

Private Fund Report—Summary of Key Developments—Winter 2016

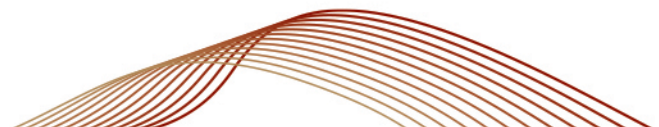
By the [Investment Management](#), [Private Investment Funds](#), [Securities Litigation](#), [Tax](#) & [Investigations and White Collar Defense](#) Practices

This continues to be a time of rapid change for the private investment funds industry, as the Securities and Exchange Commission (the “SEC”), the Commodity Futures Trading Commission (the “CFTC”), and various other regulatory agencies, including the Department of the Treasury (the “Treasury”), continue to propose and finalize rules and issue guidance relating to private funds and fund managers. There have also been a number of significant developments in the private funds tax area, and the SEC and private plaintiffs have continued to bring enforcement actions and litigation involving private funds and fund managers.

This Report provides an update since our [Spring 2016 Report](#), and highlights recent regulatory and tax developments, as well as recent civil litigation and enforcement actions as they relate to the private funds industry. Paul Hastings attorneys are available to answer your questions on these and any other developments affecting private funds and their investors and advisers.

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I. LEGISLATION AND REGULATIONS RELATING TO PRIVATE FUNDS AND PRIVATE FUND MANAGERS

A. *Advisers Act Updates*

The following items describe the status of certain proposed and final rules and regulations under the Investment Advisers Act of 1940, as amended (the “Advisers Act”).

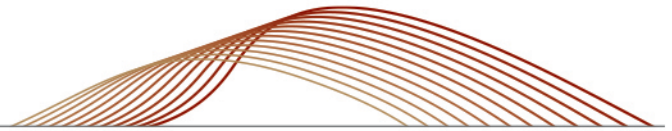
1. SEC Adopts Amendments to Form ADV and Certain Rules under the Advisers Act

On August 25, 2016, the SEC adopted amendments to Form ADV Part 1A and certain rules promulgated under the Advisers Act, as amended (such amendments collectively being the “ADV Amendments”), which were initially proposed on May 20, 2015, that augment the SEC’s efforts to increase oversight of the investment advisory industry and update certain disclosure requirements. The ADV Amendments are designed to increase disclosure regarding investment advisers, including their separately managed account (each, an “SMA”) businesses, permit certain investment adviser entities operating as single advisory businesses to use single Form ADVs, and make other explicatory and technical amendments to the Form ADV Part 1A. Certain of the ADV Amendments are discussed below.

Separately Managed Accounts

The ADV Amendments require investment advisers to report certain additional information about their SMAs, including the following:

- (a) New Section 5.K.(1) of Schedule D requires investment advisers of SMAs to report the approximate percentage of SMA regulatory assets under management (“SMA RAUM”) that is invested in the following 12 asset categories: (i) Exchange-Traded Equity Securities; (ii) Non-Exchange-Traded Equity Securities; (iii) U.S. Government/Agency Bonds; (iv) U.S. State and Local Bonds; (v) Sovereign Bonds; (vi) Corporate Bonds—Investment Grade; (vii) Corporate Bonds—Non-Investment Grade; (viii) Derivatives; (ix) Securities Issued by Registered Investment Companies or Business Development Companies; (x) Securities Issued by Pooled Investment Vehicles (other than Registered Investment Companies); (xi) Cash and Cash Equivalents; and (xii) Other/Miscellaneous. Investment advisers with \$10 billion or more in SMA RAUM will have to report both mid-year and end-of-year percentages on an annual basis. Investment advisers with less than \$10 billion in SMA RAUM will have to report only year-end percentages on an annual basis.

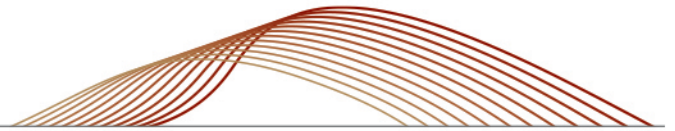


- (b) New Section 5.K.(2) of Schedule D requires investment advisers of SMAs with between \$500 million and \$10 billion in SMA RAUM to report on Section 5.K.(2)(b) the amount of SMA RAUM and the dollar amount of borrowings attributable to such SMA RAUM that correspond to three levels of gross notional exposures. Investment advisers with at least \$10 billion in SMA RAUM will be required to report on Section 5.K.(2)(a) the information required by Section 5.K.(2)(b) as well as the derivative exposures across the following six derivative categories: (i) Interest Rate Derivatives; (ii) Foreign Exchange Derivatives; (iii) Credit Derivatives; (iv) Equity Derivatives; (v) Commodity Derivatives; and (vi) Other Derivatives. Investment advisers do not have to complete either Section 5.K.(2)(a) or Section 5.K.(2)(b) with respect to any individual SMA with a net asset value of less than \$10 million.
- (c) New Section 5.K.(3) of Schedule D requires investment advisers of SMAs to identify each custodian that custodies at least 10% of such investment adviser's SMA RAUM, including the specific amount of such investment adviser's SMA RAUM that is held by each such custodian.

Umbrella Registration

Under the ADV Amendments, an investment adviser to private funds (such adviser, the "Filing Adviser") may file a single Form ADV on behalf of itself and other investment adviser entities to private funds that are controlled by, or under common control with, the Filing Adviser (each, a "Relying Adviser"), provided that such investment advisers are conducting a single advisory business.¹ The SEC expressed its view that it considers the following conditions as indicia of a single advisory business:

- (a) The Filing Adviser and each Relying Adviser advise only private funds and clients in SMAs that are "qualified clients" (as defined in Rule 205-3 of the Advisers Act) and are otherwise eligible to invest in private funds advised by the Filing Adviser or a Relying Adviser and whose SMAs pursue investment objectives and strategies that are substantially similar to such private funds;
- (b) The Filing Adviser has its principal office and place of business in the United States such that all of the substantive portions of the Advisers Act and the rules promulgated thereunder apply to the Filing Adviser's and each Relying Adviser's dealings with each of its clients, regardless of whether any such client, the Filing Adviser or any such Relying Adviser is a United States person;
- (c) Each Relying Adviser, its employees, and the persons acting on their behalf are subject to the Filing Adviser's supervision and control such that each such Relying Adviser, such employees, and such persons are "persons associated with" the Filing Adviser (as defined in Section 202(a)(17) of the Advisers Act);
- (d) The advisory activities of each Relying Adviser are subject to the Advisers Act and the rules promulgated thereunder, and each Relying Adviser is subject to examination by the SEC; and
- (e) The Filing Adviser and each Relying Adviser operate under a single code of ethics adopted in accordance with Rule 204A-1 of the Advisers Act and a single set of written policies and procedures adopted and implemented in accordance with Rule 206(4)-(7) of the Advisers Act and administered by a single chief compliance officer in accordance with such Rule.²



Reporting of Additional Information Regarding Advisers

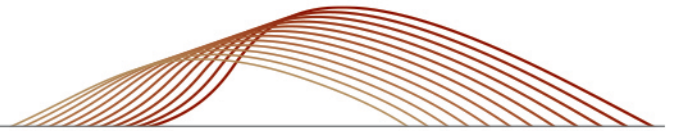
Under the ADV Amendments, investment advisers will be required to provide certain additional disclosures about their businesses and practices via Form ADV, including information regarding the following:

- (a) Use of the Internet, including use of social media (Form ADV, Item 1.I.);
- (b) Offices, including total number of offices and certain additional information about their largest offices (Form ADV, Item 1.F.);
- (c) Compensation of chief compliance officers, including whether such persons are compensated or employed by any person or entity other than such investment adviser (Form ADV, Item 1.J.);
- (d) Assets under management, i.e., investment advisers with assets of \$1 billion or more must report such assets within three ranges: (i) \$1 billion to less than \$10 billion; (ii) \$10 billion to less than \$50 billion; and (iii) \$50 billion or more (Form ADV, Item 1.O.);
- (e) Clients, i.e., investment advisers must report (i) the number of clients; (ii) the amount of regulatory assets under management attributable to each client type; (iii) the number of clients for whom such investment adviser provides advisory services, but do not have regulatory assets under management; (iv) whether such investment adviser reports client assets in Part 2A of Form ADV differently from the regulatory assets under management reported in Part 1A of Form ADV; and (v) the approximate amount of such investment adviser's total regulatory assets under management that is attributable to clients that are non-United States persons (Form ADV, Item 5);
- (f) Auditor, i.e., investment advisers relying on the annual audit or annual surprise examination for compliance with the "custody rule" (Rule 206(4)-2 of the Advisers Act) must report the auditor's PCAOB assigned number, if applicable (Form ADV, Item 7); and
- (g) Qualified Client Status, i.e., investment advisers to private funds that rely on Section 3(c)(1) of the Investment Company Act of 1940, as amended (the "1940 Act"), must report whether such investment adviser limits the offering of such private fund's interests to "qualified clients," as defined in Rule 205-3 under the Advisers Act (Section 7.B.(1) of Schedule D).

Books and Records Rule

As part of the ADV Amendments, the SEC adopted amendments to several Advisers Act rules, including Rule 204-2 promulgated thereunder (the "Amended Books and Records Rule"). Under the Amended Books and Records Rule:

- (a) Investment advisers must make and retain supporting documentation that demonstrates performance calculations or rates of return in any written communications that such investment advisers circulate or distribute, directly or indirectly, to any person (under the prior rule, investment advisers were required to make and retain such supporting documentation only if they related to written communications circulated or distributed to 10 or more people); and



- (b) Investment advisers are required to retain original versions of all written communications received, and copies of written communications sent by, such investment advisers, in each case, relating to the performance or rate of return of any or all managed accounts or securities recommendations (this increases the scope of the retention requirements, as under the prior rule, only certain categories of communications were required to be maintained).

The compliance period for the ADV Amendments starts on October 1, 2017. The SEC Release relating to the ADV Amendments can be found [here](#).

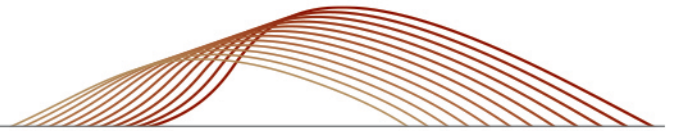
2. SEC Proposes Rule Requiring Adoption of Detailed Business Continuity Plans

On June 28, 2016, the SEC proposed Rule 206(4)-4 under the Advisers Act, which would require registered investment advisers to adopt and implement written business continuity and transition plans (a “BCT Plan”), and review their BCT Plans at least annually. Although Rule 206(4)-7 under the Advisers Act (the “BCP Rule”) already requires investment advisers to have business continuity plans, the proposed Rule 206(4)-4 would expand the issues that SEC-registered investment advisers must address in their BCT Plans. According to the rule release, the proposed rule results from the SEC staff having identified widespread weaknesses in advisers’ business continuity plans with respect to the consideration of widespread disruptions, alternative locations, vendor relationships, telecommunications and technology, and communication plans. According to the SEC staff, all fund firms and advisers should be required to adopt and maintain significantly more detailed BCT Plans that are reasonably designed to address risks that pose a significant threat of disrupting the operations of fund firms and their advisers. The SEC views an adviser’s failure to do so to be “fraudulent and deceptive” as it would not have taken the steps necessary to protect clients’ interests from being placed at risk as a result of the adviser’s inability to provide those services.

Unlike the current rules, which are silent on the types of threats and disturbances advisers must contemplate in their continuity plans, the proposed rule identifies five specific areas that BCT Plans should address: (a) systems maintenance and data protection; (b) designated backup offices and sites; (c) plans to communicate with employees and clients in the event of a business disruption; (d) reviews of third-party service providers; and (e) orderly means of winding down a firm.

In addition to the proposed rule release, the SEC staff also issued corresponding guidance focused on the preparedness of investment companies to cope with a complete breakdown at one or more critical service providers. According to the SEC staff, an investment company’s critical service providers include, but are not limited to, its investment adviser, principal underwriter, administrator, transfer agent, custodian, and pricing agent. Because key business functions are routinely delegated to third-party service providers, the SEC staff believes that an investment company’s BCT Plan should contemplate such arrangements and consider the following factors as they relate to such critical service providers: (a) backup processes, robustness of contingency plans, and how service providers intend to maintain operations during a significant business disruption; and (b) how best to monitor whether, and to what extent, a critical service provider has experienced a significant disruption that could impair that service provider’s ability to provide uninterrupted services.

In response to the proposed rule, the SEC received significant pushback from the industry. Multiple industry participants filed comment letters recommending that the SEC issue additional guidance under the existing BCP Rule, rather than adopt proposed Rule 206(4)-4. As support for their position, such industry participants claimed that the adoption of a new rule could lead to a situation in which



the same conduct may potentially be treated as violating two distinct rules. Furthermore, industry participants argued that the portion of the proposed rule that characterizes deficiencies in compliance as *per se* fraud or deceit would bring about excessive liability.

The SEC Release relating to proposed Rule 206(4)-4 can be found [here](#).

B. DOL Fiduciary Rule Update

Ongoing Uncertainty Regarding Department of Labor's Final Rules on Fiduciary Standard for Broker-Dealers

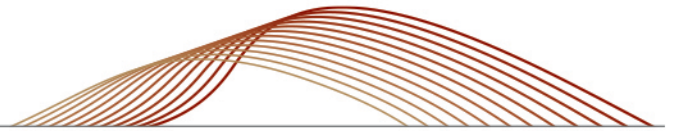
As discussed in our [Spring 2016 Report](#), on April 6, 2016, the Department of Labor (the "DOL") issued a final regulation (the "Fiduciary Rule") redefining who is a "fiduciary" under the Employee Retirement Income Security Act of 1974, as amended.

Some significant effects of the Fiduciary Rule are as follows:

- (a) The DOL makes it clear in the Fiduciary Rule that the regulation applies to communications with individual retirement account ("IRA") owners, whom the DOL has sought to protect with this regulation;
- (b) Brokers, registered investment advisers, financial planners, and other persons who advise or make recommendations to individuals or plan fiduciaries (marketing oneself or an affiliate as to the value of advisory or investment management services will not be considered a recommendation) with respect to IRA money or retirement plan assets (including rollovers and distributions) and receive a fee in connection with such recommendation would be labeled fiduciaries unless an exception applies;
- (c) Investment education will not be fiduciary advice if the materials used comply with the guidelines established in the Fiduciary Rule; provided, however, that education materials provided to IRAs, with no independent plan fiduciary, may not reference specific investment alternatives; and
- (d) Advisers who receive compensation from making recommendations regarding retirement assets could be engaging in a prohibited transaction unless an exemption applies.

The Fiduciary Rule has been the subject of widespread criticism. In September, the House Financial Services Committee approved the Financial CHOICE Act, which would repeal the Fiduciary Rule by requiring the SEC to propose any such rule first, and mandating that the SEC conduct a cost-benefit analysis before issuing a new Fiduciary Rule. However, this bill was unsuccessful in becoming law. In addition, there have also been numerous legal challenges to the Fiduciary Rule that are currently working their way through the federal courts.

As of the publication of this Report, initial compliance with the Fiduciary Rule will be required by April 10, 2017. However, there is a significant amount of uncertainty, regarding the future of the Fiduciary Rule, especially with the incoming administration of President-Elect Donald Trump, who has indicated that he may overhaul the current financial regulatory regime. In addition, there is a renewed interest in Congress to repeal the Fiduciary Rule and recently, the Fiduciary Rule was marked as one of the regulations the Freedom Caucus, a congressional caucus consisting of conservative Republican members of the United States House of Representatives, would like to see eliminated within the first 100 days of the new administration.



C. Other Legislative and Regulatory Updates

1. California Approves Law Requiring Increased Disclosure of Fees and Expenses for Certain Private Funds

On September 14, 2016, California Governor Jerry Brown approved a bill adding Section 7514.7 to the California Government Code, which will require private funds in which California public pension plans and retirement systems have invested (such private funds, the “Subject Funds” and such public pension plans and retirement system collectively, “California Retirement Plans”) to make certain annual, public disclosures regarding certain of such Subject Funds’ fees and expenses.

Under Section 7514.7, each Subject Fund will be required to disclose the following information relating to its fees and expenses: (a) the fees and expenses that a California Retirement Plan pays directly to such Subject Fund, the managers of such Subject Funds, and/or their related parties; (b) a California Retirement Plan’s pro rata share of fees and expenses that are paid from such Subject Fund to the manager of such Subject Fund or such manager’s related parties; (c) a California Retirement Plan’s pro rata share of carried interest distributed to such Subject Fund’s manager or its related parties; (d) a California Retirement Plan’s pro rata share of aggregate fees and expenses paid by all of the portfolio companies held by such Subject Fund to its manager or such manager’s related parties; and (e) any additional information required to be disclosed under the California Public Records Act.

Section 7514.7 will apply to new contracts entered into on or after January 1, 2017, and for existing contracts for which a new capital commitment is made on or after January 1, 2017. California Retirement Plans will also be required to undertake reasonable efforts to attain the disclosure summarized above for existing contracts entered into prior to January 1, 2017.

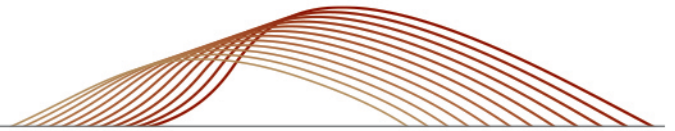
The text of the bill can be found [here](#).

2. SEC Approves FINRA Proposal to Adopt Rules Governing Capital Acquisition Brokers

On August 18, 2016, the SEC approved a proposal by the Financial Industry Regulatory Authority, Inc. (“FINRA”) to adopt a set of rules that will govern certain broker-dealers that are deemed to be “capital acquisition brokers” (each, a “CAB”), which generally include broker-dealers that engage solely in certain specific capital raising or corporate advisory activities (e.g., acting as a private placement agent). Although CABs are subject to FINRA bylaws and certain other FINRA rules, CABs benefit from decreased compliance obligations, including with respect to investor communications, annual internal inspections, business continuity plans, and supervisory personnel.

The rule (the “CAB Rule”) provides a new avenue for private funds to raise capital. In the past, private funds have relied on exemptions from broker-dealer registration, which comes with several restrictive conditions, hired third-party registered broker-dealers to act as placement agents, or arranged for affiliates to complete the process for becoming a full-fledged registered broker-dealer. The rationale for the CAB Rule is that firms looking solely to raise capital do not engage in many of the activities customarily associated with broker-dealers, and thus a more limited legal regime is appropriate.

Under the CAB Rule, CABs may advise companies regarding, among other things, (a) a purchase or sale of a business or assets; (b) corporate restructurings, including going-private transactions, divestitures, and mergers; and (c) private placement transactions with “institutional investors,” which are defined to include certain specified types of institutions, persons with assets of at least \$50 million, and “qualified purchasers” as defined under the 1940 Act. Certain other activities disqualify firms from obtaining status as a CAB, including carrying or acting as an introducing broker



with respect to customer accounts, handling customers' funds or securities, having investment discretion on behalf of any customer, and engaging in proprietary trading of securities or market making activities.

The CAB Rule will become effective on April 14, 2017. The SEC Release approving the CAB Rule can be found [here](#), and the FINRA Regulatory Notice of the adopted CAB Rule can be found [here](#).

3. Updates to BEA Filing Requirements

On October 20, 2016, the Department of Commerce Bureau of Economic Analysis (the "BEA") published a final rule (the "BEA Rule"), initially proposed on July 1, 2016, which sets forth certain reporting requirements for Form BE-13 (a form pursuant to which the BEA collects information on new foreign direct investments in the United States). The BEA previously required that any foreign investor with a voting interest of 10% or more in a U.S. private fund, including through an indirect investment, report its holdings as a "direct" foreign investment. The BEA Rule changes such reporting obligation by requiring that any such foreign investor who holds a 10% interest in a U.S. business but does not have control or influence over the management of the company in which it has invested instead report only through the Treasury International Capital ("TIC") reporting system. Under the BEA Rule, BEA reporting for foreign investors is only required for investments in which the foreign parent, through a U.S. private fund, holds a 10% or more voting interest in one or more of the operating companies. The BEA Rule is intended to reduce the regulatory burden on investors, as many currently are required to fulfill reporting obligations under both the BEA and the TIC.

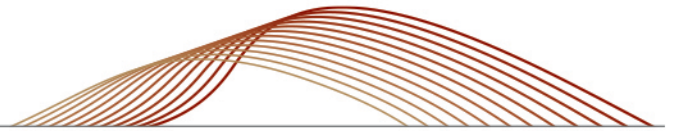
The BEA Rule also amends the reporting requirements for certain private funds in the surveys used by the BEA to collect information about foreign direct investments, including Form BE-605 (Quarterly Survey of Foreign Direct Investment in the United States), Form BE-13 (Survey of New Foreign Direct Investment in the United States), and Form BE-15 (Annual Survey of Foreign Direct Investment in the United States).

The BEA Rule became effective on November 21, 2016. The BEA Release of the adopted rule can be found [here](#).

D. *CFTC and NFA Updates*

1. Regulation AT Proposal

On November 4, 2016, the Commodity Futures Trading Commission (the "CFTC") approved a supplemental proposal (the "Supplemental Proposal") to amend a previously proposed regulation relating to automated trading (such regulation, "Regulation AT"). The initial proposal (the "Initial Proposal"), which was published on November 24, 2015, set forth a series of risk controls, transparency measures, and other safeguards with respect to automated trading on U.S. designated contract markets ("DCMs"), which are boards of trade or exchanges that operate under the regulatory oversight of the CFTC. The Initial Proposal was designed to provide the market with protection as automated trading becomes increasingly prevalent. The CFTC received significant feedback from industry participants because of the Initial Proposal's perceived burdensome requirements (particularly certain provisions that allowed the CFTC to seize proprietary source code relating to algorithmic trading). The CFTC held a Regulation AT Roundtable on June 10, 2016, where it sought additional feedback. The Supplemental Proposal amends and streamlines certain requirements of the Initial Proposal based on feedback from industry participants.



Revised Risk Control Framework

The Supplemental Proposal revises the proposed risk control framework to concentrate pre-trade risk controls at a minimum of two levels rather than three, which is intended to address concerns that three levels of controls would be superfluous and expensive.

Definition of an “AT Person”

Regulation AT seeks to impose regulatory responsibilities on each “AT Person.” As originally proposed, the term AT Person would include certain existing CFTC registrants (i.e., futures commission merchants (“FCMs”), floor brokers, swap dealers, major swap participants, commodity pool operators, commodity trading advisors, and introducing brokers) that are engaged in algorithmic trading of commodity interests, as well as persons not otherwise registered with the CFTC who are engaged in algorithmic trading via direct electronic access. The Supplemental Proposal limits the universe of entities that could be considered AT Persons by imposing a quantitative trading threshold of an aggregate average daily trading volume of at least 20,000 contracts over a six-month period.

Source Code

The Initial Proposal required algorithmic source code to be preserved and made available to the CFTC as part of its general recordkeeping requirements. Under the Supplemental Proposal, however, proprietary source code can only be accessed through a subpoena or a “special call” approved by the CFTC.

Use of Third-Party Algorithms

The Supplemental Proposal reduces the regulatory burden on AT Persons that use third-party systems or components by allowing them to rely on a certificate from such third party to attest to compliance with Regulation AT.

Miscellaneous

The Supplemental Proposal allows AT Persons and FCMs to submit annual certifications to each DCM regarding their risk control frameworks, rather than requiring annual reports, as initially proposed. Furthermore, under the Supplemental Proposal, DCMs are required to evaluate AT Persons’ and FCMs’ (including non-DCM members’) compliance with Regulation AT.

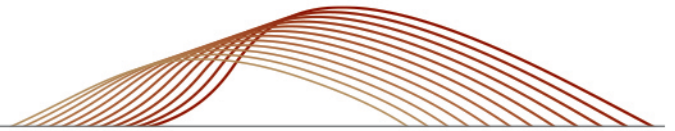
The comment period on the proposed rule will expire on January 24, 2017. The rule proposal can be found [here](#).

2. Proposed Amendments to CPO Annual Report Regulations

On November 21, 2016, the CFTC unanimously approved amendments to its regulations applicable to the financial reports that commodity pool operators (“CPOs”) are required to provide to each participant in its commodity pool regarding the pools’ operations. The amended rules are intended to provide CPOs with flexibility regarding their reporting requirements.

Accounting Standards that are Not GAAP-Compliant

The CFTC has been providing exemptive relief and no-action letters on an individual basis for certain CPOs preparing their annual reports to use accounting standards from the U.K., Ireland, Luxembourg, and/or Canada that are not necessarily compliant with generally accepted accounting principles (“GAAP”) in all respects. The approved amendments codify this practice.



Stub Period Relief

The CFTC is providing “stub period” relief by providing an exemption to the annual report requirement for a commodity pool’s first fiscal year, when such fiscal year is four months or less, in order to reduce the regulatory burden on CPOs. The amendment requires, however, that CPOs that use this exemption eventually submit an annual report that covers the time period from the date of its inception to the end of its first 12-month fiscal year.

Annual Report At Least Once During the Life of the Pool

An audited annual report must be distributed and submitted at least once during the life of a pool. The audit relief is unavailable where a CPO has not previously distributed an audited annual report to pool participants or submitted the audited annual report to the National Futures Association (the “NFA”).

The amended rules became effective on December 27, 2016. The CFTC Release relating to the amendments can be found [here](#).

3. Proposed Amendment to Exemption from Registration for Non-U.S. CPOs and CTAs

The CFTC has proposed an amendment that is intended to make it easier for foreign persons engaged in commodity interest transactions acting on behalf of certain persons and/or financial institutions located outside of the United States to qualify for an exemption from registration as FCMs, introducing brokers, commodity trading advisers (“CTAs”), and/or CPOs. The amendment would codify previous no-action relief provided by the CFTC.

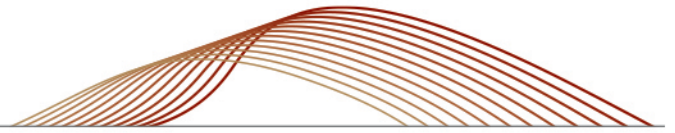
Under the current rules, these exemptions are available with respect to commodity interest transactions where the entity (a) is located outside the U.S., (b) acts only on behalf of persons located outside the U.S., and (c) submits commodity interest transactions for clearing through a registered FCM. In contrast, under the proposal, foreign persons and certain financial institutions would no longer have to clear commodity interest transactions.

The comment period on the proposed rule expired on September 6, 2016. The rule proposal can be found [here](#).

4. National Futures Association Proposes Collecting Additional Financial Information from CPOs and CTAs

On September 6, 2016, the NFA proposed an amendment to NFA Compliance Rule 2-46, which would expand the financial reporting requirements for CPOs and CTAs in order to allow the NFA to better understand the risk profiles of members of the NFA. Currently, the rule requires CPOs and CTAs to file certain forms on a quarterly basis to permit the NFA to collect information from such CPOs and CTAs regarding their pools and their assets, respectively. Under the proposed amendment, CPOs and CTAs would also be required to report information regarding their net worth and profitability. Specifically, information will be required with respect to two ratios: (a) current assets/current liabilities, which would provide a measure of a firm’s liquidity, and (b) total revenue/total expenses, which would provide a measure of a firm’s operating margin.

Under the proposed amendment, the components of the ratios would be based on the requirements of GAAP or another internationally recognized accounting standard, provided that the ratios are reported using an accrual method of accounting. Each CPO and CTA must maintain financial records supporting the calculation of these ratios. CPOs and CTAs that are part of a holding company/subsidiary structure may elect to report the ratios at the parent level.



The rule proposal can be found [here](#).

E. Cayman Islands Updates³

1. The Confidential Information Disclosure Law: Increasing Corporate Transparency

On July 22, 2016, the Cayman Islands introduced a new statutory confidentiality regime in the form of the Confidential Information Disclosure Law, 2016, to replace the repealed Confidential Relationship (Preservation) Law. The new framework was implemented as part of the Cayman Islands' commitment to being at the forefront of international standards on tax transparency as well as cooperation between taxation and law enforcement authorities globally.

The new regime removes the criminal sanction for breach of confidence, and establishes several clear exceptions under which confidential information may be disclosed without the prior consent of the person to whom the information relates. Examples of the instances in which confidential information can be disclosed without the consent of the person to whom the information relates include where the disclosure is made pursuant to requests by local tax, law enforcement, and regulatory authorities or in accordance with, or pursuant to, a right or duty created by any law or regulation of the Cayman Islands.

The new regime creates certainty because it provides that, when a duty of confidentiality arises during the course of business, the disclosure of information in accordance with the specified circumstances shall not constitute a breach of the duty of confidence and shall not be actionable at the suit of any person.

2. Changes to "Licence Under Liquidation" and "Licence Under Termination" Process and Cancellation of Licenses

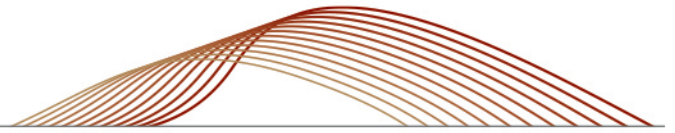
A Cayman Islands Monetary Authority ("CIMA")-regulated fund that is going into voluntary liquidation must provide CIMA with various documents which will allow CIMA to place the fund in "Licence Under Liquidation" status. Alternatively, funds can be placed in "Licence Under Termination" status if they are de-registering for other reasons and have not yet filed all de-registration documents.

CIMA recently confirmed that it will contact each fund that remains in "Licence Under Liquidation" or "Licence Under Termination" status for more than six months to request any remaining documents and/or fees that are outstanding to complete the de-registration of that fund. Further, the operators or liquidators of funds with "Licence Under Liquidation" or "Licence Under Termination" status must provide CIMA with comprehensive ongoing updates as to the status and progress of the winding down or liquidation of the fund within the first six months of it obtaining the status.

If a fund fails to comply with these obligations (noting that CIMA may, in certain circumstances, extend the period for compliance), CIMA will cancel the fund's certificate of registration or mutual fund license.

3. Cayman Islands AIFMD Passport Update

On July 19, 2016, the European Securities and Markets Authority ("ESMA") delivered its latest advice to the European Parliament, Council and Commission regarding whether the Alternative Investment Fund Managers Directive ("AIFMD") passport should be extended to non-E.U. Alternative Investment Fund Managers ("AIFMs") and Alternative Investment Funds ("AIFs") in non-European Economic Area jurisdictions including the Cayman Islands, the United States, and Hong Kong. The extension of the AIFMD passport (which is currently only available to E.U. entities) would allow non-E.U. AIFMs and



AIFs to market and manage funds throughout the E.U. without needing to comply with the national regime of each E.U. country in which they market funds.

ESMA has advised that it will complete its assessment of the Cayman Islands once the Cayman Islands adopt new AIFMD legislation and related changes are implemented; however, it is of the view that there are no significant obstacles regarding competition and market disruption impeding the application of the AIFMD passport to the Cayman Islands.

4. Incoming Changes to Enforcement Powers of Cayman Islands Monetary Authority

The Cayman Islands Government recently enacted the Monetary Authority (Amendment) Law, 2016 (the "Amendment Law"). Once in effect, the Amendment Law will introduce new enforcement powers to allow CIMA to impose substantial administrative fines upon individuals (whether or not resident in the Cayman Islands) and entities licensed and regulated in the Cayman Islands.

Under the Amendment Law, breaches will be categorized as minor, serious, or very serious. CIMA may impose fines ranging from CI\$5,000 (approximately US\$6,100) for minor breaches to CI\$100,000 (approximately US\$122,000) for individuals and CI\$1,000,000 (approximately US\$1,220,000) for body corporates for very serious breaches.

It is expected that new regulations will be introduced which will identify which provisions CIMA may impose new administrative fines in respect of and to classify breaches as minor, serious, or very serious. CIMA may also issue rules concerning the criteria which it will apply in its decision regarding fines, aggravating and mitigating factors, and any other matters required to administer the new provisions.

5. Approach to Redemption Payments—Pearson (as additional liquidator of Herald Fund SPC (in official liquidation)) v Primeo Fund (in official liquidation)

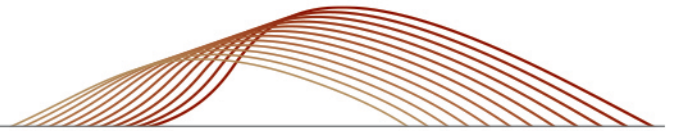
In a recent decision in an investment fund case, the Cayman Islands Court of Appeal has clarified the ranking of redeemed investors in fund liquidations. The decision confirms that an investor that has redeemed its shares (thereby becoming a creditor), but has not received redemption payments in full, will rank behind ordinary unsecured creditors but ahead of unredeemed investors. The Court also confirmed that redeemed investors have creditor claims for the redemption price of their shares.

Because investment funds in liquidation tend to have very limited ordinary creditors, the subordination of redemption claims to ordinary creditor claims is unlikely to be a material consideration in most cases.

6. Clawback of Redemption Proceeds—Skandinaviska Enskilda Banken AB (Publ) v Conway and Walker (as Joint Official Liquidators of Weaving Macro Fixed Income Fund Limited)

The Cayman Islands Court of Appeal recently upheld the decision at first instance that redemption payments made by an investment fund prior to the fund's liquidation constituted preferences over the fund's other creditors and must be repaid.

Following the financial crisis of 2008, a significant number of the fund's investors sought to redeem their shares. The fund was not in a position to meet its obligations to pay redeeming shareholders. However, instead of suspending redemptions or otherwise taking steps to cease the fund's business, the fund implemented a policy for paying investors who redeemed on December 1, 2008 but not on any subsequent redemption day. The fund went into liquidation in March 2009, and the fund's



liquidators sought the return of redemption payments made to one of the December 1, 2008 redeemers on the basis that they constituted preference payments made when the fund was insolvent.

The Cayman Islands Court of Appeal clarified and widened the scope of a number of principles which will have a wide ranging effect across a number of aspects of Cayman Islands insolvency law, including the definition of, and demonstrating, insolvency.

7. *Cayman Courts will uphold contractual arrangements—Pearson (as additional liquidator of Herald Fund SPC (in official liquidation)) v Primeo Fund (in official liquidation)*

The Cayman Islands Grand Court has provided guidance on the role of the law of common mistake in the context of investments in Ponzi schemes. The case related to two investment funds (respectively Primeo Fund (in official liquidation) (“Primeo”) and Herald Fund SPC (in official liquidation) (“Herald”)) both of which invested directly in Bernard L. Madoff Securities LLC (“BLMS”). In May 2007, a restructuring took place such that Primeo transferred its investment in BLMS to Herald in return for the issue of shares in Herald (the “*in specie* subscription”). BLMS was found to be an elaborate fraud in December 2008. Both Herald and Primeo subsequently went into liquidation. Herald’s liquidator asserted that the *in specie* subscription was void because there was a common mistake as to the existence of the subject matter (since the shares and securities purportedly held by BLMS never existed). This claim was dismissed. While all cases involving issues of mistake are highly fact-sensitive, this ruling demonstrates that the Cayman Islands courts will be slow to override an investor’s contractual rights on the basis of mistake.

II. TAXATION

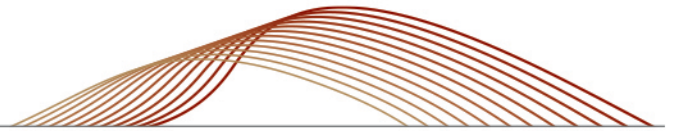
Since our last Report, the U.S. Internal Revenue Service (the “IRS”) and the Treasury have continued their efforts to combat so-called “inversion” transactions, in which U.S. companies merge into foreign companies, in part to lower worldwide taxes imposed on the former U.S. company. This was seen in the finalized regulations issued to limit certain kinds of inversions and also to limit “earnings stripping,” which may impact companies that are not contemplating an inversion. The new earnings stripping rules are discussed below.

Additionally, certain Democratic and Republican politicians and Treasury officials continue to express the importance of fundamental U.S. tax reform, including to the U.S.’s increasingly uncommon worldwide system of income taxation and to its combination of a high rate of corporate income tax, to which corporations in different industries often are subject to substantially different effective tax rates.

A. *New Rules on Earnings Stripping*

The IRS recently finalized rules under Section 385 of the U.S. Internal Revenue Code of 1986, as amended, on earnings stripping in conjunction with its new rules on inversions. The final regulations (the “Final Regulations”), issued on October 13, 2016, target foreign-owned domestic corporations that borrow from affiliated companies and receive a deduction for interest paid in the U.S., but whose affiliated corporate lenders may be in a low- or no-tax jurisdiction. The Final Regulations recharacterize certain purported debt instruments between related parties as equity, with the consequence that, among other things, interest paid on the purported debt instrument cannot be deducted against the income of the U.S. corporate issuer of the debt.

The Final Regulations contain a “general rule” that recharacterizes as equity a note issued by a U.S. corporation to a member of the issuer’s “expanded group” (a) in a distribution to a shareholder, (b) in exchange for the stock of another member of the “expanded group” (with certain exceptions for



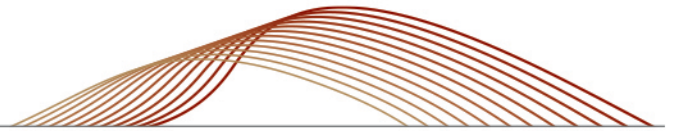
acquisitions of entities that the issuer owns), and (c) in exchange for property in certain asset reorganizations. In addition, recognizing that money is fungible, the Final Regulations contain a “funding rule,” such that debt issued in the 36-month periods before and after one of the general rule’s prohibited transactions is automatically recharacterized as equity. The Final Regulations contain certain carve-outs, such as for total outstanding debt below \$50 million and where debt issued is less than a modified form of earnings and profits. For purposes of these rules, any actions taken by members of the same U.S. consolidated group are treated as taken by one corporation, meaning that debt issued solely within a consolidated U.S. group will not be recharacterized as equity under the Final Regulations. The Final Regulations also carve out debt issued by a foreign corporation, meaning that only debt issued by a U.S. corporation is relevant under the Final Regulations. The Final Regulations only apply to the extent of actions taken within an “expanded group,” which is generally a string of corporations (foreign and/or domestic) where each owns 80% of the next by vote or value. A regulated investment company or real estate investment trust cannot be the parent of an expanded group, but it can be a member of one. An S-corporation cannot be a member or parent of an expanded group. A partnership cannot itself be a member of an expanded group, although attribution rules may cause chains of corporations with intermediate partnerships to be linked.

The Final Regulations also contain detailed documentation requirements which must be followed for debt issued beginning on January 1, 2018. Failure to follow the documentation requirements automatically causes purported debt to be recharacterized as equity. Properly following the documentation requirements does not guarantee that under prior common law tests debt will be respected as equity, but many commentators have noted that the documentation rules in part track the common law requirements, suggesting that compliance with the documentation rules should generally allow issuers to meet common law tests for the debt.

Where a private fund uses an above-the-fund entity (U.S. or foreign) that is treated as a corporation for U.S. federal income tax purposes, if that corporation owns at least 80% of the fund, it will be important to understand these rules carefully and to structure related company lending transactions with the recharacterization rules in mind. For funds that are not structured with a corporation that owns at least 80% of the fund, it will still be important to monitor affiliated party lending activity and movement of cash below the fund among corporations that are not solely U.S. corporations or solely foreign corporations. Even where transactions are structured so as to avoid being recharacterized by the “general rule” or the “funding rule,” certain applicable debts will need to be carefully documented to comply with the new documentation rules beginning in 2018 or they will automatically be recharacterized as equity.

B. New Partnership Audit Rules

As reported in our prior [Client Alert](#), new partnership audit rules will generally take effect for tax years beginning January 1, 2018. Limited liability companies and partnerships may elect to have the rules apply prior to such time. These rules expand the role of the “tax matters partner,” renamed as the “partnership representative,” and introduce the possibility of tax adjustments occurring at the partnership level, rather than solely on a partner-by-partner basis. One consequence of this is that partners that leave a partnership are now increasingly being asked to indemnify the partnership for taxes allocable to the leaving partner long after it has left the partnership, so as to prevent a partnership-level tax adjustment in respect of a period before the transfer of the partnership interest from being imposed on later-admitted partners. Partnerships will have some flexibility over whether to undergo these adjustments at the level of the partnership (the “default” rule) or to make an election to push out the liability to those that were partners at the time the liability was incurred. However,



making this so-called “push-out” election comes at a cost of an increased interest rate on the past-due taxes and increased administrative expenses for the partnership due to the requirement to reissue past IRS Forms K-1.

Treasury Regulations are still largely forthcoming relating to most of these rules, and so there are many open questions as to how exactly the new partnership audit regime will work. A bill with bipartisan support, the Tax Technical Corrections Act of 2016 (the “TTCA”), may pass in 2017 to address some concerns that practitioners have expressed about the new rules. These changes may include:

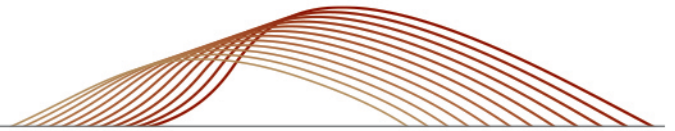
- (a) Clarifying that a partnership can make a “push-out” election when its partners are themselves partnerships. The existing statute is unclear as to how the “push-out” election operates in the presence of tiered partnerships. The TTCA requires tiered partnerships to report additional information and make additional disclosures with respect to their upper-tier partners so as to facilitate easier assessment and collection of taxes by the IRS from upper-tier partners;
- (b) Providing a way for a partnership to use the “default” method of paying partnership liabilities without requiring partners to file amended tax returns. Instead, such partners would pay the tax owed, make binding changes to the relevant tax attributes, and provide information to the IRS to substantiate that the tax was correctly paid; and
- (c) Instructing the IRS to promulgate regulations to either carve out foreign partnerships from the new partnership audit rules or to draft special rules for foreign partnerships.

Limited liability company and partnership agreements should be reviewed prior to 2018 to determine what updates may be necessary to account for the new and developing rules.

C. New Tax Legislative Proposals

House and Senate Republicans and President-Elect Donald Trump have announced tax policy changes they plan to enact in early 2017. While much is speculation at this point, here are some of the more concrete potential proposals:

- (a) *Lowering the U.S. corporate tax rate to 20% (House and Senate Republicans) or 15% (President-Elect Trump).* This lower tax rate, if enacted, could impact private fund structures by making it sufficiently tax efficient for some funds to use U.S. corporate “blockers” instead of offshore ones in situations in which offshore blockers are expected to pay significant withholding taxes on dividends and interest or branch profits taxes on certain active trade or business investments;
- (b) *Disallowing certain interest deductions.* This change, being discussed as one way to pay for other tax cuts, could significantly impact some tax structures which utilize leverage, the interest payments on which is currently deductible;
- (c) *Repealing the favorable tax treatment of “carried interest.”* Although this change has not been frequently discussed since the election and is not as favored by Republican legislators, President-Elect Trump and a number of Democrats have expressed support to repeal the favorable tax treatment of so-called “carried interest”; and



- (d) *Moving from a “worldwide” to a “territorial” tax system.* Currently U.S. persons pay income taxes based on their “worldwide” income, although they receive tax credits and tax deductions to the extent taxes are paid to foreign governments. When a corporation earns profits overseas, those profits are not taxed until they are repatriated, incentivizing some corporations to leave cash overseas. By contrast, most major economies use a “territorial” system in which residents are only taxed on their earnings of domestic sources of income. Both Democratic and Republican legislators have proposed moving the U.S. to a territorial system of taxation in the past. Although this proposal is perhaps the least likely of the major policy proposals to be enacted because it would require a fundamental overhaul of many portions of the tax code, such a change, if enacted, would profoundly impact all aspects of international tax structuring involving U.S. investors and U.S. investments.

III. CIVIL LITIGATION

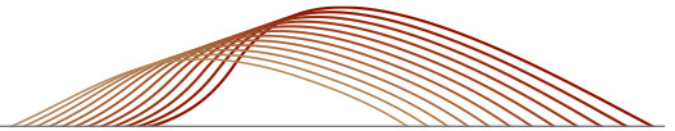
Litigation matters involving private funds continue to involve interesting and novel issues. Significant recent developments include the following:

- (a) A California judge overruled objections to the discovery of documents from related litigation despite claims under the business strategy doctrine in the ongoing dispute over Pershing Square and Valeant Pharmaceuticals’ failed takeover of Allergan, Inc. (“Allergan”);
- (b) New York congressional representatives weighed in against abuses of *inter partes* review (“IPR”);
- (c) Deutsche Bank appealed a New York state court’s ruling that hedge funds are entitled to \$22 million due to breach of credit default swap contracts;
- (d) Certain hedge funds have filed suit against start-up healthcare company Theranos, Inc. (“Theranos”);
- (e) A hedge fund has filed suit against its fund administrator for gross negligence in allegedly transferring money from the fund’s accounts to Chinese hackers on multiple occasions; and
- (f) A New York judge dismissed a suit against hedge funds that allegedly controlled American Apparel.

A. *Update on Previously Reported Cases*

1. *Defendant in Ongoing Allergan Dispute Obtains Discovery from Previous Litigation*

In our [Spring 2016 Report](#), we first reported that claims by shareholders of Allergan against Pershing Square Funds and Valeant Pharmaceuticals had survived a motion to dismiss. Plaintiff shareholders, including two public retirement funds, claimed that Valeant had tipped off Pershing about its undisclosed plans to acquire Allergan.⁴ According to plaintiffs, the Pershing Square Funds then acquired a 10% stake in Allergan.⁵ When Valeant announced its takeover plans, the Pershing Square Funds allegedly sold their shares at a profit and provided a kickback to Valeant.⁶ The U.S. District Court for the Central District of California (the “C.D. Cal. Court”) rejected defendants’ motion to dismiss, reasoning that the plaintiffs had “adequately alleged that Valeant knew that its tip would be traded on,” and the parties engaged in discovery.⁷ Defendant Pershing Square served a subpoena on Allergan (a third party) requesting documents from Allergan’s own (now settled⁸) suit against Pershing Square and Valeant. A special master issued an order compelling production under



the subpoena, and Allergan appealed to the C.D. Cal. Court.⁹ Allergan argued the documents were irrelevant because “they concerned other potential transactions that Allergan was considering at the time.”¹⁰

The C.D. Cal. Court overruled Allergan’s objections. The C.D. Cal. Court noted that the “discovery must be ‘proportional to the needs of the case,’ in light of the importance of the issues at stake in the case” and that the party opposing production ultimately bore the burden of persuasion.¹¹ The C.D. Cal. Court agreed with the special master that, although the test under SEC Rule 14e-3 is objective, Allergan’s internal analysis of the tender offer was relevant to the reasonableness of defendants’ actions.¹² Likewise, the C.D. Cal. Court stated that the fact Allergan was considering *other* offers “would lend credence to Defendants’ argument that they were proposing a merger to Allergan, rather than attempting a takeover.”¹³ Consequently, the C.D. Cal. Court held that the documents were relevant and affirmed the special master’s order compelling production.¹⁴

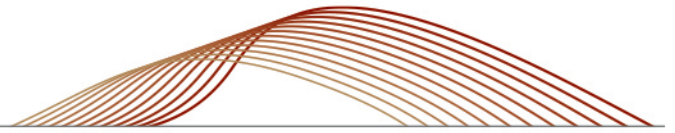
2. *New York Delegation Weighs In Against Abuse of Inter Partes Review*

In our [Fall 2015 Report](#) and [Spring 2016 Report](#), we reported on Kyle Bass’ use of IPR under the America Invents Act as part of the investment strategy of Bass’s fund, Hayman Capital Management LP (“Hayman Capital”). Neither Hayman Capital nor related entities such as the Coalition for Affordable Drugs are direct competitors with the pharmaceutical companies who owned the challenged patents. Although Hayman Capital’s strategy is not clear, Bass has indicated that it is a component of his “short activist strategy.”¹⁵

Bass’ strategy has received widespread criticism, and members of New York State’s delegation to the U.S. House of Representatives have weighed in. In a December 5, 2016 letter to the U.S. Patent and Trademark Office (the “USPTO”), the New York representatives wrote, “we are concerned with numerous recent attempts by hedge funds to short the stocks of targeted companies prior to IPR filing. We are also concerned that hedge funds are filing repeat petitions challenging certain patents, even though previous IPR petitions on these patents had already been rejected by the U.S. Patent & Trademark Office (PTO).”¹⁶ The representatives urged the USPTO to take action, writing: “[U]nder 35 U.S.C. 314(a), the PTO has general discretion to deny institution of petitions in cases where institution would not be in the interests of justice...[T]he PTO has express authority to deny institution of repeat petitions that are cumulative and which, if instituted, would otherwise violate the spirit and purpose of the IPR system.”¹⁷ The USPTO has not yet responded to the delegation’s letter.

3. *Deutsche Bank Appeals \$22 Million Judgment in Hedge Funds’ Breach of Contract Case*

In our [Spring 2016 Report](#), we reported that hedge funds Good Hill Master Fund LP and Good Hill Master Fund II LLP (collectively, “Good Hill”) won a \$22 million judgment against Deutsche Bank in New York state court. Good Hill had asserted claims for breach of contract of credit default swap agreements and sought the return of collateral the hedge funds posted to Deutsche Bank.¹⁸ Deutsche Bank refused to return the collateral, arguing that Good Hill acted in bad faith and in a commercially unreasonable manner when Good Hill sold the notes at a higher than justified price at Deutsche Bank’s expense.¹⁹ The trial court found that under the swap agreements, Good Hill was “free to negotiate a favorably-priced sale” and that the mere fact that the sale was “advantageous to Good Hill and disadvantageous to Deutsche Bank” was “hardly sufficient to establish bad faith.”²⁰ Deutsche Bank appealed the trial court’s ruling.²¹ On October 19, 2016, counsel for Deutsche Bank argued before a panel of New York state justices that the trial court’s ruling was erroneous.²² The panel questioned



counsel for Deutsche Bank about the bank's allegations of bad faith. The New York appellate court has yet to issue a decision at the time of this Report.

B. New Developments in Securities Litigation

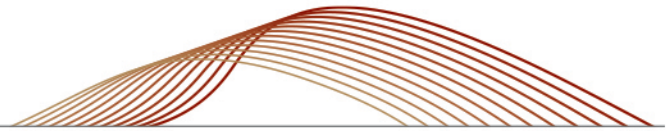
1. Hedge Funds Allege Start-Up Healthcare Company Theranos Defrauded Investors

On October 10, 2016, hedge funds Partner Investments, L.P., PFM Healthcare Master Fund, L.P., and PFM Healthcare Principals Fund, L.P. (collectively, "PFM") filed a complaint in Delaware Chancery Court, alleging that Theranos, its Chief Executive Officer, Elizabeth Holmes, and its former Chief Operating Officer, Ramesh Balwani, defrauded investors. PFM invested approximately \$96.1 million in Theranos, a privately held consumer healthcare technology company.²³ In fall 2013, Theranos became known for its blood testing technology, which, according to a company press release, enabled consumers to "complete any clinician-directed lab test with as little as a few drops of blood and results available in a matter of hours."²⁴ In October 2015, the *Wall Street Journal* published an investigative report that showed that Theranos struggled with its blood-test technology and, in fact, only used its proprietary technology for a small number of tests, some of which had questionable results.²⁵ The United States Department of Justice and the SEC are currently investigating Theranos, and the Centers for Medicare and Medicaid Services ("CMS") have sanctioned Theranos, revoking its license to operate a lab in California, and Holmes, banning her from lab operations for at least two years.²⁶ PFM alleges that "Theranos, Holmes, and Balwani repeatedly made misrepresentations, misleading statements, and material omissions about, among other things, the Company's technology, methods, regulatory interactions, and business plan."²⁷

On November 23, 2016, Theranos, Holmes, and Balwani moved to dismiss certain counts of PFM's complaint, arguing that those counts "invoke[d] consumer fraud, unfair competition, indemnification, and theories based on alleged misrepresentations that post-date PFM's investment [that] have no place in this case."²⁸ While the court cannot resolve factual disputes at this stage of the litigation, the motion previews the defendants' argument that "Theranos encountered challenges in its initial commercial strategy and changed its business plans" and that PFM was aware that any business plans were speculative, and, accordingly, no one was misled.²⁹ PFM has not yet filed its opposition to defendants' motion to dismiss and, accordingly, the Delaware Chancery Court has not yet ruled on the motion at the time of this Report.

2. A Hedge Fund Sued its Fund Administrator for Allegedly Transferring Funds to Chinese Hackers

On September 16, 2016, hedge fund Tillage Commodities Fund, L.P. ("Tillage"), filed suit in New York Supreme Court for the County of New York against its fund administrator, SS&C Technologies, Inc. ("SS&C") for allegedly transferring millions of dollars from Tillage's accounts.³⁰ According to Tillage's complaint, the transfers were in response to "spoofing" emails that contained typos, account errors, and unusual syntax.³¹ The fraudulent transfers were for millions of dollars (the largest was \$3 million), while legitimate transfers by Tillage in the preceding four years ranged from \$3,567 to \$12,410.³² The complaint alleged, "Either SS&C processed this series of fraudulent wire transfer requests without any review whatsoever, in total abdication of its obligations—or SS&C knowingly facilitated the fraud."³³ In response, SS&C filed a motion to dismiss contending that Tillage was bound by a contractual limitation of liabilities, which limited liability to "intentional wrongdoing or reckless disregard."³⁴ SS&C argued that the wire transfer requests "included confidential information regarding Plaintiff's account at First Republic Bank and bore signatures that exactly matched those of Plaintiff's authorized signatories."³⁵ Further, SS&C claimed that it acted immediately once it discovered the fraud, barring a finding of intentional wrongdoing or reckless disregard.³⁶ In response, Tillage argued



that it alleged sufficient facts to show that SS&C acted with reckless disregard, or “consciously—and, thus, with general intentionality, not necessarily with intent to cause particular injury—disregard[ed] known serious risks of harm.”³⁷ Further, Tillage argued that “[a]s gross negligence is a ‘factual matter’ going to the defendant’s state of mind, it is not generally amenable to pre-discovery resolution.”³⁸ The parties’ motions are pending before the court.

3. Judge Dismisses Shareholder Suit Against Hedge Funds That Allegedly Controlled American Apparel

On August 30, 2016, the Supreme Court of New York dismissed a shareholder class action against hedge funds Standard General L.P., Standard General Master Fund L.P., and Standard General Ltd. (collectively, “Standard General”) in connection with Standard General’s alleged control of American Apparel.³⁹ American Apparel was founded in 1989 by Dov Charney, who served as Chief Executive Officer of the company until June 2014, when the board of directors of American Apparel (the “Board”) voted to suspend Charney due to allegations that Charney harassed employees. Shortly after Charney’s suspension, Standard General entered into an agreement with Charney to purchase 10% of American Apparel’s outstanding shares and sell them back to the former executive through a loan secured by all of his shares.⁴⁰ Charney and Standard General, collectively owning 44% of American Apparel’s shares, entered into a nomination agreement, in which Standard General would supply \$15 million to American Apparel as needed and, in exchange, would be able to appoint three new Board members.⁴¹ Later, Standard General also became a creditor of American Apparel and received interest payments from the company.⁴²

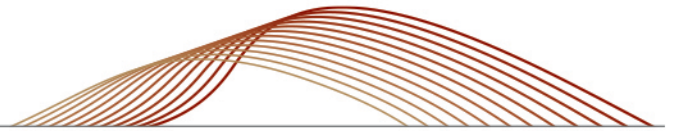
In December 2014, Irving Place Capital allegedly offered to acquire American Apparel for \$1.40 per share, which would result in a premium of 103% for shareholders.⁴³ Plaintiffs alleged that Standard General “stood more to gain from a weakened or a bankrupt American Apparel than it did from a third-party sale” and used its control over the company to stop it from adequately considering the offer.⁴⁴ In doing so, plaintiffs alleged that Standard General breached its fiduciary duty as controlling shareholder and unjustly enriched itself at the expense of other shareholders.⁴⁵ In October 2015, American Apparel filed for bankruptcy.

The Supreme Court of New York dismissed plaintiffs’ suit without granting leave to amend.⁴⁶ The Supreme Court of New York found that plaintiffs did not have standing to pursue the suit, and that Standard General did not control American Apparel and thus owed no fiduciary duty to other shareholders.⁴⁷ First, the Supreme Court of New York explained that plaintiffs’ ability to bring the suit depended on their status as American Apparel shareholders, a status that no longer existed after the bankruptcy proceedings.⁴⁸ Second, it found that plaintiffs failed to prove that Standard General controlled the company because the mere fact that Standard General selected certain directors did not establish that those directors were beholden to Standard General.⁴⁹

IV. REGULATORY ENFORCEMENT

On October 11, 2016, the SEC reported record-breaking enforcement results for fiscal year 2016. Enforcement actions reached this high watermark, with the SEC filing 868 enforcement actions, while collecting over \$4 billion in disgorgement and penalties, and distributing \$57 million to whistleblowers.⁵⁰

In addition to an uptick in enforcement efforts, the SEC’s year-end numbers reveal the agency’s continued focus on, and aggressive pursuit of, enforcement actions in the investment adviser space.



The SEC reported 160 enforcement actions involving investment advisers or investment companies—also a single-year record—including 98 independent or standalone cases.

These figures are not altogether surprising given the SEC's expressed focus on investment companies and advisers. When the Office of Compliance Inspections and Examinations (the "OCIE")—the self-described "eyes and ears" of the SEC—released its 2016 examination priorities for the 2016 fiscal year, it emphasized several initiatives geared toward investment advisers and private equity funds.⁵¹ Enforcement Division Director Andrew Ceresney likewise reiterated the SEC's intensifying commitment to policing the private equity area in his May 12, 2016 keynote address.⁵²

Given the intensifying regulatory focus on the private fund space, we have highlighted below the conduct and themes that have garnered the SEC's attention in this area during the past six months.

A. Insider Trading

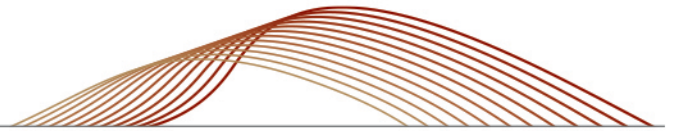
Since our [Spring 2016 Report](#), the Supreme Court (the "Court") handed down the highly anticipated opinion in *Salman v. United States*, in which the Court unanimously sided with the government in upholding defendant Bassam Salman's conviction for insider trading.⁵³

The Court held that prosecutors could establish tipper liability, even if a tipper received no pecuniary benefit, where the tipper provided only a gift of material, nonpublic information to a trading relative or friend. In such circumstances, a gift would be sufficient to demonstrate that the insider received a "personal benefit" in breach of the insider's fiduciary duty. In so ruling, the Court rejected the more restrictive view articulated in *United States v. Newman*, which had required prosecutors to prove that an insider, who "gifted" information to a trading relative or friend, also received "a pecuniary or similar benefit" in exchange for the tip.⁵⁴ The *Salman* decision reaffirms the standard that existed prior to *Newman*, which the Court set decades ago in *Dirks v. SEC*.⁵⁵

The Court's reasoning in *Salman* relied heavily on the language and standard established in *Dirks*, starting with the premise that, for a tippee to be liable for insider trading, the tipper must have breached a fiduciary duty. For the purposes of insider trading, however, a breach of fiduciary duty by an insider who discloses material, non-public information occurs only when the insider personally benefits from the disclosure. The Court emphasized that a tipper's disclosure of inside information without a personal benefit is "not enough" to prove insider trading. Although some "objective" facts may demonstrate that the insider received a personal benefit (e.g., the receipt of pecuniary gain or a reputational benefit that will translate into future earnings), the *Salman* Court made clear that a gift of confidential information from an insider to a trading relative or friend can also satisfy the "personal benefit" requirement, because the tip and subsequent trade is the equivalent of an insider who trades on the information and then gives the proceeds to the relative or friend. Thus, according to the Court, "the tipper benefits personally because giving a gift of trading information is the same thing as trading by the tipper followed by a gift of the proceeds."⁵⁶

The *Salman* decision rejected *Newman* to the extent *Newman* required the government to prove that an insider who provided information to a trading relative or friend must also have received something of a "pecuniary or similarly valuable nature."⁵⁷

Despite the ongoing uncertainty that emerged after *Newman*, but prior to the Court's *Salman* decision, the SEC continued to aggressively pursue perceived insider trading violations. Below we analyze a significant enforcement case that involves an adviser's perceived failure to supervise an employee and to detect the employee's insider trading.



In re Artis Capital Management, L.P. and Michael W. Harden

On October 13, 2016, the SEC reached a settlement with San Francisco based hedge fund advisory firm Artis Capital Management (“Artis”) and its senior research analyst, Michael W. Harden, on charges related to their failure to reasonably supervise and detect insider trading by an employee, Matthew G. Teeple.⁵⁸

The SEC order alleged that (a) Artis did not maintain adequate policies to prevent insider trading at the firm and (b) neither Artis nor Harden responded appropriately to information that should have led a reasonable supervisor to investigate Teeple’s access to insider information.⁵⁹ Specifically, Artis had no written policy or procedures to monitor and regulate the conduct of its employees, like Teeple, whose primary function was to cultivate industry insiders. For example, Teeple was not required to report interactions with employees of public companies and Artis had no procedures set in place to track information acquired from industry professionals. Further, Artis and Harden failed to reasonably investigate red flags raised by Teeple’s trade recommendations. Artis never questioned Teeple’s trade recommendations that generated profits or avoided losses, and that also mirrored subsequent unscheduled industry press releases. In addition, Harden did not inquire about the source of Teeple’s information despite having knowledge of Teeple’s close relationships with industry insiders.

Artis agreed to settle the charges by disgorging the trading profits Teeple generated for the firm totaling \$5,165,862, plus interest of \$1,129,222 and an additional penalty of \$2,582,931. Harden personally settled charges with the SEC for a penalty of \$130,000 and a 12-month suspension from the securities industry.⁶⁰ The settlement serves as a warning to firms and individuals in supervisory roles to be vigilant of suspicious activity and proactive in tailoring policies for employees to ensure compliance and to adequately account for, and adjust to, the adviser’s specific business.

B. Failure to Disclose Fees

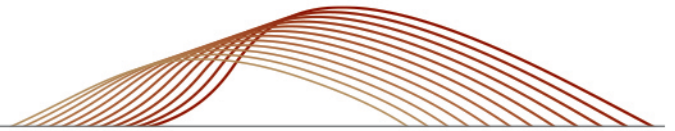
In his keynote address at the Securities Enforcement Forum West, Director Ceresney noted the SEC’s focus on appropriate disclosures of conflicts of interest and fees and expenses, particularly by private equity funds and advisers.⁶¹ Ceresney emphasized that due to the unique investment structure of private equity funds, it is “critically important that advisers disclose all material information, including conflicts of interest, to investors at the time their capital is committed.”⁶²

Below we highlight a recent SEC enforcement action involving the failure to disclose fees.

In re WL Ross & Co. LLC

On August 24, 2016, private equity fund adviser WL Ross & Co. LLC (“WL Ross”) consented to the entry of an SEC administrative order arising out of allegations that WL Ross failed to adequately disclose its management fee offset practices to certain private equity funds it advised (the “WLR Funds”) and their investors, which resulted in WL Ross charging the WLR Funds approximately \$10.4 million in additional management fees over the course of 10 years.⁶³

According to the SEC, WL Ross was entitled to receive periodic management fees from the WLR Funds and such management fees were supposed to be offset by a percentage amount of certain transaction fees that WL Ross received in connection with certain services (e.g., financial advising or investment banking) provided by WL Ross to the portfolio companies in which the WLR Funds were invested.⁶⁴ The SEC alleged that the limited partnership agreements and other documents governing the WLR Funds and their relationships to WL Ross were ambiguous regarding how the management fee offset should be calculated when multiple WLR Funds and other investors (collectively, the



“WLR Portfolio Company Investors”) were invested in the same portfolio company. In such instances, WL Ross allegedly calculated the management fee offset based on the relative ownership percentages of all WLR Portfolio Company Investors in a given portfolio company, regardless of whether or not a WLR Portfolio Company Investor was actually entitled to receive a management fee offset. According to the SEC, this practice had the effect of reducing the overall amount of transaction fees that were applied to offset WL Ross’ management fees such that over a 10-year period, WL Ross received approximately \$10.4 million in management fees that should have been offset by transaction fees. As such, in the SEC’s view, such practice needed to be clearly disclosed to WL Ross’ investors.

Furthermore, the SEC alleged that WL Ross did not disclose its management fee offset calculation methodology to the WLR Funds, their advisory boards, or their limited partners. As a result of this omission, the WLR Funds allegedly might not have known about the portion of transaction fees retained by WL Ross.

WL Ross, without admitting or denying the SEC’s findings, agreed to the entry of an order that concluded that it violated Section 206(2) and Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. In determining the appropriate penalty, the SEC considered the remedial measures undertaken by WL Ross including its self-reporting of the management fee offset calculation issue to the SEC’s OCIE, its determination to revise its management fee offset calculation methodology after discovery of the issue, and its voluntary reimbursement of the excess management fees, plus interest. WL Ross agreed to the SEC’s imposition of a \$2.3 million civil penalty.

C. Valuation and Liquidity

We summarize below a recent SEC enforcement action, which included a parallel criminal case, relating to allegations that an investment adviser and its principals inflated the value of the assets they managed in order to conceal significant liquidity issues and poor investment returns.

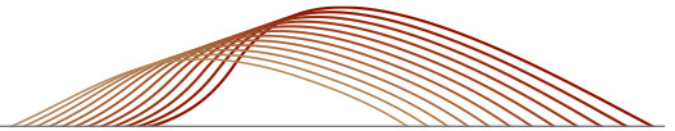
In re Platinum Management (NY) LLC, et al.

On December 19, 2016, the SEC charged Mark Nordlicht, the founder of Platinum Partners, two of its hedge fund advisory firms, Platinum Management (NY) LLC (“Platinum Management”) and Platinum Credit Management, L.P. (“Platinum Credit”), and six other individuals with fraudulently inflating asset values, unlawfully shifting investor money between funds to conceal growing losses and liquidity issues, and using misrepresentations to attract investors to the funds.⁶⁵ In a parallel criminal case, the U.S. Attorney for the Eastern District of New York announced criminal charges against the individuals.

The SEC complaint alleges that Platinum Management deceived investors by inflating the value of Platinum Private Value Arbitrage Fund LP’s (“PPVA”) largest assets—an interest in a small oil production company—Golden Gate Oil LLC (“Golden Gate”).⁶⁶ The inflated valuation allegedly led to an overstatement of the fund’s assets under management by as much as 13%.⁶⁷

The SEC further alleges that Platinum Management concealed an ongoing liquidity crisis at PPVA by continuing to market the PPVA’s flexible redemption policy to potential investors, while internally, the fund viewed the redemptions as “Hail Mary time” and struggled to pay out redemption requests from current investors. As investors sought redemption, Nordlicht, Platinum Management, and Platinum Credit engaged in unlawful schemes to meet redemption requests.

First, in connection with its other major oil investment, Black Elk Energy Offshore Operations LLC (“Black Elk”), Nordlicht and affiliates diverted almost \$100 million in proceeds out of Black Elk and



into PPVA. The SEC alleges that by rigging a noteholder vote that changed noteholders' priority over preferred shares—and using deceptive solicitations in the process—Nordlicht and Platinum were able to wire proceeds out of Black Elk.

Second, Nordlicht sought out investor monies held in separate funds to conceal PPVA's illiquidity. Specifically, the SEC alleges that Nordlicht and Platinum Management conspired with Platinum Credit to have Platinum Credit Opportunities Master Fund L.P. ("PPCO") make over \$30 million in loans to PPVA "contrary to promises made to investors in each fund."⁶⁸

The SEC and criminal charges are pending and the SEC seeks to disgorge, on a joint and several basis, all ill-gotten gains, unjust enrichment, and interest from all but one individual defendant. The SEC also seeks a court-appointed receiver to oversee the funds and other Platinum-related entities. Separately, the funds managed by Platinum Management are currently in liquidation proceedings in the Cayman Islands.

D. Whistleblowers

The SEC's expanding scope of awards and emphasis on protecting whistleblowers from retaliation demonstrates the SEC's continued commitment to its whistleblower program. Below we summarize the SEC's first-ever standalone whistleblower retaliation case as well as two enforcement actions demonstrating the SEC's crackdown on the use of language in severance agreements that in effect impede exiting employees from providing information to the SEC.

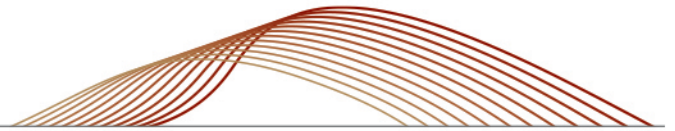
1. In the Matter of International Game Technology

On September 29, 2016, the SEC announced its first stand-alone whistleblower retaliation case.⁶⁹ According to the SEC cease-and-desist order, International Game Technology ("IGT"), a Nevada-based casino-gaming company, retaliated against a director of an IGT division (the "Whistleblower") who reported to senior management and the SEC that IGT's financial statements might contain misstatements.⁷⁰ In a presentation to senior management, the Whistleblower raised concerns over IGT's accounting for costs associated with used parts. Following the presentation, IGT senior management reached an agreement to terminate the Whistleblower. However, a human resources representative instructed senior management to put a hold on the termination when the Whistleblower submitted a complaint to IGT's internal reporting hotline. Thereafter, IGT and its outside counsel conducted an internal investigation and found the accounting model was appropriate. During the investigation, IGT removed the Whistleblower from a merger project and attendance at a global gaming convention, both of which the Whistleblower deemed significant to performing his job. At the conclusion of the investigation, IGT senior management terminated the Whistleblower. During his tenure at IGT, the Whistleblower received several years of positive performance reviews, bonuses and grants at or near the highest level, and no formal disciplinary action for his job performance.

The SEC alleged that IGT's termination of the Whistleblower violated Section 21F(h) of the Securities Exchange Act of 1934. Without admitting or denying the SEC's findings, IGT agreed to pay a civil money penalty of \$500,000 and to cease and desist from future violations of Section 21F(h).

2. In the Matter of BlueLinx Holdings Inc. and In the Matter of Health Net, Inc.

On August 10, 2016 and August 16, 2016, the SEC announced two settlements—the first with BlueLinx Holdings Inc. ("BlueLinx"), an Atlanta-based building products distributor⁷¹ and the second with Health Net Inc. ("Health Net"), a California-based health insurance provider⁷²—for using



severance agreements that allegedly inhibited exiting employees from freely providing information to the SEC.

The SEC asserted that BlueLinx's use of certain severance agreements violated Rule 21F-17.⁷³ The agreements at issue prohibited employees from disclosing confidential information concerning the company unless legally compelled to do so (and upon providing written notice to or receiving permission from BlueLinx). Later versions of those agreements contained provisions that purportedly prevented employees from obtaining any monetary awards from the SEC's whistleblower program. Health Net, like BlueLinx, allegedly used similar agreements that required exiting employees to waive receipt of the whistleblower program's monetary awards.⁷⁴

The SEC alleged that the severance agreements inhibited a potential whistleblower's ability to provide information to the SEC and thus violated the SEC's whistleblower rules. In pursuing the enforcement actions, the SEC emphasized the importance of the whistleblower program's monetary incentives. Notably, the SEC did not allege that a whistleblower was actually affected by the severance agreements.

Both BlueLinx and Health Net settled the charges, without admitting or denying the allegations, for civil penalties of \$265,000 and \$340,000, respectively. Both companies agreed to undertake reasonable efforts to notify its employees within 60 days of the SEC settlement that they are not prohibited from collecting SEC whistleblower awards. In light of these cases, investment advisers are encouraged to review the terms of their severance agreements to ensure compliance with the SEC's whistleblower rules.

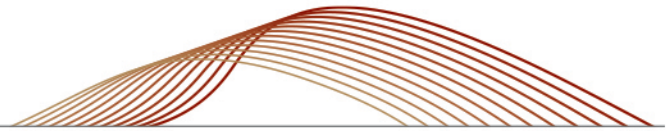
E. Gatekeeper Failures

As noted in its year-end enforcement results, the SEC expressed its commitment to hold gatekeepers such as attorneys and accountants accountable for failures to comply with professional standards. Below we summarize an SEC enforcement action against a private fund administrator charged with gatekeeping failures for missing or ignoring "red flags" while engaged by two private funds.

In the Matter of Apex Fund Services (US), Inc.

On June 16, 2016, the SEC announced that Apex Fund Services (US), Inc. ("Apex"), a New Jersey-based private fund administrator, agreed to settle charges that it failed to detect indicators of fraud while contracted to provide accounting and administrative services to ClearPath Wealth Management ("ClearPath") and EquityStar Capital Management ("EquityStar"), both of which were subsequently charged with fraud by the SEC.⁷⁵

The SEC alleged that Apex, during its engagement with ClearPath, missed or ignored undisclosed brokerage and bank accounts as well as undisclosed margin or credit agreements; failed to account for inter-series and inter-fund transfers stemming from ClearPath's sale of a large investment, which resulted in a \$6.6 million cash deposit; and failed to correct materially false accounting reports and capital statements.⁷⁶ In its services for EquityStar, the SEC claimed that Apex did not properly account for more than \$1 million in undisclosed withdrawals from the EquityStar fund by company owner Steven Zoernack and provided monthly account statements to investors that materially overstated the investors' holdings in the funds because Apex incorrectly characterized the withdrawals as receivables owed to the funds.⁷⁷



The SEC alleged that Apex caused ClearPath and EquityPath to violate Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. Without admitting or denying the SEC's findings, Apex agreed to pay a penalty of \$352,449 and \$16,599 in prejudgment interest and to disgorge \$185,850 in ill-gotten gains. Apex also agreed to pay an additional \$150,000 in civil money penalties for its role in the alleged EquityStar and ClearPath frauds. As part of the settlement, Apex also agreed to retain an independent compliance consultant.

Our prior Reports are available here:

[Spring 2016](#), [Fall 2015](#), [Spring 2015](#), [Fall 2014](#), [Spring 2014](#), [Fall 2013](#), [Spring 2013](#), [Fall 2012](#), [Spring 2012](#), [Fall 2011](#) and [Spring 2011](#).



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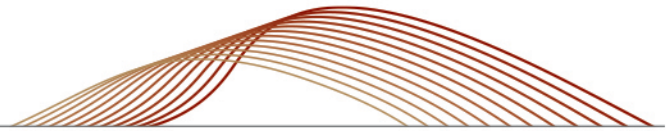
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¹ This set of amendments codify an SEC staff no-action letter issued in January 2012 clarifying the circumstances under which certain advisers operating their businesses through multiple advisory entities could file on a single Form ADV, rather than multiple Forms ADV. American Bar Association, Business Law Section, SEC No-Action Letter (Jan. 18, 2012), available at <http://www.sec.gov/divisions/investment/noaction/2012/aba011812.htm> ("2012 No-Action Letter"). For a discussion of the factors considered in connection with conducting a single advisory business by multiple advisory entities, see 2012 No-Action Letter.

² Although the Filing Adviser and each Relying Adviser must operate under a single code of ethics, the code may take into account that different requirements may apply as a result of different jurisdictions in which a relying adviser operates. Form ADV and Investment Advisers Act Rules," Investment Advisers Act Release No. 4509 (Aug. 25, 2016) (the "Release"), Footnote 209, available at: <https://www.sec.gov/rules/final/2016/ia-4509.pdf>.

³ This portion of the Report was prepared with the assistance of Mourant Ozannes, a leading international law firm that advises on the laws of the British Virgin Islands, the Cayman Islands, Guernsey and Jersey.

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⁶ *Id.*

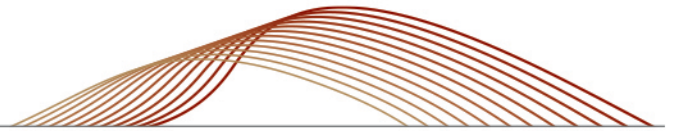
⁷ Order Denying Motion to Dismiss, *In re Allergan, Inc. Proxy Violation Securities Litigation*, No. SA-CV-14-2004-DOC at 22 (C.D. Cal. Nov. 9, 2015).

⁸ Liz Hoffman & David Benoit, *Allergan, Valeant, Pershing Square Settle Lawsuits Over Takeover Attempt*, WALL ST. J. (Apr. 9, 2015).

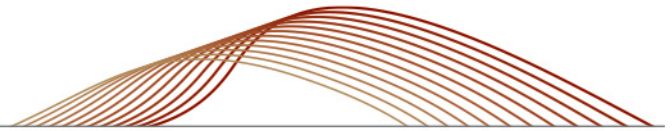
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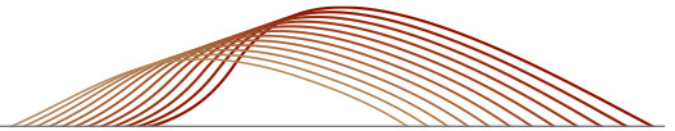
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- ¹³ *Id.*
- ¹⁴ *Id.* at 5.
- ¹⁵ Julia La Roche, *Hedge Fund Manager Kyle Bass is Going After Big Pharma and Their 'BS Patents,'* BUSINESS INSIDER (Jan. 7, 2015), <http://www.businessinsider.sg/kyle-bass-going-after-us-pharma-2015-1/#.VmDrrnPIvct>.
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- ¹⁹ *Id.*
- ²⁰ *Id.* at 16-17.
- ²¹ Notice of Appeal, *Good Hill Master Fund L.P. v. Deutsche Bank AG*, Index No. 600858/10 (N.Y. Sup. Mar. 4, 2016), Dkt. No. 233.
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- ³² *Id.* ¶ 57.
- ³³ *Id.* ¶ 70.
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- ⁴⁶ *Vaughan*, 2016 WL 4529040, at *7.
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- ⁵⁰ SEC Announces Enforcement Results for FY 2016, Exchange Act Release No. 2016-212 (Oct. 11, 2016), <https://www.sec.gov/news/pressrelease/2016-212.html>.
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- ⁶⁶ Complaint, ¶¶ 2-4, *SEC v. Platinum Management (NY) LLC*, (E.D.N.Y. Dec. 19, 2016), <https://www.sec.gov/litigation/complaints/2016/comp-pr2016-267.pdf>.
- ⁶⁷ *Id.*
- ⁶⁸ *Id.*
- ⁶⁹ SEC: Casino-Gaming Company Retaliated Against Whistleblower, Exchange Act Release No. 2016-204 (Sep. 29, 2016), <https://www.sec.gov/news/pressrelease/2016-204.html>.
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- ⁷² Company Punished for Severance Agreements That Removed Financial Incentives for Whistleblowing, Exchange Act Release No. 2016-164 (Aug. 16, 2016), <https://www.sec.gov/news/pressrelease/2016-164.html>.
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- ⁷⁶ *In the Matter of Apex Fund Services (US), Inc.*, Administrative Proceeding File No. 3-17299, Order Instituting Cease-And-Desist Proceedings Pursuant to Section 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing a Cease-And-Desist Order, <https://www.sec.gov/litigation/admin/2016/ia-4428.pdf>.
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