactions and found that 37 files needed further clarification. We asked for and received additional information (such as more legible copies of signatures or documents with permissible Power of Attorney or signature verification processes)[17] and were satisfied with responses on all but one file.[18] We discussed resolution of these issues with Compliance and we believe that the process of determining that the transactions for the Rule 506 Entities are "in good order" would benefit from enhanced oversight of internal middle office and outside counsel processes, which we document as a recommendation, below.

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[15] These include transactions from the Wealth Management platform of the Rule 506 Entities, including 392 files from the statistically valid random sample and 17 additional files. This calculation does not include the two institutional transactions we reviewed from the Asset Management platform.

[16] The SIF is used to determine whether a client who is a prospective investor for an interest in a hedge fund, private equity fund or other private investment company is an accredited investor and is otherwise eligible to invest in a fund. By signing the SIF, or other similar document, a prospective subscriber is representing and warranting that the information in the form is accurate and complete as of the date of the signature and that the subscriber will notify the Rule 506 Entity promptly of any change in information. Each SIF form is valid for a year ending the first of the month following the client's signature, and a single signed SIF will suffice for all subscription made within the 12-month period. Part A of the SIF requires certain subscriber information (i.e., name, contact information, ownership type and tax information); Part B defines accredited investor status and requires subscribers to attest whether they meet the qualification requirements for natural persons or for entities. The SIF includes a signature page that represents, warrants and covenants that the information contained in the form is accurate and complete. An individual is required to print the name of the subscriber, any joint subscriber and sign and date the form. An entity representative must print the name of the subscriber, sign and date the form as an authorized signatory, and print the name of the authorized signatory.

[17] In several instances, Waterside noted that we could not read the signed or printed name of an agent signing on behalf of an entity and we were assured that either the outside law firm or the middle office were comfortable that the documents were properly executed.

[18] For one private equity transaction, Waterside found that the account number on the files we reviewed was not the same account number for which the transaction had been consummated. We received assurances from outside counsel and front office staff that the appropriate client had entered into the subscription, but the documentation we reviewed does not reflect that conclusion.

The requirements for hedge fund transactions in brokerage accounts are similar to those for private equity – generally there must be a SIF (or other similar document) as well as a Subscriber Agreement (or an "Instruction to Subscribe" document in EMEA jurisdictions [Europe, Middle East, Africa] including Switzerland) on file with attestations as to the accredited investor status of the client.[19]

With regard to hedge fund transactions in managed or discretionary accounts, the requirements are that each client must meet certain accredited investor and client suitability standards and must enter into an Investment Adviser agreement with the Rule 506 Entity to open a discretionary or managed account. Once a client has agreed to the terms of the fiduciary account, individual transactions in hedge funds are entered into at the direction and discretion of the Portfolio Manager. For specific private placements, the investment manager submits an Accredited Investor/Qualified Purchaser form attesting to the client's eligibility for the transaction.

For our first annual review of transactions taking place in 2015, Waterside reviewed all 43 hedge fund transactions in brokerage as well as managed or discretionary accounts. We had follow-up questions with one transaction that was resolved to our satisfaction.

In this second annual review, Waterside reviewed all 193 hedge fund transactions[20] and had questions or comments on 53 transactions.[21] We asked for and promptly received additional documents and explanations from the Rule 506 Entities after which we were satisfied with responses on all but one file.[22]

Waterside reviewed written policies and procedures related to the accredited investor status of prospective clients for private placements, as well as subscription documents, marketing materials and subscriber identification forms used by the Bank, and following testing as required by the Order. Waterside believes that the written procedures are being followed and are reasonably designed to assure compliance with Rule 506 of Regulation D.

### C. General Solicitations for Unregistered Products

Waterside found that marketing documents for private placements for private equity and hedge fund subscriptions routinely included language to make prospective subscribers aware that the

[19] The Instruction to Subscribe form used in EMEA was replaced in mid 2017 with a requirement to use a SIF or other similar document and a Subscription Agreement, which Waterside endorses as an improvement in cross-jurisdictional consistency.

[20] Using the statistically valid random sampling methodology and table found in Appendix B, sampling for the 2016 population of 193 hedge fund transactions within the scope of the Order for this review, Waterside could either sample 144 hedge fund transactions or review all 193 files. We elected to review all transactions rather than use the sampling approach.

[21] For example, we were given only a signature page instead of a complete Subscriber Agreement, or the Signature Verification stamp (required in some jurisdictions) was not showing on the documentation we reviewed.

[22] In one hedge fund transaction the signature for a responsible party is illegible with no printed name or agent showing. We were assured by Compliance that the front office staff had followed up on the signature, but the documentation remains unclear, with notes "Follow up on signature" on the document Waterside reviewed.

funds were unregistered and were being offered only to known prospects without a general or public solicitation of sales. We also found that almost all Subscriber Agreements submitted by brokerage clients for private equity offerings included language referencing accredited investor status, and frequently included attestation language that stated that the client had not been made aware of the offering through a general solicitation.

### D. Filing a Form D with the SEC

With regard to filing the required Form D for the products within scope for this review, Waterside found that all required forms had been filed with the SEC, as required by Rule 506 of Regulation D and as required by the written policies and procedures of the 506 Entities.

### E. Compliance with "Bad Actor" Rule

Waterside found that appropriate disclosures of the Rule 506 Entities regulatory actions had been included in marketing and subscription documents for private equity and hedge funds in 2016. The Bank, in 2017, adopted new policies and procedures to reflect existing practice regarding the requirements of the "Bad Actor" portion of the SEC rules, and the policies and procedures appear to be reasonably designed and are being followed. Additionally, there are procedures and checkpoints in place to require disclosure by a client approaching a 20% ownership level in a private placement vehicle, giving the Bank appropriate notice.

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In the first annual review of policies and procedures from 2015 and testing of transactions made in 2015, Waterside made recommendations for changes to existing policies and procedures including:

- enhancing controls over structure, numbering and version tracking of the written documents;
- making procedures more consistent across worldwide jurisdictions (where permissible and appropriate);
- clarifying which documentation requirements apply to private equity transactions when subscribers are directed to send documents directly to a third-party fund administrator bypassing the Rule 506 Entities' processing;
- clarifying requirements for specific documentation in individual jurisdictions to make it readily apparent when differences apply; and
- clarifying whether specific procedures apply to brokerage or discretionary accounts or both.

Bank management accepted all of our recommendations for changes to the policies and procedures, and acted to implement amendments prior to year-end 2016.

During the course of this second review of written policies and procedures applicable to transactions that closed in 2016, Waterside reviewed amendments and updates to written policies and procedures that were made in 2016 and 2017. We posed questions and comments on selected policies and procedures and saw evidence that amendments had been made to address our earlier concerns.

During the testing of 2016 private placement transactions, Waterside noted that three transactions initially identified as in scope (made in reliance on Regulation D) were actually made in reliance on Regulation S, and thus not in scope. Six other transactions were added from the Asset Management platform and considered in scope for this review. Accordingly, we make a recommendation below as to the efficiency and accuracy of identifying transactions made in reliance on Regulation D.

Waterside had questions or comments, or required additional documentation and research for approximately 10% of the sample population of private equity transactions, and more than 25% of the hedge fund transactions. Almost all of the issues were addressed to our satisfaction, but this leads to a recommendation regarding enhancing oversight of the business acceptance and documentation processes for these types of transactions.

Accordingly, following review and testing of over 600 private placement transactions made in reliance of Rule 506 of Regulation D that closed in 2016, as well as extensive document review, Waterside makes the following recommendations for changes to existing policies and procedures:

1. Continue to monitor compliance with recommendations made in the first annual review to assure that policies and procedures remain current, relevant and consistent across international jurisdictions, where possible.
2. Enhance oversight of new business acceptance processes for both private equity and hedge fund private placement transactions to improve quality and consistency of creating and maintaining completely documented transaction files, whether in-house or with outside counsel.
3. In light of the continuing review of compliance with Rule 506 under the Order, enhance processes to readily identify individual private placement transactions done in reliance on Rule 506 of Regulation D and to readily identify the areas of the Rule 506 Entities that have transactions made in reliance on Rule 506 of Regulation D for the applicable time frame.

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For this second Annual Report, Waterside conducted a comprehensive review of the policies and procedures relating to compliance with Rule 506 of Regulation D including but not limited to, policies and procedures relating to the Rule 506 Entities' activities as investment manager and placement agent to private funds relying on Rule 506 of Regulation D.

In this second Annual Report, Waterside states that we have tested the Rule 506 Entities policies and procedures relating to Rule 506 of Regulation D by conducting a statistically valid random sampling of transactions conducted in reliance on Rule 506 of Regulation D that closed in calendar year 2016.

Waterside hereby certifies that:

"JPMCB's policies and procedures designed to ensure compliance by the Rule 506 Entities with their obligations under Rule 506 of Regulation D are reasonably designed to achieve their stated purpose."

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## Appendix A

## Background

On December 18, 2015, the Securities and Exchange Commission granted a waiver of disqualification under Rule 506(d)(2)(ii) of Regulation D under the Securities Act of 1933 at the request of JPMorgan Chase Bank, N.A.[23] The waiver of disqualification was requested because on the same date, the U.S. Commodity Futures Trading Commission ("CFTC") instituted proceedings pursuant to Sections 6(c) and (d) of the Commodity Exchange Act making findings and imposing remedial sanctions as a result of JPMCB's failure to adequately disclose certain conflicts of interest to clients.[24] Because of the CFTC proceedings, JPMCB requested and received a waiver of disqualification pursuant to Rule 506(d) of Regulation D by the SEC for JPMCB and its subsidiaries, the "Rule 506 Entities."[25]

Rule 506(d)(2)(ii) of Regulation D provides that disqualification from certain regulated activities, in this instance, participation in private placements of select unregistered offerings, "shall not apply…upon a showing of good cause and without prejudice to any other action by the Commission, if the Commission determines that it is necessary under the circumstances that an exemption be denied."

In granting the waiver, the Commission determined that as part of the Rule 506(d)(2)(ii) showing of good cause, JPMCB would retain a qualified independent compliance consultant not unacceptable to Commission staff,[26] to conduct a comprehensive review of the policies and procedures relating to compliance with Rule 506 of Regulation D. The ICC is required to complete its review and submit a written report to JPMCB on an annual basis for a period of five years following the Order.

The ICC is charged with reviewing policies and procedures by the Rule 506 Entities including but not limited to, activities as investment manager and placement agent to private funds relying on Rule 506 of Regulation D. According to the Order, JPMCB must require the ICC to test the

[23] Securities Act of 1933, Release No. 9993, December 18, 2015.
[24] CFTC Docket No. 16-05, December 18, 2015.
[25] The Rule 506 Entities are JPMorgan Chase Bank, N.A. including its Singapore, Hong Kong and Paris Branches and the following of its subsidiaries or affiliates: J.P. Morgan International Bank, Ltd., J.P. Morgan (Suisse) S.A. and J.P. Morgan Securities (Far East) Limited, Seoul Branch.
[26] In addition, the Order requires the Consultant to enter into an agreement that provides for the period of the engagement and for a period of two years from completion of the agreement, the ICC shall not enter into any other professional relationship with the Rule 506 Entities.

Rule 506 Entities' policies and procedures relating to compliance with Rule 506 of Regulation D by conducting a statistically valid random sampling of transactions conducted in reliance on Rule 506 of Regulation D. If the Consultant finds that Rule 506 Entities' policies and procedures have been reasonably designed to achieve compliance with their obligations under Rule 506 of Regulation D then the ICC shall certify annually to that finding.

Waterside Enterprises, LLC was engaged as the Independent Compliance Consultant in March 2016. Waterside is a financial services consulting firm established in 2003 by its two principals, Paul Bruce and Beth Weimer. Paul and Beth have over 60 years combined experience in the securities and insurance industries including working for regulators (SEC and FINRA [NASD]), and working as Chief Compliance Officers, corporate officers and regulatory and compliance consultants. For this engagement, Waterside also retained two experienced independent consultants (Michael Raney and Robert Arndt) who have many years of broad financial services experience and who have worked with Waterside on other engagements.

According to the terms of the Order, in 2016 Waterside conducted the first annual comprehensive review of the policies and procedures in place in 2015 applicable to compliance with Rule 506 of Regulation D by the Rule 506 Entities. The first annual report was submitted to JPMCB in December 2016 and after review and acceptance, JPMCB submitted the report to the SEC. The SEC published the first annual report on March 14, 2017.[27]

Accordingly, in 2017 Waterside conducted the second annual comprehensive review of policies and procedures applicable to compliance with Rule 506, reviewing those policies and procedures in place in 2016 and testing a statistically valid random sampling of transactions conducted in 2016 in reliance on Rule 506 of Regulation D. The process of the review as well as findings and recommendations are presented in the body of the report.

[27] ***See***: sec.gov/divisions/corpfin/cf-noaction/2017/jpmorgan-chase-na-waterside-report-031417.pdf.

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## December 13, 2017

## Appendix B

## Statistically Valid Random Sampling Methodology for 2016 Wealth Management Private Equity Transactions

Language in the Order states: "JPMCB shall require that the Consultant test the Rule 506 Entities policies and procedures relating to Rule 506 of Regulation D by conducting a statistically valid random sampling of transactions conducted in reliance on Rule 506 of Regulation D."

As discussed in the Report, JPMCB prepared a list of all private equity fund offerings that closed in 2016, refined to reflect the offerings for which the Rule 506 Entities acted as placement agent and relying on Rule 506 of Regulation D. From that list, a population of client transactions that closed in 2016 was determined, and Waterside applied the following statistical review approach to select a random sample from that population of transactions.

The generally accepted purpose of utilizing a statistically valid random sampling process is to be able to review an abbreviated subset of a population and use the results of that review to draw conclusions about the entire population. To comply with the statistically valid random sampling requirements of the Order, Waterside used a methodology that was intended to optimize the sample size while maintaining statistical integrity.[28] The approach we chose is based on a normal approximation to a binomial distribution and the Central Limit Theorem, adjusted for a finite population.

For any given population, a Central Limit Theorem approach states that regardless of the distribution of the underlying population, any set of sufficiently large samples reviewed will follow an approximately normal distribution. Even if we do not know the distribution of the underlying population, this approach should routinely produce a valid sample. The method used allows us to determine a sample size for a given population based on three key criteria:

- Confidence Level relative to the standard normal distribution;
- Population Proportion estimate; and
- Margin of Error.

[28] Any number of statistical sampling approaches may be applied. Based on the education, training and experience of the Waterside review team, we selected a standard approach from a 1970 article by Krejcie and Morgan and documented in the Penn State University online course website under course 414/415: "Estimating a Proportion for a Small, Finite Population."

### I. Confidence Level

A confidence level or confidence interval gives an estimated range of values that are likely to include an unknown population parameter, the estimated range being calculated from a given set of sample data.[29] Relative to statistical sampling and sampling distributions of population proportions, a 95% confidence level means that 95% of confidence intervals constructed from samples of a given size (n), will contain the true population proportion parameter. This implies that only 5% of confidence intervals constructed with the specified criteria will not contain the true population proportion. This also equates to an assumption that the population parameter being tested falls within two standard deviations of the predicted value of the parameter.

### II. Population Proportion

If we know nothing about the underlying population vis-a-vis the criteria for which we are sampling, we need to use a population proportion estimate, ("$\hat{P}$") of .5. This is a common approach for situations such as election sampling where we anticipate about a 50/50 response for each of two candidates. This $\hat{P}$ of .5 leads to the largest sample size, since for every sample data element selected we are unable to predict whether we will get a positive or negative result.

If, however, we know or believe the population is skewed in one direction or another, in other words, we expect the clear majority of the items in the sample will be either positive or negative, we can select a more informed estimate of *P* and reduce the sample size while maintaining the accuracy and integrity of the sampling process. In other words, the better we can predict the population parameter for which we are testing, the smaller the required sample size.

For our purposes and to meet the terms of the Order, we reviewed the firm's policies and procedures, conducted interviews and observed control points applicable to the private equity private placement business of Rule 506 Entities relying on Rule 506 of Regulation D within the scope of our review. We also applied our experience in brokerage and other client focused businesses in which we see that if policies and procedures are reasonably designed to achieve their stated purposes, we generally find that client files contain the appropriate documents and signatures well in excess of 90% of the time.

Based on our review of the Rule 506 Entities policies, procedures and control points, including documents, interviews and observation, we concluded that those policies, procedures and processes would lead to similarly accurate and complete client files.

Using these inputs, we set our estimated sampling population proportion at 0.90. The ultimate test of that assumption is whether our sampling results demonstrated that at least 90% of the sampled files met the population parameter we were testing, i.e., do the transaction files show that the Rule 506 of Regulation D requirements are being met. If so, it should indicate that our population proportion assumption is accurate.

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[29] Definition of confidence interval is from Valerie J. Easton and John H. McColl's Statistics Glossary v 1.1. (Available at: http://www.stats.gla.ac.uk/steps/glossary/confidence_intervals.html).

## III. Margin of Error

The next key sampling criteria is Margin of Error. In other words, how predictive are our results? To refer again to election polling type sampling, we often see a result that is noted to be accurate within "plus or minus" 2% or 3%. This is the margin of error for that poll. We decided to use a margin of error of 2.5%, which is more conservative than the 3% frequently utilized in practice. Thus, a result of 95% of files in good order in a sample would be indicative of a population proportion falling within the interval 92.5% to 97.5%.

## IV. Using These Criteria to Set a Sample Size

Accordingly, for the purpose of this review, to test compliance with written policies and procedures as they pertain to the requirements of Rule 506 of Regulation D, we predicted (based on experience in the industry) that the required paperwork for at least 90% (Population Proportion) of the client transactions reviewed will be "in good order" (defined here as signed and dated by an appropriately authorized party and containing assertions that the client is an accredited investor, and that appropriate relevant disclosures were made to each investor). Additionally, we selected a Confidence Level for the population of "in good order" transactions of 95% with a 2.5% Margin of Error.

## V. Wealth Management Private Equity Population and Sampling Results

Waterside was provided a population of 1,339 Wealth Management private equity transactions that closed in 2016. Of those 1,339 transactions, it was observed that 18 of those transactions were not completed via the normal JPMCB entity conduit process, which requires JPMCB paperwork. Those transactions were instead issued to Rule 506 Entity clients but placed directly with the offering fund. We anticipated a variety of forms and processes and so we pulled those 18 out of the population and reviewed each one individually.

Via that analysis we determined that three of the transactions for one fund family had actually been issued under Regulation S, rather than Regulation D, and so were out of scope for this review. That left us with 1,336 reviewable transactions, with 15 segregated out for separate review, leaving 1,321 in our sampling population.

We numbered those 1,321 private equity transaction files from 1 to 1,321 and we used the table below to determine that the minimum sample size to meet our criteria was 391. We thus divided 1,321 by 391, arriving at a ratio of approximately 3.3785. In other words, to develop the minimum sample from the 1,321 we would need one transaction out of every 3.3785. To ensure adequacy of sample coverage, we truncated that ratio to 3.37. We next used a standard random number generator to generate a random number between zero and one. We multiplied that random number by 3.37 to arrive at a starting point of 1.41. Finally, we added 3.37 successively to 1.41 to arrive at our sample, as follows (using standard rules of rounding):

- 1 (closest to 1.41),
- 5 (closest to 4.78),
- 8 (closest to 8.15),
- 12 (closest to 11.52),
- 15 (closest to 14.89), and so forth,

until we had identified a sample of 392, which is more than the minimum sample size of 391 that our process would require for a statistically valid random sample.

Once we selected our random sample of 392, we reviewed that sample for adequate representation of the population. Through this process, we added two transactions to the sample to ensure coverage of all fund families, including those with small transaction volumes.[30]

Accordingly, we have a general population of 1,336 Wealth Management private equity transactions of which we reviewed 409:

| | |
|---|---|
| Beginning Population | 1,339 |
| Minus Direct Investments | 18 |
| Used to Sample Population | 1,321 |
| Sample Selected | 392 |
| Additional Selections | 2 |
| Adjusted Direct Investments | 15 |
| Total Wealth Management Transactions Reviewed | 409 |

The table below illustrates the application of the statistical criteria to arrive at the minimum sample size.

[30] In addition, we were informed of six transactions initiated by the Asset Management platform of the Far East Rule 506 Entity. Of those six transactions, Waterside reviewed two, as addressed in the body of the report. These two files are not represented in the chart above.

**Illustration of required minimum sample sizes based on: (1) Confidence Level, (2) Population Proportion estimate and (3) Margin of Error:**

| Estimated Population Proportion, $\hat{P}$ = | 90% | | | $\hat{P}$ = | 50% | |
|---|---|---|---|---|---|---|
| Confidence Level = | 95% | | | 95% | | |
| | Margin of Error, E = | | | Margin of Error, E = | | |
| Population Size N = | 3.0% | 2.5% | 1.0% | 3.0% | 2.5% | 1.0% |
| 100 | 80 | 85 | 98 | 92 | 94 | 99 |
| 193 | 129 | **144** | 183 | 164 | 172 | 190 |
| 500 | 218 | 263 | 437 | 341 | 378 | 476 |
| 1,000 | 278 | 357 | 776 | 517 | 607 | 906 |
| 1,321 | 298 | **391** | 956 | 591 | 711 | 1,162 |
| 10,000 | 370 | 525 | 2,570 | 965 | 1,333 | 4,900 |
| 25,000 | 379 | 542 | 3,038 | 1,024 | 1,448 | 6,939 |
| 100,000 | 383 | 551 | 3,342 | 1,056 | 1,514 | 8,763 |
| 1,000,000 | 384 | 553 | 3,446 | 1,066 | 1,535 | 9,513 |
| Very Large | 385 | 554 | 3,458 | 1,068 | 1,537 | 9,604 |

This table clearly illustrates that for very large population sizes we see the most optimum leveraging abilities of statistical sampling. However, a sampling procedure still provides benefits to a population of 1,321.

We subsequently made the following observations regarding the sample set:

At the culmination of the transactional review of private equity files, we found 37 files (or about 9% of the files reviewed) for which we had questions or comments that required follow-up with JPMCB. We noted that, using these criteria, over 90% of the files were found to be in good order, i.e., complying with policies and procedures reflecting Regulation D control points. Further, all but one of the files for which we had questions have subsequently been resolved or clarified by JPMCB to Waterside's satisfaction, bringing the 'in good order' percentage to just slightly less than 100%.

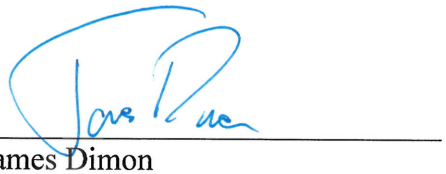
Finding most of the files in the sample in good order allows us to make the same conclusion about the population from which the sample was drawn, i.e., that we would expect to find the majority of any files we might select to be in good order and thus we can extrapolate the same conclusion to the entire population.

The conclusions of the review are discussed further in the body of the report.[31]

[31] Using the statistically valid random sampling methodology described above and illustrated in the table, sampling for the 2016 population of 193 hedge fund transactions within the scope of the Order for this review, Waterside could either sample 144 hedge fund transactions or review all 193 files. We elected to review all transactions rather than use the sampling approach.

CERTIFICATION

I am the principal executive officer of JPMorgan Chase Bank, N.A. Pursuant to Section III.E of the Order under Rule 506(d) of the Securities Act of 1933 Granting a Waiver of the Rule 506(d)(1)(iii) Disqualification Provision issued by the Securities and Exchange Commission on December 18, 2015, I certify that I have reviewed the written report of Waterside Enterprises LLC, dated December 13, 2017.



James Dimon
Chief Executive Officer and President
JPMorgan Chase Bank, N.A.

Date: January 16, 2018

CERTIFICATION

I am the principal legal officer of JPMorgan Chase Bank, N.A. Pursuant to Section III.E of the Order under Rule 506(d) of the Securities Act of 1933 Granting a Waiver of the Rule 506(d)(1)(iii) Disqualification Provision issued by the Securities and Exchange Commission on December 18, 2015, I certify that I have reviewed the written report of Waterside Enterprises LLC, dated December 13, 2017.

Stacey Friedman
General Counsel
JPMorgan Chase Bank, N.A.

Date: January 16, 2018