Annual Compliance and Review Requirements for Investment Advisers

BY THE INVESTMENT MANAGEMENT GROUP

Investment advisers are subject to certain annual updating and review obligations, many of which apply regardless of whether an adviser is registered with the Securities and Exchange Commission ("SEC"). This Alert summarizes certain of these regulatory and compliance requirements. Please contact us if you need our help to meet any of your filing deadlines or other obligations discussed below or would like more extensive advice with respect to your ongoing regulatory obligations.

A. SEC-Registered Investment Advisers

1. Annual ADV Update. Each investment adviser registered with the SEC is required to update its Form ADV Part 1 at least annually. The annual update of Part 1 must be filed within 90 days of the investment adviser’s fiscal year-end. The amendment should update responses to all items in the Part 1. SEC-registered advisers must make all amendments to Part 1 electronically using the Investment Adviser Registration Depository ("IARD") system unless the adviser has received an exemption. The adviser’s annual renewal fee for IARD is due at the time of its annual updating amendment.

2. Other ADV Amendments. In addition to the annual updating amendment, an SEC-registered adviser must amend its Form ADV Part 1 promptly if (a) any information provided in response to Items 1, 3, 9 or 11 of Part 1A becomes inaccurate in any way or (b) any information provided in response to Items 4, 8 or 10 of Part 1A becomes materially inaccurate.

An SEC-registered adviser should also amend Part II of its Form ADV promptly if any information in Part II becomes materially inaccurate. Part II of the Form ADV must also include a description of the adviser’s code of ethics and state that it will provide a copy to any client or any prospective client upon request. Although advisers are not currently required to file Part II with the SEC, you should maintain an updated copy in your files. Effective April 23, 2007, Form ADV Part II can be filed electronically through the IARD system; however, unlike Form ADV Part 1, Part II must be completed offline and uploaded to the IARD system. The form must be submitted in a text searchable pdf format in order to be accepted by the IARD system. For SEC-registered advisers, the SEC has taken a position of neither encouraging nor discouraging the posting of the ADV Part II.

3. Offer to Provide ADV Part II. An SEC-registered adviser must offer to provide Part II of its Form ADV (or brochure containing equivalent information) at least annually to each advisory client. The offer can be made with an individual account client’s bill, in a letter to limited partners (or members) reporting financial results or in a correspondence delivered via email if the advisory contract with your client permits this method of delivery for notices.
4. **State Notice Filings.** An SEC-registered adviser may also be required to make notice filings and pay fees in states in which it has had six or more advisory clients during the preceding 12-month period or a place of business. All states that require notice filings participate in the IARD system for the filing of Part 1 of the Form ADV. Some states may also require additional information, including Part II of the Form ADV, to be submitted on paper. Generally, these states will send the adviser a request for the additional items.

An SEC-registered adviser also may be required to register its investment adviser representatives in each state in which a representative has a place of business. All states that regulate investment adviser representatives participate in IARD for investment adviser representatives. The laws of many states permit an SEC-registered adviser to rely on the federal definition of an “investment adviser representative” in Rule 203A-3(a)(1) under the Advisers Act for purposes of determining the adviser’s obligation to register its investment adviser representatives in the state.

5. **Electronic IARD Filings.** SEC-registered advisers that make electronic state notice and investment adviser representative filings should receive an email notification from FINRA with instructions for obtaining information for the 2010 Renewal Program. Renewal information is also currently available at [http://www.iard.com/renewals.asp](http://www.iard.com/renewals.asp). All existing state notice and investment adviser representative filings should be handled through IARD. Beginning on November 16, 2009, Preliminary Renewal Statements became available for SEC-registered advisers to determine the renewal fees required. For 2010 renewals, the annual System Processing Fee for advisers and annual System Processing Fee for investment adviser representatives are waived.

B. **Investment Advisers Certificated by the California Commissioner of Corporations (the “COC”)**

1. **Annual ADV Update.** A California registered adviser must amend its Form ADV each year by electronically filing through IARD an annual updating amendment within 90 days after the end of its fiscal year. The amendment should update responses to all items in the Form ADV.

2. **Other ADV Amendments.** A California registered adviser must promptly (and within 30 days after the change occurs) electronically file through IARD amendments to its Form ADV to reflect any change in the information (other than financial information) contained in Part 1 of Form ADV and to correct any disclosure contained in Part II of Form ADV that has become materially inaccurate.

3. **Electronic IARD Filings.** California requires mandatory electronic filing of Part 1 and Part II of Form ADV and Form U-4 for all investment advisers and investment adviser representatives registered with the COC through IARD.

4. **Offer to Provide ADV Part II.** In June 2008, the COC announced revisions to rules and amendments originally proposed in August 2007, which, if adopted, will subject California registered advisers to a number of new and revised rules (the “Proposed CA Rules”). One of the Proposed CA Rules is to require California registered advisers to offer to provide Part II of Form ADV (or brochure containing equivalent information) at least annually to each advisory client.⁶

5. **Annual Balance Sheet Filing.** A California registered adviser with custody of or investment discretion over client assets or that receives prepayment of more than $500 per client in fees for advisory services six months or more in advance must file with the COC an annual balance sheet with a schedule showing the required minimum net worth or net capital computations (discussed below). The financial statements included in the report must be audited unless the adviser, during the period covered by the report, has not held or accepted custody of funds or securities for any client or owed money or securities to any client, and only has discretionary authority over client funds or
securities and has taken only limited powers of attorney to execute transactions on behalf of clients. The report should be filed as of the same date for each calendar year, except that the first report must be filed within 12 months after the adviser’s certificate becomes effective. This financial information should be submitted with the verification form required by the COC and must be filed within 90 days after the date as of which the financial information is provided.

6. **Capital Requirements.** A California registered adviser with its principal place of business located in California must meet minimum financial requirements. If the adviser has custody of client funds or securities, it must at all times maintain a minimum net worth of $35,000. If the adviser has discretionary authority over client funds or securities, but does not have custody of client funds or securities, it must at all times maintain a minimum net worth of $10,000. The Proposed CA Rules propose to add additional requirements that (i) any adviser that is subject to either the $35,000 or $10,000 minimum net worth requirement must also maintain a positive current ratio (current assets over current liabilities) and (ii) any adviser that has custody or discretion must compute and prepare a trial balance and compute the minimum financial requirements on a monthly basis.

If the adviser merely accepts prepayment of more than $500 per client six or more months in advance, then it must at all times maintain a positive net worth. Further, an adviser must, by the close of business on the next business day following the discovery that its net worth is less than the minimum required, notify the COC and file a report of its financial condition. This report of financial condition must contain a trial balance of all ledger accounts, a statement of all client funds or securities that are not segregated, a computation of the aggregate amount of client ledger debit balances, and a statement as to the number of client accounts. If the adviser’s net worth is reduced to less than 120% of its required minimum net worth, it must file a report with the COC within 15 days.

Any investment adviser subject to these reporting requirements must prepare and file with the COC trial balances and net capital or net worth computations at least once a month.

7. **Annual Fees.** A California registered adviser is required to pay a $125 renewal registration fee in December of each year (the deadline for 2009 was December 11, 2009). The COC usually sends to each investment adviser a notice requesting this fee. A California registered adviser that files its Form ADV electronically should receive an email notification from FINRA with instructions on the procedures for paying the $125 fee and additional FINRA system fees through the IARD system.

8. **State Notice Filings.** A California (or other state) registered adviser may also be required to register or make notice filings and pay fees in other states in which it has six or more advisory clients during the preceding 12-month period or a place of business. All states that require notice filings participate in the IARD system. Some states may also require additional information to be submitted on paper. Generally, these states will send the adviser a request for the additional items.

A California (or other state) registered adviser also may be required to register its investment adviser representatives in each state in which a representative has a place of business. All states that regulate investment adviser representatives participate in IARD for investment adviser representatives. If you have questions regarding these obligations, please contact us.

9. **Form U-4 and Investment Adviser Representatives.** All investment adviser representative filings (whether made on paper or electronically through IARD) are required to be made on Form U-4. A California registered adviser has an obligation to conduct formal background investigations on investment adviser representatives within 30 days of filing the Form U-4. The adviser must obtain a properly executed Form U-4, evidence that the investment adviser representative has the appropriate examination qualifications, a Form U-5 from the prior employer (if
applicable) and by reasonable investigation ascertain the good character, business reputation, qualifications, and experience of the investment adviser representative. As examples of the kind of steps that could be taken in the course of a reasonable investigation, an investment adviser might request and verify reputable references or corroborate the accuracy of the investment adviser representative’s stated credentials. The investment adviser must also maintain evidence of this investigation in its books and records.

C. Other Matters

1. Annual Notice of Privacy Policy and Compliance with Regulation S-AM. Investment advisers, whether or not registered with the SEC, and investment limited partnerships (or limited liability companies) are subject to SEC and Federal Trade Commission regulations governing the privacy of consumer financial information (the “Privacy Regulations”). The Privacy Regulations require every adviser and investment limited partnership (or limited liability company) to establish policies and procedures to protect the confidentiality of client or investor records and to provide an initial and annual notice to each client or investor disclosing the types of nonpublic personal information the adviser or investment limited partnership collects and the extent to which it discloses that information. The annual notice required by the Privacy Regulations must be delivered at least once during each 12-month period. You may define the 12-month period, but you must apply it consistently. For example, you can make the annual notice by including it in an individual account client’s first quarter bill or in the letter to limited partners reporting last year’s results. After providing a notice to a client or investor in an investment fund, you may not disclose any nonpublic personal information of that client or investor to an affiliate or a third party other than as described in the notice, unless you give a new notice describing the proposed disclosure to the client or investor.

In addition, as of June 1, 2010, investment advisers who use certain information (“eligibility information”) about consumers obtained from their affiliates, or provide such eligibility information to their affiliates, for the purpose of making marketing solicitations, will be subject to Regulation S-AM. An investment adviser that does not have affiliates or does not communicate eligibility information to its affiliates will not be subject to Regulation S-AM. Compliance with Regulation S-AM also will not be required where eligibility information is shared with an affiliate but the affiliate does not use the information to make marketing solicitations. If an adviser is subject to Regulation S-AM, it must ascertain whether it is required to send out the required notice.

For investment advisers with clients located in California, the California Financial Information Privacy Act (the “Act”) sets forth specific requirements that financial institutions, including investment advisers, must satisfy in notifying consumers before sharing a consumer’s nonpublic personal information, including the details of the notice. However, no notice is needed if the financial institution does not share such information with any affiliated or nonaffiliated entities. On June 20, 2005 and again in September 2008, the U.S. Ninth Circuit Court of Appeals held that the federal Fair Credit Reporting Act preempts at least some part of the California Financial Information Privacy Act. These rulings free affiliated entities to share certain consumer information.

2. Custody. On December 16, 2009, the SEC adopted amendments to Rule 206(4)-2 (the custody rule under the Advisers Act) that impose additional regulatory requirements on all investment advisers deemed to have custody of client funds and securities. SEC-registered advisers should review their procedures with respect to the safeguarding and custody of client assets and securities and compliance with the existing and new requirements of Rule 206(4)-2. If the adviser is a general partner or adviser to a limited partnership and it does not send out quarterly statements detailing the
For California registered investment advisers, California has not amended its custody rule to either reflect the provisions of the SEC’s custody rule or the model rule proposed by the North American Securities Administrators Association ("NASAA"). The Proposed CA Rules would provide an amendment to these rules to mirror the NASAA model. Until the Proposed CA Rules are effective, California registered advisers may continue to rely on procedures outlined in the John B. Kennedy No-Action Letter (publicly available June 5, 1996) for separate account client billing and the Bennett Management Co., Inc. No-Action Letter (publicly available February 26, 1990) for private investment fund clients to avoid being considered to have custody of client funds and securities. Advisers registered in other states should review the laws of such states with respect to custody issues.

3. Investment Fund Issues. An adviser that manages one or more affiliated investment limited partnerships (or any other private investment pool) should also review and update the fund offering documents to reflect changes in such matters as soft dollar arrangements and other brokerage practices, performance data, annual financial information and tax and legal requirements. SEC registered advisers that manage investment funds and are deemed to have custody of client assets (which generally will be most fund managers) must provide audited financial statements of their funds to avoid complying with the full requirements of the Advisers Act custody rules. In addition, if you wish our assistance you should inform us, prior to making any offer or sale of interests in a fund, of the states of residence of potential new investors and of investors who may make additional capital contributions, so that we can review and advise you on compliance with applicable state securities laws.

4. Compliance Policies and Procedures and Code of Ethics. Each SEC-registered adviser is required to perform an annual review of the firm’s policies and procedures, including its Code of Ethics. Written evidence of these reviews should be retained. The annual review must assess the adequacy of the adviser’s compliance policies and the effectiveness of their implementation. The SEC has indicated that, in conducting its annual review, an adviser should consider any compliance matters that arose during the previous year, any changes in the business activities of the adviser or its affiliates, and any changes in the Advisers Act or applicable regulations that would suggest a need to revise the adviser’s policies and procedures. The adviser should determine whether it needs to provide any ethics-related training of employees or enhancements to its code in light of current business practices.

5. Employee Trading Policies. Many advisers’ personal trading policies and procedures require that each employee certify annually that he or she has complied with those policies and procedures and provide annual reports of the employee’s holdings in his or her personal accounts. Accordingly, each employee should submit such signed certification and report to the adviser’s compliance officer every year.

6. Business Continuity Plans. Many advisers have business continuity plans that specify how an investment advisory business would respond to various emergencies and to provide safeguards for clients in the event of death or incapacity of the investment adviser or any of its representatives. Many of such plans and the Proposed CA Rules would require the investment adviser to conduct an annual review of its business continuity plan to determine whether any modifications are necessary in light of changes to the adviser’s operations, structure, business or location.

7. Identity Theft or “Red Flag” Programs. As of June 1, 2010, investment advisers who qualify as creditors under the Red Flag Rules may be required to develop and implement written
Identity Theft Prevention Programs to detect, prevent, and mitigate identity theft and other fraudulent activity in relation to customer accounts.¹²

8. **Management Company Allocations.** Over the past few years, many of our advisory clients have organized themselves as limited liability companies or limited partnerships. Key employees and other members or limited partners may have been given membership or limited partner interests. The operating agreement or limited partnership agreement frequently provides that the manager or general partner may adjust each participant’s interest for the coming year on or before a specified date (typically January 31 of that year). Such advisers should make these allocation decisions, in writing and in accordance with the applicable operating agreement or limited partnership agreement, on or before the specified date.

9. **Offshore Funds.** Many of our clients that act as investment advisers to offshore funds have previously elected to defer some or all of the investment management fees payable by the fund. In January 2009, the Internal Revenue Service (the “Service”) issued interim guidance (the “Notice”) under Section 457A of the Internal Revenue Code of 1986, as amended (“Code”). Enacted in October 2008, Section 457A of the Code largely eliminates compensation deferrals by nonqualified entities (“NQEs”), and thus any compensation that is deferred under a “nonqualified deferred compensation plan” of a NQE is includible in gross income when the amounts deferred are no longer subject to a “substantial risk of forfeiture.” Generally, NQEs are non-US. corporations that are not subject to U.S. tax and not subject to foreign income tax, or partnerships with substantially all limited partners that are not subject to U.S. tax and not subject to foreign income tax.

Most offshore investment funds will likely be treated as NQEs if they are organized in tax-haven jurisdictions and are classified as corporations for U.S. federal income tax purposes. In general, a corporation will not be an NQE if it is both eligible for the benefits of an income tax treaty between its country of residence and the U.S. (the tax treaties with Bermuda and the Netherlands Antilles do not qualify for this exemption), and is not subject to a beneficial tax regime in its country of residence. This latter requirement may disqualify, among others, certain Irish or Luxembourg corporations. Section 457A can also apply to plan sponsors that are classified as partnerships for U.S. federal income tax purposes. Under the Notice, in general, a partnership will be an NQE unless at least 80% of its gross income is allocated to persons subject to tax on the income.

Existing deferrals for services provided before January 1, 2009 may continue to be deferred, but must generally be included in gross income before 2018.


10. **Section 13D or 13G.** Investment advisers may be required to file Schedule 13D or 13G if they exercise voting power or investment discretion over 5% or more of a class of securities of a publicly traded company. If you have reached or anticipate reaching that threshold with respect to any class of securities, you should contact us. Any material changes to Schedule 13D must be reported promptly. If you have previously filed a Schedule 13G and the information reflected in the Schedule will change as of December 31, 2009, you may be required to file an amended Schedule by February 16, 2010.

11. **Section 16 Reports (Forms 3, 4 and 5).** In general, an adviser that exercises investment discretion or voting power over more than 10% of a class of equity securities of a publicly traded company may be required to file with the SEC an initial ownership report on Form 3 within 10 days after exceeding the 10% threshold. Changes in an insider’s beneficial ownership of securities
generally must be reported on Form 4 before the end of the second business day following the day on which the change occurred. Due to the changes in the filing time frame for the Form 4, a Form 4 may be due before the Form 3 is due. In these situations, the SEC encourages the filer to submit both forms at the same time. An annual report on Form 5 must be filed with the SEC within 45 days after the fiscal year by every person who was an insider of a publicly traded company during the entire year to report previously unreported transactions during the year that should have been reported on Form 4 but were not, and certain other transactions that may be reported on Form 5. All Section 16 reports (Forms 3, 4 and 5) must be filed electronically via EDGAR.

12. **Form 13F.** An adviser, whether or not registered with the SEC, must file a report of holdings on Form 13F within 45 days after the end of the first calendar year in which it reached the $100 million investment threshold (as of the end of any month) in 13(f) securities traded on a national securities exchange. Quarterly filings are required thereafter. In general, 13(f) securities include exchange-traded securities, securities of closed-end investment companies and certain convertible debt securities.

13. **FINRA Rule 5130 “New Issues.”** FINRA Rule 5130 generally prohibits broker-dealers from selling equity securities in initial public offerings (“new issues”) to their own accounts or to the accounts of other persons who may be in a position to direct future business to the broker-dealer (“restricted persons”). In accordance with Rule 5130, hedge funds and other private investment funds that invest in new issues must decide which investors are restricted persons and how to handle investments from such persons. Rule 5130 requires that this determination of restricted investor status be made annually. Accordingly, advisers wishing to purchase new issue securities should confirm their investors’ status.

14. **Anti-Money Laundering Procedures.** The rules proposed in 2002 and 2003 by the Department of the Treasury that would have required certain unregistered investment companies (including hedge funds), investment advisers and commodity trading advisors to establish Anti-Money Laundering (“AML”) Programs have been withdrawn. Investment advisers are currently not required to establish AML Programs; however, some advisers may wish to maintain AML programs since many parties with which advisers do business (such as broker-dealers, banks, futures commission merchants) require an entity to have AML provisions in place as a condition of doing business with or through them. In addition, all investment advisers continue to be subject to economic and trade sanction programs enforced by the U.S. Treasury Department’s Office of Foreign Assets Control (“OFAC”) and the currency reporting requirements of the Internal Revenue Code and the Bank Secrecy Act. For those investment advisers that have established an AML Program, the adviser should review the program on an annual basis to determine whether the program is reasonably designed to ensure compliance in light of its business and client base. That review should be independent and conducted by internal audit, an outside professional or an appropriate officer or employee of the adviser with the requisite knowledge.
If you have any questions or comments, need any forms or otherwise need assistance in satisfying any of the requirements and obligations summarized in this letter, please contact a member of our Investment Management Group.

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1 If an adviser is unable to file electronically, the SEC has adopted two hardship exemptions. A temporary hardship exemption permits the adviser to extend the deadline for a filing for seven business days if unexpected difficulties, such as a computer malfunction or electrical outage, prevent it from filing. A continuing hardship exemption is available only to an adviser that is a “small business” and can demonstrate that filing electronically would create an undue hardship (e.g., the adviser has no computer and is unable to afford a filing service).

2 The SEC staff has approved a five-month waiver of initial set-up and annual IARD filing fees for SEC-registered advisers or advisers applying for SEC registration through December 31, 2009.

3 On March 3, 2008, the SEC proposed amendments to Part II of Form ADV and related rules under the Advisers Act. In order to provide improved disclosure to investors and additional information about advisory personnel, the SEC has proposed that advisers deliver a new type of narrative brochure to clients and prospective clients, replacing the often disjointed disclosures in Part II of the current Form ADV. As proposed, the new Part II of Form ADV would consist of a narrative brochure containing more detailed plain English descriptions of an investment adviser’s business, services, and conflicts of interest. In addition, each adviser’s Part II would be filed electronically with the IARD, making Part II, like Part 1, publicly available on the internet to the general public. Although the comment period for these amendments ended in 2008, as of the date of this Alert, no further action has been taken by the SEC staff on the proposal.

4 Electronic filing of Form ADV Part II is mandatory for advisers seeking to register in the following states: Arizona, California, Georgia, Idaho, Kansas, Kentucky, Maine, Massachusetts, Minnesota, Montana, Nevada, New Hampshire, New Jersey, New York, North Dakota, South Dakota, Oregon, and Texas.

5 The SEC has recently indicated that an adviser to a private investment fund is not required to deliver Part II of Form ADV to each investor in the fund because an “investor” is not a “client” for certain purposes of the Advisers Act. However, Rule 206(4)-8 under the Advisers Act generally requires an adviser to make full disclosure of all material facts to fund investors. Accordingly, it is a good practice for registered investment advisers to private investment funds to deliver Form ADV Part II to existing and prospective fund investors.

6 If adopted, the Proposed CA Rules will also require advisers to adopt and maintain a code of ethics and business continuity plan. A provision originally in the Proposed CA Rules that would have required certain unregistered investment advisers (in particular hedge funds and other private equity funds) to register with the COC has been withdrawn. The comment period on the Proposed CA Rules ended June 20, 2008.
If the adviser’s principal place of business is in a state other than California, the adviser should maintain capital as required by such state, provided it is licensed in such state and in compliance with such state’s minimum capital requirements. If it is not so licensed, it is subject to the California minimum financial requirements.

In March 2008, the SEC proposed amendments to the Privacy Regulations that would require advisers to (1) develop an information security program appropriate to the size and complexity of the firm, to the nature and scope of its activities, and to the sensitivity of any personal information in the possession of the firm; (2) designate an employee (or employees) responsible for the oversight and coordination of the program; (3) require the coordinator to be responsible for identifying foreseeable security risks, designing policies and measures to prevent those risks, regularly testing and monitoring the effectiveness of the safeguards, training staff and overseeing service providers to the firm and assessing their safeguards regarding privacy of customer information; and (4) implement procedures for responding to unauthorized access and use of customer information, including prompt notice to any affected customers, as well as notice to the appropriate designated examining authority.

In November 2009, eight federal regulatory agencies, including the SEC, released a model privacy notice form that advisers may, but are not required to, use to notify consumers of their information-sharing practices and inform consumers of their right to opt out of certain sharing practices. The model form can be used by advisers to ensure compliance with the Privacy Regulations.


Such financial statements must be prepared in accordance with generally accepted U.S. accounting principles and presented to the fund’s investors within 120 days after the fund’s fiscal year-end, or 180 days for a fund-of-funds.


Since the publication of our alert, the FTC has extended the deadline for compliance with the Red Flag Rules to July 2010. In addition, subsequently, the U.S. District Court for the District of Columbia ruled that the FTC may not apply the Red Flag Rules to attorneys, and a bill has passed the House of Representatives which would exempt health care practices, accounting practices, legal practices (each with 20 or fewer employees) and certain other businesses approved by the FTC that engage in services where identity theft is rare and have no incidence of identity theft. It is not clear as of yet what effect these developments will have on the requirements that investment advisers adopt Identity Theft Programs.

Under Rule 5130, a private investment fund that invests in a “new issue” has three choices: (1) prohibit investments by “restricted persons”; (2) sell two classes of interests – one to “non-restricted persons,” which class can participate in profits and losses from “new issues;” and the other to “restricted persons,” which class cannot participate in such investments; or (3) agree to limit investments by “restricted persons” to not more than 10% of the fund’s capital, thereby qualifying for a general de minimis exemption.

The OFAC sanctions generally prohibit (i) U.S. persons from entering into prohibited transactions with particular jurisdictions or specially designated nationals, and (ii) require the blocking of accounts and property of such prohibited persons.