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Private Fund Report—Summary of Key Developments—Spring 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 fund industry, as the Securities and Exchange Commission (the "SEC"), the Commodity Futures Trading Commission (the "CFTC"), and various other regulatory agencies, including the Board of Governors of the Federal Reserve System (the "Federal Reserve") and the Department of the Treasury (the "Treasury"), continue to propose and finalize rules and issue guidance to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and the Jumpstart Our Business Startups Act (the "JOBS Act"). There have also been a number of significant developments in the private fund tax area, and the SEC and private plaintiffs have continued to bring enforcement actions and litigation involving private investment funds and fund managers.

This Report provides an update since our last **Report** in Fall 2015, and highlights recent regulatory and tax developments, as well as recent civil litigation and enforcement actions as they relate to the private fund industry. Paul Hastings attorneys are available to answer your questions on these and any other developments affecting private funds and their investors and advisers.

TABLE OF CONTENTS

I. SECURITIES-RELATED LEGISLATION AND REGULATION

A. Dodd-Frank Act Updates

The following items describe the status of various proposed and final rules and regulations implementing the Dodd-Frank Act that are most relevant to the private fund industry.

1. SEC Issues Staff Report on the Definition of 'Accredited Investor'

On December 18, 2015, the SEC released a staff report (the "AI Report") on the definition of "accredited investor" in Regulation D of the Securities Act of 1933, as amended (the "Securities Act"). The AI Report was prepared by SEC staff from the Divisions of Corporation Finance and Economic and Risk Analysis. As discussed in our **Spring 2014** Report, Section 413(b) of the Dodd-Frank Act requires the SEC to undertake a review of the definition of "accredited investor," as it applies to natural persons, at least once every four years. The AI Report represents the first such review.

The AI Report contains a history of the accredited investor definition, as well as an overview of other investment eligibility criteria used in both the United States and in foreign countries. It then turns to focus on the current set of criteria to be deemed an accredited investor and explores the ways in which the current definition overlooks certain segments of the population that may be capable of making informed investment decisions. The AI Report concludes with the SEC staff's recommendations, which include, but are not limited to, the following:

- Natural Persons. The AI Report recommends leaving the current income and net worth thresholds in place, subject to investment limitations, and creating new inflation-adjusted income and net worth thresholds that are not subject to investment limitations. In addition, the staff recommends indexing all financial thresholds for inflation on a going-forward basis. Most notably, the AI Report suggests creating additional means by which natural persons may become accredited that are not tied to the traditional financial metrics. These alternative methods of qualifying may include (i) individuals with a minimum amount of investments, (ii) individuals with certain professional credentials, (iii) individuals with experience investing in exempt offerings, (iv) knowledgeable employees of private funds (in addition to those already qualified to invest), and (v) individuals who pass an accredited investor examination.

- Entities. For entities, the AI Report recommends revising the $5 million assets test with a $5 million investments test, as well as including all types of entities instead of specifically enumerated types of entities.

- Grandfathering. The AI Report suggests that existing investors that are accredited investors under the current definition should be grandfathered and allowed to invest in future offerings of the issuer's securities, even if they are not accredited under a revised definition.

The SEC is soliciting comments from the public on the accredited investor definition and on the recommendations contained in the AI Report. A full copy of the AI Report can be found on the SEC's website **here**.

2. *SEC's Division of Investment Management to Concentrate on Rulemaking for Stress Testing and a Uniform Fiduciary Standard in 2016*

David Grim, the head of the SEC's Division of Investment Management, stated that the SEC staff continues to press forward on at least two outstanding Dodd-Frank Act initiatives. Speaking on December 16, 2015 at the Investment Company Institute Securities Law Development Conference, Mr. Grim remarked that in 2016, the SEC staff hopes to make progress with respect to the following:

- Stress Testing. Mr. Grim noted that the SEC staff is considering a recommendation for new requirements for stress testing by large investment advisers and investment companies. The SEC's goal, according to Mr. Grim, is that such requirements would help large advisers and funds understand the potential impact of stress events.

- Uninform Fiduciary Standard. Mr. Grim confirmed that the Division of Investment Management staff is working closely with the staff throughout the SEC, in particular, in the Division of Trading & Markets, to develop a recommendation to establish a uniform fiduciary standard of conduct for broker-dealers and investment advisers when they provide investment advice to retail customers. Mr. Grim's comments follow SEC chair Mary-Jo White's November 2015 remarks, which were discussed in our previous **Report**, that the SEC staff is fully engaged in formulating such a proposal. As previously discussed in our **Spring 2015 Report**, the rulemaking would be pursuant to Section 913(f) of the Dodd-Frank Act, which authorizes, but does not require, the SEC to promulgate rules which would hold broker-dealers providing investment advice about securities to retail customers to a similar standard of conduct applicable to investment advisers. As described below in Section I.C.1, the Department of Labor (the "DOL") finalized its own rules that raise investment advice standards for brokers handling retirement accounts. The DOL's rules are facing legal challenges, and some industry observers see the SEC's efforts in this area as a bid to defend its traditional regulatory space from perceived encroachment by the DOL.

Mr. Grim also indicated that the SEC staff will focus on crafting proposals in 2016 relating to (i) transition planning by registered investment advisers in the event of a major disruption, and (ii) establishing a program of third-party compliance reviews.

The complete transcript of Mr. Grim's remarks can be found **here**.

3. *SEC Approves Adjustment to Net Worth Threshold for Qualified Clients*

On June 14, 2016, the SEC issued an **Order** increasing the net worth requirement for a fund investor to be deemed a "qualified client" for purposes of the Investment Advisers Act of 1940 (the "Advisers Act"). The Order raised the net worth threshold from $2.0 million to $2.1 million. An investor is also a qualified client if the investor has at least $1 million under management with the investment adviser. This $1 million threshold has not changed under the Order.

SEC registered investment advisers are prohibited under the Advisers Act from entering into a compensation arrangement that pays the adviser based on a share of capital gains or capital appreciation of client funds unless the client is a qualified client or, in the case of a private fund, all of the fund's investors that are subject to performance-based compensation are qualified clients. Most types of performance allocations, performance fees, and carried interest arrangements will trigger the prohibition.

The change was made pursuant to a Dodd-Frank Act amendment to the Advisers Act, which requires the SEC to adjust the qualified client standards for inflation every five years. The Order is effective as of August 15, 2016. Existing client fee arrangements entered into prior to the effective date of the Order generally will not be impacted by the change.

4. *Volcker Rule Updates*

The Volcker Rule (Section 619 of the Dodd-Frank Act) is now largely in effect. As discussed in our prior **Reports** and **Client Alerts**, the Volcker Rule generally prohibits banking entities from engaging in proprietary trading and from acquiring or retaining ownership interests in, sponsoring, or having certain relationships with a hedge fund or a private equity fund. These prohibitions are subject to a number of statutory exemptions, restrictions, and definitions. Final rules implementing the Volcker Rule were adopted by the Federal Reserve, the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), the SEC, and the CFTC in December 2013, and are available **here** (OCC, Federal Reserve, FDIC, and SEC) and **here** (CFTC).

Given the complexities of the Volcker Rule, the Federal Reserve, OCC, FDIC, SEC, and CFTC (collectively, the "Agencies") continue to issue coordinated guidance on Volcker Rule implementation issues in the form of responses to Frequently Asked Questions ("FAQs"). Substantively identical versions of the FAQs (although formatted differently) and responses are available on each Agency's website, which may be accessed **here** (Federal Reserve), **here** (OCC), **here** (FDIC), **here** (SEC), and **here** (CFTC).

Developments since our Fall 2015 Report include the Agencies updating the FAQs addressing various issues such as:

- Terminating a permissible line of business or trading activity, and the procedures to divest of formerly permissible assets;
- The effective date of restrictions on covered transactions under Regulation W with a covered fund and the treatment of covered transactions prior to the restrictions being imposed; and
- The capital treatment of certain Collateralized Debt Obligations backed by Trust Preferred Securities.

Finally, legislative attempts to amend the Volcker Rules continue, with the Investor Clarity and Bank Parity Act (HR 4096) being passed by the U.S. House of Representatives by a commanding 395-3 vote, which would allow covered funds to invest in a bank affiliate, as long as that affiliate does not share the same or similar name with the related bank, and the fund does not use the word "bank" in its name at all. While such legislation must be adopted by the U.S. Senate and approved by the President before becoming effective, the overwhelming approval in the House clearly suggests that legislative changes to the margins of the Volcker Rule's limitations may be possible.

B. JOBS Act Updates

1. Crowdfunding Rules Take Effect

"Regulation Crowdfunding," which allows issuers to offer and sell their securities via online crowdfunding portals that are registered with the SEC, became effective on May 16, 2016.

As discussed in our prior **Report**, Regulation Crowdfunding allows an issuer, together with its predecessors and other issuers under common control, to raise up to $1 million during any 12-month period through an online funding portal intermediary. In addition to the limitation on capital raised, the rules impose limits on the amount that individual investors may contribute over a 12-month period to all Regulation Crowdfunding offerings. If either of an investor's net worth or annual income is less than $100,000, then that individual may invest the greater of either $2,000 or 5% of the lesser of the investor's annual income or net worth. An investor may invest up to 10% of the lesser of the investor's annual income or net worth if both figures are over $100,000.

All Regulation Crowdfunding capital raises must be made through an intermediary that is registered with the SEC as either a broker-dealer or funding portal, the latter representing a new type of SEC registration. Each offering must be conducted online through the intermediary's public website in a manner such that potential participants may exchange information, ideas, and evaluations concerning the issuance.

Issuers are subject to a variety of disclosure and reporting requirements, some of which phase-in depending on the amount of capital the issuer is trying to raise. For example, in response to comments to the proposed rules, the requirement that an issuer's financial statements be subject to an annual audit is, in the final rules, limited to offerings targeting $500,000 or more. Issuers seeking to raise between $100,000 and $500,000 would need to have an independent public accountant review its financial statements, while issuers seeking less than $100,000 would be required only to have their financial statements reviewed and certified by the issuer's chief financial officer. Issuers are also subject to limitations on advertising relating to the capital raise.

By statute, certain issuers of securities are not eligible to raise capital via crowdfunding, including non-U.S. issuers and private investment funds that rely on exclusions from the definition of "investment company" under Sections 3(b) or 3(c) of the Investment Company Act of 1940, as amended. In addition, the final rules preclude certain "bad actors" and other categories of issuers from participating in a Regulation Crowdfunding offering.

The full text of Regulation Crowdfunding is available **here**.

C. *Other Securities-Related Updates*

1. Department of Labor Adopts Final Rules on Fiduciary Standard for Broker-Dealers

On April 6, 2016, the Department of Labor (the "DOL") issued a final regulation (the "Final Rule") re-defining who is a "fiduciary" under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The Final Rule re-writes and expands the scope of the current 40-year-old regulation that delineates when a person becomes a fiduciary by reason of providing "investment advice" for a fee or other compensation with respect to plan assets. The DOL makes it clear in the Final Rule that the regulation applies equally to communications with IRA owners, whom the DOL has sought to protect with this regulation.

Some significant effects of the Final Rule are as follows:

- Brokers, registered investment advisors, 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 its own 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.

- Investment education will not be fiduciary advice if the materials used comply with the guidelines established in the final rule; provided, however, that education materials provided to IRAs, with no independent plan fiduciary, may not reference specific investment alternatives.

- Advisors who receive compensation from making recommendations regarding retirement assets could be engaging in a prohibited transaction unless an exemption applies.

- The DOL has issued two new prohibited transaction exemptions:

  - "Best Interest Contract Exemption" to permit advisors of small plans and IRAs to continue to receive compensation if certain conditions are met.

  - Class Exemption for "Principal Transactions" which would allow investment advice fiduciaries to engage in purchases and sales of certain investments out of their inventory with plans, participants, beneficiary accounts, and IRAs provided that certain conditions are satisfied.

The Final Rule and subsequent prohibited transactions contain over 1,000 pages of new material and at this early juncture it is not clear exactly how the Final Rule will relate to real world situations. The DOL has indicated a willingness to listen to issues that the Final Rule creates and provide guidance where necessary. The Final Rule will go into effect in April of 2017.

2. SEC 2016 Examination and Enforcement Priorities

On January 11, 2016, the SEC Office of Compliance Inspections and Examinations ("OCIE") published its 2016 National Exam Program ("NEP") priorities for examinations of SEC-registered entities, including private fund advisers (the "Priorities List"). The purpose of the Priorities List is to communicate with investors and registrants about areas perceived by the NEP to have potentially heightened risk to investors and/or the integrity of capital markets. For 2016, the Priorities List focuses on the same three thematic areas as the previous year, which we previously reported in our **Spring 2015 Report**. These three areas are:

- Examining matters of importance to retail investors, including investors saving for retirement. OCIE states that its focus on retirement investments stems from the increasing number of products, information, and services that are available to retail investors, including, but not limited to, private funds. The NEP's examination initiatives to assess risks related to this trend include, among others, a review of potential conflicts and risks involving advisers to public pension plans, and a registered entity's supervision of branch offices.

- Assessing issues related to market-wide risks. OCIE intends to examine for structural risks and trends that may involve multiple firms or entire industries, including, but not limited to, monitoring registrants' cybersecurity controls and evaluating investment advisers' liquidity risk management practices.

- Using data analytics to identify and examine registrants that may be engaged in illegal activity. OCIE intends to use its enhanced capabilities in data analytics to focus on registrants and firms that appear to be potentially engaged in fraudulent and/or other potentially illegal activities, including, among others, registrants with a history of misconduct. OCIE also plans to focus on anti-money laundering programs, microcap fraud, excessive or inappropriate trading, and suitability issues related to the promotion and sales practices of new, complex, and high risk products.

In addition to the three thematic areas described above, OCIE expects to allocate additional examination resources to other areas that may be relevant to private fund advisers, such as continuing its examinations of fees and expenses of private equity fund advisers, never-before-examined advisers, and the practices of transfer agents involved with private offerings. In addition, OCIE plans to focus on private placements generally in 2016, including offerings involving Regulation D of the Securities Act or the Immigrant Investor Program, commonly known as the "EB-5 Program," to evaluate whether legal requirements are being satisfied in connection with such private placements.

The Priorities List is not exhaustive and OCIE staff intends to conduct additional examinations in 2016 focused on risks, issues, and policy matters that are not addressed in the Priorities List. The full Priorities List is available **here**.

3. FINRA 2016 Regulatory and Examination Priorities

On January 5, 2016, the Financial Industry Regulatory Authority ("FINRA") published its 2016 Regulatory and Examination Priorities Letter (the "Letter"), which sets forth areas of focus and recurring concern on which FINRA will concentrate during its exams of member broker-dealers. The Letter highlights three broad areas of concern, which are as follows:

- Culture, Conflicts of Interest, and Ethics. FINRA plans to continue to evaluate the norms, practices, and expected behaviors of a member firm's executives and employees, especially as they relate to conflicts of interest and ethics issues that may arise during the course of business. Specifically, FINRA will concentrate on five indicators of firm culture: (i) whether control functions are valued within the organization; (ii) whether policy or control breaches are tolerated; (iii) whether the organization proactively seeks to identify risk and compliance events; (iv) whether supervisors are effective role models of firm culture; and (v) whether sub-cultures (*e.g.*, at a branch office or separate department) that may not conform to corporate culture are identified and addressed. FINRA notes in the Letter that its emphasis on culture is closely related to another area of focus for 2016: supervision.

- Supervision, Risk Management, and Controls. This area of focus will include management of conflicts of interest, technology considerations, use of outsourcing, and anti-money laundering policies and procedures. As part of these initiatives, FINRA plans to examine, among other things, firms' incentive structures, information leakage, valuation, cybersecurity practices, suspicious activity monitoring, and activities involving microcap securities.

- Liquidity. FINRA plans to continue monitoring member firms' practices to manage funding and liquidity risk by evaluating the adequacy of firms' contingency funding plans in light of their business models. In particular, FINRA plans to focus on high-frequency trading ("HFT") firms in this regard. Because of such firms' market-making activities, FINRA is concerned that changes to an HFT firm's execution rate triggered by a market event or other circumstances could create liquidity challenges for the firm.

In addition to the three broad areas summarized above, the Letter singles out several other issues on which FINRA will focus during its examinations in 2016. One such area of concentration relates to private placements and the ability to conduct general solicitations under SEC Rule 506(c) of Regulation D and the crowdfunding rules discussed in our prior **Report**. FINRA notes in the Letter that it has observed some communications used by firms concerning private placements have not reflected a discussion of significant risks and lack of liquidity associated with the investments offered. The Letter specifically states that FINRA plans to continue monitoring advertisements and materials posted on the internet concerning private placements.

The full text of the Letter can be accessed through FINRA's website **here**.

4. FINRA to Require Registration of Developers of Algorithmic Trading Strategies

On April 7, 2016, the SEC approved a FINRA proposal which will require associated persons of a registered broker-dealer to register as securities traders if they are primarily responsible for designing, developing, or modifying algorithmic trading strategies. Such individuals had previously not been required to register under most circumstances. However, with the widespread adoption of systematic and quantitative trading strategies, FINRA now believes that requiring registration of algorithmic trading personnel, and the associated education and testing of such personnel, would help reduce "problematic conduct" that can stem from such strategies. Specifically, FINRA has observed instances where algorithmic programs are deficient in "checking for order accuracy, inappropriate levels of messaging traffic, wash sales, failure to mark orders as 'short' or perform proper short sale 'locates,' and inadequate risk management controls."

Although the new registration requirements do not apply to registered investment advisers, unless the investment adviser is also a registered broker-dealer, firms utilizing algorithmic trading strategies should ensure that their policies and procedures contain measures aimed at detecting and reducing the types of deficiencies noted above.

The full text of the SEC's order adopting FINRA's proposal can be found **here**.

5. *SEC Official Says to Expect More Cybersecurity Enforcement Action*

The head of the SEC's Division of Enforcement, Andrew Ceresney, stated at the Investment Company Institute's Mutual Funds and Investment Management Conference that the industry should expect to see more enforcement actions centered on cybersecurity matters in the future.

The remarks follow an extended period of evaluation of firms' cybersecurity practices by the SEC and other regulators. As discussed in our prior **Report**, OCIE published a risk alert in September 2015, which initiated a second round of cybersecurity sweep examinations to be performed by OCIE. The initial round of examinations in 2014 culminated with a report summarizing OCIE's findings and suggesting ways to improve firm practices. The initial round of examinations and report of OCIE's findings were discussed in our **Fall 2014 Report** and our **Spring 2015 Report**, respectively. Mr. Ceresney's statements may signal that the SEC staff feels ready to pivot from what has been largely an information gathering initiative toward increased enforcement activity.

For further information on cybersecurity trends among financial institutions, please see the November 2015 **Client Alert** prepared by the Paul Hastings Global Privacy & Cybersecurity Practice Group.

6. *FAST Act Reduces Privacy Notice Delivery Requirements for Registered Investment Advisers*

On December 4, 2015, President Obama signed into law the Fixing America's Surface Transportation Act (the "FAST Act"). The law's major focus is to authorize certain highway expenditures, but it also amends rules applicable to financial institutions (including registered investment advisers) relating to such firms' obligations to deliver privacy policies.

Specifically, the FAST Act amends the Gramm-Leach-Bliley Act (the "GLB Act"), which requires all financial institutions to disclose their policies for collecting, using, and disclosing nonpublic personal information ("NPI"). Under the previous rules, such disclosures were required to be made both at the time of establishing a relationship with an individual client and on an annual basis thereafter. The FAST Act removes the annual notice requirement so long as the following two conditions are satisfied:

- Limited Sharing of NPI. The financial institution must only share NPI within the scope of the GLB Act's enumerated exceptions that do not trigger an opt-out right by the client (*i.e.*, the right of the client to opt out of the type of NPI sharing). Some examples of acceptable NPI sharing that do not trigger an opt-out right are: (i) sharing NPI with third parties for the purposes of performing services for the financial institution; (ii) sharing NPI as necessary to effect, administer, or enforce a transaction requested or authorized by the client; and (iii) to protect the security of the financial institution's records against fraud and for institutional risk control purposes.

- No Changes to Policy. In addition, in order to be exempted from the annual delivery requirement, the financial institution must not have made any amendments to the NPI sharing policies or procedures since the last privacy notice was provided to its clients.

For so long as both requirements are satisfied, a financial institution will not be obligated to deliver annual privacy notices to its clients (although the requirement of an initial notice remains in place).

7. *Brexit—Political Uncertainty within the European Union*

As has been extensively covered in the media, a referendum was held in the United Kingdom on June 23, 2016, the outcome of which was a vote in favor of the United Kingdom leaving the EU. As a result of and based on the pronouncements of the U.K. government both before and after that referendum, it is probable that negotiations will take place to determine the terms of the U.K.'s departure from, and of its new relationship with, the EU. These negotiations will likely be further complicated by the installation of Theresa May as the new U.K. prime minister following David Cameron's resignation. The events around Brexit and the likely U.K. negotiations may create a period of political uncertainty both in the U.K. and the EU more widely and may be exacerbated by other EU Member States seeking to renegotiate their own relationships with the EU in each case resulting in significant uncertainty in both domestic and global financial markets.

It is important to note that, for the time being and in all likelihood for at least two years, the U.K. remains a member of the EU and accordingly, all existing EU regulations and directives (including EMIR and AIFMD that are discussed below) will continue to apply to the U.K. on their current bases. If the U.K. does ultimately leave the EU, then the terms of its departure will dictate the ongoing applicability of EU law to the U.K.: for example, were the U.K. to leave the EU but achieve membership of the European Economic Area ("EEA"), the U.K. would remain a member of the so-called "EU single market" and remain subject to, and benefit from, ongoing EU regulations and directives.

For more information, please see our recent Client Alert, available **here**.

8. *Update on European Derivatives Regulation*

As reported in our **Fall 2015 Report** and our previous related Client Alerts, available **here**, Europe's implementation of its Dodd-Frank Act equivalent, EMIR[1] continues. Most notably since our last report, the timelines for the go-live of the first EMIR clearing obligation was published (relating to a limited number of G4 currency denominated interest rate derivatives) and June 21, 2016 marked the beginning of clearing for so-called "Category 1" entities *i.e.*, existing Clearing Members in relation to the relevant types of derivatives. Go-live for the same products will follow for other entities on a staggered time line from December 21, 2016 (Category 2) to December 21, 2018 (Category 4). Also in June, the implementation of the other key outstanding EMIR obligation, that relating to margin for OTC derivatives which are not centrally cleared, was delayed from the planned September 2016 implementation. Notwithstanding such delay, it is not anticipated that the timeline for the implementation of the corresponding Japanese and U.S. rules will change.

9. *Update on AIFMD—Latest Developments in Europe*

We set out below a brief update of recent guidance and steps taken in connection with the implementation and functioning of the Alternative Investment Fund Managers Directive[2] ("AIFMD"), relating to alternative investment fund managers ("AIFMs") and alternative investment funds ("AIFs") in the EEA.[3]

Marketing Funds—Update

As mentioned in our **Fall 2014 Report**, the European regulator ("ESMA") sent its advice to the European Commission ("EC") regarding the extension of the AIFMD passport regime to certain non-EU countries along with their opinion on the functioning of the AIFMD passport regime.[4] In January 2016, ESMA published the letter of response from the EC.[5]

The EC confirmed that it is in agreement with ESMA's approach of implementing a country-by-country assessment of the suitability of an AIFMD passport for specified countries. ESMA has already recommended that Jersey and Guernsey have the passport extended to their jurisdictions. The recommendation of an extension also applied to Switzerland, under the condition that it enacts proposed amendments to local law, aimed at improving the effectiveness of the cooperation process between national authorities.

The EC has asked ESMA to complete its assessment of the U.S., Hong Kong, Singapore, Japan, Canada, the Isle of Man, the Cayman Islands, Bermuda, and Australia by June 30, 2016. The assessment should include details on the capacity of the relevant supervisory authorities and their track record in ensuring effective enforcement as well as any potential market disruption of the proposed extension, through an outline of the expected inflow of funds by type and size.

The EC's response letter also confirmed its agreement to ESMA's suggestion that, as a lack of evidence was available at the time of their original opinion in July 2015, ESMA should provide a further opinion on the functioning of the AIFMD passport regime and National Private Placement Regime, once there is some experience of AIFMD functioning across Member States. The EC has suggested that it would like this opinion to be delivered before 2017.

AIFMD—Remuneration Guidelines

The AIFMD includes a requirement for each AIFM to have remuneration policies and practices in place for different groups of staff ("identified staff"), including senior management, risk takers, and those who have a material impact on the risk profile of the AIFM or AIFs.[6] These policies and practices must be consistent with, and promote, sound and effective risk management and not encourage inconsistent risk taking.

The AIFMD includes a further requirement for ESMA to ensure the existence of guidelines on sound remuneration policies, which comply with the relevant requirements laid out in AIFMD, (the "AIFMD Guidelines").[7] The AIFMD Guidelines were recently used as a basis for a new set of guidelines on sound remuneration for undertakings for collective investment transferable securities ("UCITS") as required under the UCITS V Directive, which were published on March 31, 2016.[8] The March publication also included an amendment to the AIFMD Guidelines, which will apply from January 1, 2017.

The purpose of the revision is to clarify that AIFMs which are part of a group subject to different sectorial rules will continue to also be subject to AIFMD. However, non-AIFMs may be permitted to deem certain staff of an AIFM in the same group to be "identified staff" for the purpose of its own sectoral remuneration rules. This helps clarify the application of the rules to groups, aligning the rules in the industry by removing any discrepancy with the prudential rules for banks and investment firms (the Capital Requirements Directive IV).[9]

New AIFMD Q&As

As part of its role as the supervisory authority, ESMA develops question & answer documents ("Q&As") to clarify and develop market understanding and practices related to certain EU legislation.

On April 5, 2016, ESMA updated its AIFMD Q&A to include clarification on the notification requirements regarding additional investment in existing AIFs.[10] The Q&A makes clear that where an AIF makes an offer of additional fund units to existing investors only, no notification to the relevant national competent authority under Article 31(2) of AIFMD is required.

10. Cayman Update

Update Regarding Automatic Exchange of Information

On April 12, 2016, the Cayman Islands Department for International Tax Cooperation ("DITC") issued an industry advisory announcing the issuance of the Cayman Islands Common Reporting Standard ("CRS") Guidance Notes (the "Guidance Notes") and the availability of an updated Entity Self-Certification Form.

The Guidance Notes, which were issued following consultation with industry and the Cayman Islands CRS working group, aim to provide practical assistance in complying with CRS in the Cayman Islands. The requirements of CRS became operative in the Cayman Islands from January 1, 2016. Any account opened in a Cayman Islands reporting financial institution from this date is subject to new account due diligence procedures and any account opened before such date is subject to pre-existing account due diligence procedures to identify reportable accounts. Notification and reporting requirements will come into effect in 2017.

In terms of the updated Entity Self-Certification Form, the most notable change reflected is the option for "Passive NFFEs" to disclose, for U.S. FATCA purposes, either their controlling persons, under the CRS definition, or their substantial U.S. owners using the U.S. Treasury regulations definition.

On April 12, 2016, the DITC also announced the publication of an updated list of CRS participating jurisdictions.

The DITC has also announced that it will be adopting a "soft approach to enforcement of notification and reporting due dates" for purposes of U.S. FATCA and the U.K. equivalent regime, commonly referred to as U.K. CDOT, for 2016. According to the DITC, Cayman Islands' reporting financial institutions that submit notifications to the DITC for U.S. FATCA and U.K. CDOT on or before June 10, 2016, and file returns for U.S. FATCA and U.K. CDOT on or before July 8, 2016, will not attract any adverse consequences or enforcement measures.

The Limited Liability Companies Law, 2016

On June 8, 2016, the Cayman Islands published the Limited Liability Companies Law, 2016, which provides for the formation and registration of a new vehicle, the Cayman Islands limited liability company (a "Cayman LLC"). The law is expected to be brought into effect in late June 2016. The introduction of the Cayman LLC is in response to a number of requests from the U.S. investment funds industry that the Cayman Islands offer a vehicle more closely aligned with the U.S. LLC vehicles (*i.e.*, a vehicle along the lines of a Delaware LLC, having separate legal personality like a Cayman Islands exempted company, but with features of a Cayman Islands exempted limited partnership, in the sense that such company would not be limited by shares nor by guarantee but rather by reference to members' capital accounts and capital commitments, with freedom of contract among the members as to the internal workings of the company). Some advantages of a Cayman LLC would be to allow for simplified fund administration (*i.e.*, easier tracking/calculation of the value of a member's investment in the LLC), more flexible governance concepts, and possibly a closer matching of the legal framework applicable between the "onshore" and "offshore" investors (*e.g.*, where there are parallel "onshore" and "offshore" funds in a structure). The flexible nature of the Cayman LLC makes the vehicle also suitable for a broad range of general corporate and commercial uses, such as joint venture companies, management holding vehicles, carried interest distribution vehicles, and general partner entities.

The Confidential Information Disclosure Bill, 2016

On May 11, 2016, the Cayman Islands published The Confidential Information Disclosure Bill, 2016, the aim of which is to repeal and replace the Confidential Relationships (Preservation) Law by September 2016. The bill seeks to: revise the circumstances in which a person may be required or authorized to disclose confidential information without the express consent of the person to whom the duty of confidentiality is owed; clarify the local competent authorities to whom information can be disclosed and in what circumstances; and remove the current criminal sanction for breach of confidential information while maintaining common law civil liability.

Primacy of Arbitration Recognized as Stay Granted in Cayman Insolvency—In Re the SPhinX Group of Companies

The Cayman Islands Court of Appeal has recently upheld a stay of certain Cayman liquidation applications, in favor of an arbitration in New York. The applications were for a reserve to be made for a disputed debt. The Court held that the reserve application would have required the Cayman Court to consider the substantive merits of the disputed debt, which dispute was governed by an arbitration agreement. The legislative justification is grounded in section 4 of the Foreign Arbitral Awards Enforcement Law (1997 Revision) of the Cayman Islands which provides that any party to Court proceedings may apply to have the proceedings stayed if they are “in respect of any matter agreed to be referred” to arbitration. The decision is reflective of a broader international trend towards recognizing the greater prominence of arbitration and the decline in the types of disputes that are considered non-arbitrable. In particular, it underlines the importance of arbitration in insolvency proceedings, and allows for potential stays in such proceedings where mandated by the contractual obligations of the insolvent company and third parties.

II. TAXATION

Since our last Report, the U.S. Internal Revenue Service (“IRS”) and the U.S. Treasury Department (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 additional 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. However, it seems increasingly likely that such reform, if and when it comes, will not occur until at least in 2017, after the November 2016 presidential election.

A. New Reporting Requirements for Holders of Specified Foreign Financial Assets

A U.S. individual has a filing obligation on IRS Form 8938 as part of its annual tax return if it holds an amount in excess of a certain threshold of “specified foreign financial assets.” The relevant minimum ownership threshold amount ranges from $50,000 to $600,000, depending on whether the U.S. individual is married and depending on whether the U.S. individual lives abroad. Specified foreign financial assets are (i) certain financial accounts maintained by a "foreign financial institution," (ii) certain stocks or securities issued by a non-U.S. person held for investment, (iii) financial instruments or contracts with a non-U.S. issuer or counterparty, and (iv) interests in a "foreign entity."

The Treasury has recently finalized regulations, effective for tax years beginning January 1, 2016, to expand the reporting requirements from specified foreign financial assets owned directly by individuals to also include domestic corporations and partnerships owned by such individuals which themselves own specified foreign financial assets.

The new filing obligation is a two-part test. First, an entity is captured by the new rules only if it is a specified domestic entity, which is a domestic corporation or partnership if it is "closely held" and at least 50% of that entity's gross income for the tax year is passive income (*e.g.*, dividends, interest, rents, etc.) or at least 50% of the assets, based on fair market value or book value, held by that entity for the tax year, weighted by total assets, measured quarterly, are assets that produce passive income. "Closely held" for these purposes generally means, in the case of a corporation, a U.S. individual holds an 80% or greater total combined voting power of all classes of stock of the corporation entitled to vote or an 80% or greater total value of the stock of the corporation, and in the case of a partnership, a U.S. individual holds an 80% or greater interest in the capital or profits of the partnership. Constructive attribution rules may apply for these purposes.

Second, the entity itself will have a filing obligation on Form 8938 only if it has an interest in specified foreign financial assets above $50,000 on the last day of the taxable year or $75,000 at any time during the taxable year, taking into account certain attribution rules.

The most significant change in the Final Regulations relative to the Proposed Regulations is that the Final Regulations solely rely on an objective 80% ownership test to assess whether the relevant domestic entity is "closely held." The Proposed Regulations had contained an alternate test to the 80% ownership rules that looked to whether the principal purpose of the U.S. individual's ownership was to evade the Form 8938 reporting requirement. The finalized Treasury Regulations eliminated this subjective test and rely wholly on the 80% ownership rules.

B. New Partnership Audit Rules

As reported in our recent **Client Alert**, new partnership audit rules will generally take effect for tax years beginning January 1, 2018, although 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 harming later-admitted partners. Partnerships will have some flexibility over whether to undergo these partnership-level adjustments or to adjust taxes at the partner level in a fashion similar to the prior partnership audit regime. However, electing to make adjustments at a partner level comes at a cost of an increased interest rate on the past-due taxes and likely increased administrative expenses for the partnership. Treasury Regulations are still forthcoming relating to these rules, and so there are many open questions as to how exactly the new partnership audit regime will work. Limited liability company and partnership agreements should be reviewed prior to 2018 to determine what updates may be necessary to account for the new rules.

C. New Rules on Earnings Stripping

The IRS released rules on earnings stripping in conjunction with its new rules on inversions. The Proposed Regulations, effective for debt instruments issued on or after April 4, 2016, target foreign-owned domestic companies that borrow from affiliated companies and receive a deduction for interest paid in the U.S., but whose lending affiliated companies may be in a low- or no-tax jurisdiction. Although the rules are currently effective for new debt instruments, informal guidance from the Treasury suggests that the rules may not be enforced until the Proposed Regulations are finalized; a task which the Treasury has said is a high priority.

The rules also seek to minimize the benefits to companies that utilize excessive indebtedness between related domestic parties, and so the rules apply to related parties without regard to whether they are foreign or domestic, and the rules also impact tax-exempt organizations and corporations held indirectly through partnerships. The rules authorize the IRS to characterize certain intercompany loans from debt to equity, which deprives the domestic company borrower of a deduction on interest. The rules also allow the IRS to treat certain intercompany debt as part debt and part equity in certain circumstances. Finally, the rules contain new documentation requirements for certain companies using certain kinds of intercompany debt, although such documentation requirements will only become effective when the regulations are finalized, and they are only applicable to certain large taxpayers, such as entities related to publicly traded companies or those with assets exceeding $100 million or annual revenue exceeding $50 million.

D. Changes to FIRPTA Requirements

As part of a broader effort to prevent a number of preferential tax items from expiring, on December 18, 2015, Congress enacted a number of changes to the regime governing withholding taxes on the disposition of real property by non-U.S. persons. The changes impact the Foreign Investment in Real Property Tax Act of 1980, as amended (“FIRPTA”), which imposes requirements on buyers of U.S. real property interests to obtain a certification that the disposition was not of a U.S. real property interest or that the seller is not a foreign person. Without such a certification, a buyer typically would be required to withhold 10% of the purchase price; the new legislation increases the applicable withholding rate under FIRPTA from 10% to 15%. The FIRPTA regime is an exception to the general rule that non-U.S. persons typically do not owe taxes in connection with the sale of U.S. capital assets.

The new legislation exempts from the FIRPTA requirements any U.S. real property interests held directly or indirectly through one or more partnerships by “qualified foreign pension plans.” A qualified foreign pension plan is one which (i) is organized outside of the U.S., (ii) is established to provide retirement or pension benefits to current or former employees, (iii) does not have a single participant or beneficiary with a right to more than 5% of its assets or income, (iv) is regulated by its home government and provides annual information to its taxing authorities, and (v) under its home country laws, receives contributions which are deductible, excluded from tax or taxed at a reduced rate, and tax on its investment income is deferred or taxed at a reduced rate.

The FIRPTA changes became effective on December 18, 2015.

E. Increased Audit Attention to Partnerships that Utilize Management Fee Waivers

As we reported in our past **Report**, the Treasury issued Proposed Regulations relating to disguised payments for services to partners. These rules related in part to management fee waivers, provisions in partnership and LLC agreements that allow such funds to forego certain fixed consideration, typically taxed as ordinary income, for a larger share of profits, typically taxed at capital gain rates. The Treasury has identified this as a high priority area, for which it plans to issue additional rules. The preamble to its Proposed Regulations suggested that certain common industry practices may, under currently law, be subject to re-characterization under audit. Some practitioners have begun to report increased audit activity among private equity funds, with a focus on management fee waivers.

III. CIVIL LITIGATION

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

- A New York federal judge refused to dismiss antitrust claims against 14 large banks in ongoing suits brought by hedge funds and others for conspiring to artificially depress LIBOR.
- The controversial practice some hedge funds use to challenge pharmaceutical patents continues.
- Argentina and hedge fund creditors have settled an international sovereign debt dispute, thus ending more than a decade of litigation.
- Court denies Pershing Square Fund's motion to dismiss in a class action.
- Deutsche Bank loses a $22 million judgment to hedge funds.

A. Update on Previously Reported Cases

New York Federal Judges Disagree on Antitrust Implications of Alleged Benchmark Rate Fixing

In our **Fall 2011** Report, we first noted that European asset manager FTC Capital GmbH ("FTC Capital") and two of its futures funds had filed a putative class action in the Southern District of New York, alleging that during the 2006-2009 period, banks conspired to artificially depress the London Interbank Offered Rate ("LIBOR"). FTC Capital alleged that the defendant banks colluded to suppress LIBOR in order to make the banks appear more financially healthy than they actually were. The Judicial Panel on Multi-District Litigation then transferred and consolidated this and over 20 other LIBOR-related cases to the Southern District of New York.[11] On March 29, 2013, the District Court dismissed the heart of the litigation—the federal antitrust claims—and allowed certain commodity manipulation claims to proceed. The court's refusal to certify its order for appeal with other claims still pending went all the way to the Supreme Court and, as we reported in our **Spring 2015** Report, the Supreme Court remanded the case to the Second Circuit, holding that it had jurisdiction to consider the antitrust appeals despite the pending claims.[12]

Another court considering benchmark manipulation antitrust claims recently disagreed with the earlier 2013 dismissal ruling by the SDNY district court, refusing to dismiss claims against 14 of the world's biggest banks accused of rigging the derivative benchmark "ISDAfix" from 2009 to 2012.[13] At the motion to dismiss stage, the court must accept the factual allegations set forth in the complaint as true. In allowing plaintiffs' antitrust claims to survive the motion to dismiss stage, U.S. District Judge Jesse Furman "respectfully disagree[d]" with U.S. District Judge Naomi Buchwald, the judge in the multidistrict LIBOR litigation described above. Judge Buchwald had dismissed the class-wide antitrust claims because she considered the LIBOR rate-setting to be a cooperative, collaborative process, not a competitive one that would be subject to potential antitrust violations. Judge Furman reasoned that plaintiffs' allegations that the banks worked together to send their rate quotes at the point where it was most profitable to them was the "sort of coordinated action" that "antitrust laws 'were intended to prevent.'" Judge Furman dismissed plaintiffs' claims alleging breach of implied covenant of good faith and fair dealing and tortious interference with contract. On May 11, 2016, Judge Furman preliminarily approved the settlement of the matter between plaintiffs and seven banks. The settlement agreement provides that the settling defendants will pay a total of $324 million.

Controversial Hedge Fund Continues to Target Pharmaceutical Patents

In our **Fall 2015** issue, we reported on Kyle Bass' controversial use of Inter Partes Review ("IPR") under the American Invests Act ("AIA") to challenge pharmaceutical patents. Bass, Hayman Capital Management LP, and the entities he is connected to, like the Coalition for Affordable Drugs, are not direct competitors of these pharmaceutical companies. Hayman's strategy to profit from these actions is unclear, but Bass has stated that "[t]his is a short activist strategy and we hold the hammer."[14]

To date, this strategy has received wide criticism. Congress established the IPR process in 2011 to "provid[e] quick and cost effective alternatives to litigation."[15] Commentators argue that Bass' challenges turn IPR on its head by increasing costs through a process designed to serve judicial efficiency. So far, Bass has not convinced the Patent Trial and Appeal Board ("PTAB") that any challenged claims are unpatentable. Since our last report, Bass has continued this practice. In a proceeding against Biogen MA Inc., Bass first failed to convince the PTAB to consider a patent under IPR, but was then granted IPR when making a different prior art argument.[16]

B. New Developments in Securities Litigation

Argentina and Hedge Funds Settle International Legal Battle over Sovereign Debt

Argentina has settled its ongoing dispute with several hedge funds, ending more than a decade of litigation. Argentina has stayed out of global capital markets ever since it defaulted on its debt in 2001. While Argentina reached agreements with many bondholders years ago, a number of hedge fund hold-out creditors have waged an international legal battle with Argentina for payment on the defaulted debts. The funds, led by Paul Singer's firm, NML Capital, often used what could be characterized as aggressive tactics to push Argentina to the negotiating table, including convincing a Ghanaian court to seize an Argentinian naval vessel when it visited Ghana as part of a training mission.

Both houses of the Argentinian legislature have now approved the holdout debt deals, including issuing new bonds to pay the hold-out creditors. On March 2, 2016, Judge Griesa of the Southern District of New York lifted injunctions that had been preventing Argentina from raising new money in international bond markets to pay existing creditors. Despite the deal, the hedge funds have appealed to the Second Circuit, and the Second Circuit temporarily stayed Judge Griesa's lifting of the injunctions. The Justice Department filed an amicus brief on March 23, 2016 supporting Judge Griesa's decision to lift the injunctions voicing the government's strong policy interest in resolving the dispute. On April 13, 2016, the Second Circuit heard oral arguments. The next day, the Second Circuit affirmed Judge Griesa's order lifting the injunctions. In its subsequent summary order, the Second Circuit explained that "keeping the Injunctions in place would now serve to further frustrate settlement attempts and perhaps close the door to ending this protracted and difficult history."[17]

District Court Denies Motion to Dismiss Class Action against Hedge Fund Managers

A class action in federal court in the Central District of California named Pershing Square Funds and several related entities as defendants. The lawsuit relates to Pershing's unsuccessful tender offer of Allergan, Inc. Plaintiffs are Allergan shareholders who sold their shares of Allergan while the offer was pending. The class alleges that defendants failed to disclose material information about the Allergan tender offer while Pershing was acquiring its position in Allergan, violating tender offer rules by feeding insider information to the hedge fund. The court rejected the hedge funds' argument that, under the circumstances, the activist hedge fund could properly work together with a corporate bidder to acquire Allergan.[18]

Deutsche Bank Loses $22 Million Judgment to Hedge Funds

On February 3, 2016, Good Hill Master Fund LP and Good Hill Master Fund II LP won a $22 million judgment against Deutsche Bank in New York state court. The case involved a breach of contract dispute regarding credit default swaps. Deutsche Bank provided $22 million in collateral as part of the agreement, but argued that Good Hill acted unreasonably and in bad faith by selling notes underlying the swaps at high prices at the bank's expense.[19]

IV. REGULATORY ENFORCEMENT

It is unlikely that SEC enforcement actions and sanctions will slow in 2016, after a record year on both accounts in 2015. In recent testimony before the United States Senate Subcommittee on Financial Services and General Government Committee on Appropriations, SEC Chairwoman Mary Jo White supported the SEC's request for additional budget funding by noting that, in 2015, the SEC secured penalties and disgorgement of $4.2 billion, which is more than twice the budget the SEC is now seeking.[20] Part of the requested budget increase is expected to go toward enhancing the SEC enforcement program, further leveraging cutting-edge technology to keep pace with market activity, and hiring additional staff to conduct regulatory examinations. Under the planned budget, the Enforcement Division would add 52 members, with 10 dedicated solely to developing tools for data analytics and analyzing information received through the SEC's tips, complaints, and referrals system. Along with seeking additional resources, Chairwoman White reinforced the SEC's resolve in fully litigating cases "where it believes admissions of wrongdoing are necessary to achieve greater public accountability," highlighting that the SEC is expected to take even more aggressive positions in regulatory investigations.

A. Whistleblower Awards

The SEC's whistleblower program continues to gather tips that lead to successful enforcement actions and generate whistleblower awards. Whistleblower tips have originated from a variety of sources, including insiders/employees, compliance professionals, and officers. However, whistleblower awards are not limited to insiders of an investigated entity. In fact, on January 16, 2015, the SEC announced an award of more than $700,000 to a company outsider who conducted a detailed analysis that led to a successful SEC enforcement action.[21]

Awards are also apparently available to recidivists who provide information to the SEC. In a first-of-its-kind whistleblower order, on April 5, 2016, the SEC granted a whistleblower an award of more than $275,000 for information provided in an SEC enforcement action and related criminal action, but ordered that a portion of the proceeds be used to pay off an outstanding court-ordered final judgment that included an order for monetary payments of disgorgement and penalties.[22] This offset of the award to pay off the outstanding judgment clearly suggests that the award recipient was subject to a prior SEC enforcement action.

The pace of awards demonstrates there is no reason to believe the SEC's commitment to the program will abate anytime soon. During a one-week period in May 2016, the SEC issued three whistleblower awards totaling more than $10 million. On May 13, 2016, the SEC granted a whistleblower an award of more than $3.5 million to a company employee who provided evidence of wrongdoing that strengthened an ongoing investigation.[23] On May 17, 2016, the SEC granted the third highest award in the history of the program of between $5 million and $6 million to a former company insider who provided information about wrongdoing that the SEC believes would have been nearly impossible to detect without the whistleblower's information.[24] Then, on May 20, 2016, the SEC awarded more than $450,000 to two individuals for a tip that led the agency to open a corporate accounting investigation and for their assistance during the investigation.[25]

The SEC, however, is not the only agency with an active whistleblower program. In April 2016, the CFTC's nascent whistleblower program announced its largest award to date: $10 million for providing "key original information" that led to a major enforcement action for violations of the Commodity Exchange Act ("CEA"). The CFTC order noted that the whistleblower's information was "sufficiently specific, credible, and timely to cause the [CFTC] to open an investigation" and that the whistleblower "provided assistance to [CFTC] staff during the course of the investigation," including providing documents upon request.[26] In addition, the CFTC found the whistleblower did not have any involvement in the underlying violations or interfered with compliance or reporting procedures. These factors suggest that the award may have been in the upper range of the scale of between 10% to 30% of the sanctions collected. This multimillion dollar award will likely motivate other whistleblowers to provide information of alleged violations of the CEA.

B. Insider Trading

The ramifications of the U.S. Court of Appeals for the Second Circuit's decision in *U.S. v. Newman* continue to work their way back through past enforcement actions. As we previously noted, all eyes are on the Supreme Court in the matter of *Salman v. United States* to determine whether and how *Newman* will set the parameters of insider trading law. The Supreme Court's decision in *Salman* is expected by the end of the Supreme Court's next term.

In the meantime, insider trading remains at the forefront of the SEC's enforcement program. In a recent speech at the International Institute for Securities Market Growth, Chairwoman White highlighted three tools used in insider trading investigations to identify and assess suspicious trading: (1) the Advanced Relational Trading Enforcement Metrics Investigation System, which analyzes patterns and relationships among traders from among over six billion electronic equities and options trading records; (2) the SEC's Center for Quantitative and Risk Analytics, which "conducts advanced data analytics to generate new leads and assist existing investigations;" and (3) the SEC's Forensic Lab that assists investigation with "recovering deleted documents, deciphering metadata and geo-location information." Chairwoman White has noted, however, that, in the approximately 30 insider trading cases filed since *Newman*, none have involved the tipper/tippee issues raised in *Newman*.

Below we provide updates on the SEC settlement with Steven A. Cohen ending the enforcement saga against now defunct S.A.C. Capital and a settlement involving the funds at the center of the *Newman* decision.

In re Steven A. Cohen

On January 8, 2016, Steven A. Cohen consented to the entry of an administrative order alleging that Cohen failed to supervise a former portfolio manager, Matthew Martoma, who engaged in insider trading while employed at CR Intrinsic Investors, LLC ("CR Intrinsic") an investment advisory firm that was a wholly-owned subsidiary of S.A.C. Capital Advisors, LLC ("S.A.C. Capital") which was owned and controlled by Cohen.[27]

The SEC alleged Cohen ignored red flags that Martoma might have had access to material nonpublic information about the clinical trial of a drug produced by two companies in which by CR Intrinsic and S.A.C. Capital held extensive long positions.[28] In addition, the SEC alleged that Cohen encouraged Martoma to talk to a doctor about the nonpublic results of the drug trial, after two CR Intrinsic analysts advocated against the long positions. Instead of taking prompt action to determine whether Martoma was engaged in unlawful conduct or taking reasonable steps to prevent violations of federal securities laws, Cohen allegedly oversaw the liquidation of the long positions and the accumulation of a short position, which earned CR Intrinsic and S.A.C. Capital approximately $275 million in illicit profits and avoided losses.[29]

Without admitting or denying the SEC's findings, Cohen consented to an order alleging that he failed to reasonably supervise Martoma and Martoma's violation of Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 thereunder. The settlement prohibits Cohen from serving in a supervisory role with any broker, dealer, or investment advisor for two years. In addition, Cohen's family office must retain an independent consultant, adopt the consultant's recommendations, and undergo SEC examinations.[30] In the event that the SEC brings a new enforcement action against Cohen or a Cohen-related entity during the two year period, the terms of the settlement agreement are automatically extended for a two-year period.[31]

Level Global Investors, L.P. and Diamondback Capital

On January 26, 2016, the U.S. District Court for the Southern District of New York issued an order vacating a settlement between Level Global Investors, L.P. ("Level Global") and the SEC.[32] The settlement was entered into in May 2013, after Level Global's co-founder, Anthony Chaisson, was convicted of insider trading based, in part, on the testimony of a Level Global analyst, Spyridon Adondakis, who pled guilty to insider trading. As a result of the district court's order vacating the settlement, the SEC was ordered to return the $21.5 million amount Level Global paid the SEC in disgorgement, prejudgment interest, and civil penalties. Diamondback Capital Management LLC, the entity with which Todd Newman was associated, will also receive approximately $9 million back from the SEC in connection with the same investigation.

In January 2016, Level Global made a motion to vacate the settlement after the U.S. Court of Appeals for the Second Circuit overturned Chaisson's conviction in *U.S. v. Newman* and the SEC had vacated its civil judgments against the two former Level Global employees. Level Global argued that, in its decision in *Newman*, the Second Circuit "found that the transactions that formed the basis of the criminal charges against Chaisson and Adondakis—which charges also formed the basis of the claims made in this action against [Level Global]—did not constitute insider trading."[33] The SEC elected not to oppose Level Global's motion, though it took the position in a letter to the court that its lack of opposition should not be construed to indicate agreement with Level Global's arguments or reasoning.

C. Material Misrepresentations and Omissions / Valuation Issues

Below are summaries of two enforcement actions involving allegations that investment advisors misled investors as to the valuation of the investments and the management fees charged. A third summary involves allegations that an investment advisor defrauded investors by using a shell corporation with a similar name to a legitimate entity. The fourth and final summary relates to a notable enforcement action in which the SEC settled with a private equity adviser that violated the broker-dealer registration requirements in brokering transactions relating to portfolio companies.

In re Equinox Management Fund, LLC

On January 19, 2016, the SEC announced that Equinox Fund Management, LLC ("Equinox"), a Denver-based alternative fund manager, consented to the entry of an SEC administrative order relating to allegations that the firm overcharged investors on management fees and misled investors about how it valued certain assets.[34]

According to the SEC, Equinox calculated its management fees for the Frontier Fund ("TFF")—a publicly registered managed futures fund with multiple investment series for which Equinox serves as TFF's commodity pool operator and managing owner—contrary to disclosures made to investors. From its inception through March 2011, TFF allegedly disclosed in registration statements that Equinox charged management fees, which ranged from .50% to 3.5%, based upon net asset value ("NAV"). Contrary to its disclosures, however, Equinox charged management fees based on the value of the notional assets held. Although Equinox later disclosed in TFF's Form 10-K that its management fees were based on the value of the notional assets—allegedly after TFF's independent auditors questioned the fees—Equinox did not refund the additional fees it had already received to investors, alleged to be approximately $5.4 million.[35]

In addition, the SEC alleged that Equinox misled its investors as to how Equinox valued certain "highly customized derivatives" (the "Derivatives") in which TFF invested.[36] In its regulatory filings, TFF disclosed that certain derivatives were reported at fair value based upon daily valuations provided by a third-party pricing service, which were also corroborated by weekly counterparty settlement values. TFF's disclosures were allegedly misleading because Equinox received, but failed to consider, information concerning the counterparty's pricing of the Derivatives, and that the information was materially different from the valuation information that was reported by TFF.

Equinox consented to the entry of the SEC's order finding that the firm violated Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933 (the "Securities Act") and caused TFF's violations of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13. Equinox has agreed to refund investors approximately $5.4 in excessive management fees collected during a seven-year period plus $600,000 in prejudgment interest.[37] Equinox also agreed to pay a $400,000 penalty. Without admitting or denying the SEC's findings, Equinox agreed to be censured and must cease and desist from future violations.

In re Marco Investment Management, LLC

On March 2, 2016, the SEC announced that Marco Investment Management, LLC ("MIM"), a Georgia-based investment advisor for high-net-worth individuals and institutional clients, and its principal, owner and sole officer, Steven Marco, consented to the entry of an SEC administrative order relating to allegations that MIM overcharged management fees and misled investors.[38]

According to the SEC, MIM had discretionary authority to manage client holdings by investing in both equity and fixed-income securities through custodial accounts at a registered broker-dealer ("Custodial Broker-Dealer"). At the end of each quarter, MIM sent its clients statements disclosing the client's "portfolio value," the resulting quarterly management fees, and the portfolio appraisal detailing the client's account holdings and the market value of such holdings. The portfolio appraisal allegedly calculated the client account's market value, upon which the management fee was calculated. The portfolio appraisal also allegedly calculated a total value that included adjustments to market value, such as the balance of any outstanding margin loans. Clients also received statements for their custodial account from the Custodial Broker-Dealer.

According to the SEC, a quarter of MIM's clients had margin agreements with the Custodial Broker-Dealer which allowed MIM to utilize margin in managing the client's portfolio. Under these margin agreements, the proceeds from any transaction in the custodial account were immediately applied to reduce any margin balance. The SEC maintained that for approximately 25 clients with margin accounts, MIM allegedly inflated management fees by failing to subtract the margin balance from the sale proceeds, which resulted in an increased value for each account.[39] By contrast, the statements from the Custodial Broker-Dealer reflected that the sale proceeds had been applied to the margin balance.

MIM and Marco consented to the entry of the SEC's order finding that they violated Sections 206(4), 204(a), and 207 of the Advisers Act and Rules 206(4)-7 and 204-2(a) thereunder, and that Marco aided and abetted and caused MIM's violations of Sections 204(a) and 206(4) of the Advisers Act, and Rules 204-2(a) and 206(4)-7 thereunder. MIM agreed to pay disgorgement of $124,750.44 in overcharged fees, prejudgment interest of $7,595.94, and a civil penalty of $100,000.[40] Marco agreed to pay a civil penalty of $50,000. In addition, MIM agreed to designate a new part-time Chief Compliance Officer, who was deemed acceptable to the Commission's staff, and appointed a temporary independent compliance consultant.

SEC v. Caspersen and Irving Place III SPV, LLC

On March 28, 2016, the SEC charged Andrew W.W. Caspersen, a securities professional associated with a registered broker-dealer, with defrauding two institutions he solicited to invest in a shell company he controlled with a name deceptively similar to that of a legitimate private equity fund.[41]

According to the SEC's Complaint, Caspersen solicited approximately $95 million in funds from two investors and successfully obtained a $25 million investment from a non-profit charitable affiliate by offering a promissory note issued by Irving Place III SPV, LLC ("Irving Place III SPV").[42] The note promised 15% annual interest, payable quarterly and redeemable on 90 days' notice. To facilitate the offering, Caspersen allegedly drafted the promissory note as well as a security agreement and signed both documents on behalf of Irving Place III SPV using the fictitious name, John Nelson.[43] The SEC alleged that Caspersen named his LLC Irving Place III SPV, so that investors would assume it was related to Irving Place Capital Partners III SPV, a legitimate private equity fund not associated with Caspersen. In fact, while soliciting the $25 million investment, Caspersen allegedly stated that the funds would be secured by approximately $900 million of assets of Irving Place Capital Partners III SPV. Caspersen's LLC, however, allegedly had no legitimate business; Irving Place III SPV's only asset was a bank account allegedly used by Caspersen to take control of invested funds for his personal use.

The SEC charged Caspersen and Irving Place III SPV with violating Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder. The SEC is seeking a permanent injunction, the return of the ill-gotten gains with interest, and monetary penalties. Caspersen is also subject to a parallel criminal action brought by the United States Attorney's Office for the Southern District of New York.

In re Blackstreet Capital Management, LLC

On June 1, 2016, the SEC announced that Blackstreet Capital Management, LLC ("Blackstreet") and its principal owner and managing member, Murry N. Gunty, consented to the entry of an SEC administrative order relating to allegations that Blackstreet provided brokerage services without complying with broker-dealer registration requirements, engaged in conflicted transactions, and misled investors as to fees and expenses charged.[44] According to the SEC, Blackstreet provided investment advisory and management services to two funds (collectively, the "Funds"), which invested in undervalued portfolio companies and were each governed by a limited partnership agreement ("LPA").

An SEC examination of Blackstreet uncovered a series of alleged securities violations.[45] Most notably, the SEC alleged that Blackstreet served as a broker for the Funds and collected at least $1,877,000 in related transaction-based compensation without ever registering as a broker with the SEC or affiliating with a registered broker-dealer. Specifically, the SEC's allegations noted that the LPAs allowed Blackstreet to provide brokerage services in handling the acquisition and disposition of portfolio companies and even authorized Blackstreet to charge transaction or brokerage fees for that service. Thus, rather than employing investment banks or brokerage firms to provide brokerage services, including soliciting deals, identifying purchasers and sellers, negotiating or structuring the transactions, arranging financing, and executing the transactions, Blackstreet performed those services in-house. In doing so, the SEC alleged that Blackstreet violated the broker-dealer registration provisions because Blackstreet never registered as a broker-dealer or affiliated itself with a broker-dealer.

Other claims made by the SEC related to allegations that Blackstreet charged portfolio companies for fees that were not disclosed to the Funds, the failure to disclose the conflicts associated with the receipt of those fees, the misuse of fund assets by Blackstreet to pay expenses, and Blackstreet's failure to disclose conflicted transactions involving Blackstreet personnel.

Blackstreet and Gunty, without admitting or denying the SEC's findings, consented to the entry of the SEC's order finding that they violated Section 15(a) of the Exchange Act, and Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder. The SEC considered remedial actions undertaken by Blackstreet and Gunty, including voluntary retention of a compliance consultant, revisions to Blackstreet's written policies and procedures, repayments made to the Funds in connection with the conduct discussed above, and the cessation of the receipt of certain fees. Blackstreet and Gunty agreed to disgorge $2,339,000, pay prejudgment interest of $283,737, and a civil penalty of $500,000. Blackstreet and Gunty also agreed to cease and desist from future violations of the above securities laws, and Blackstreet agreed to be censured.

D. Spoofing

On the heels of the first ever criminal conviction for "spoofing," a strategy by which orders are allegedly placed into the market with the intent of never executing them and artificially affecting the appearance of supply and demand, the SEC and other market regulators are more focused on pursuing enforcement proceedings involving such schemes. Below is a summary of a recent enforcement action involving spoofing on an options exchange.

In the Matter of Afshar, et al.

On December 3, 2015, the SEC entered an administrative order instituting administrative proceedings alleging Behruz Afshar, Shahryar Afshar, and Richard Kenny ("Respondents"), conducted two fraudulent schemes by executing trading schemes that allegedly circumvented the structure of the market.[46] Specifically, the SEC alleged that: (1) the Respondents mismarked option orders to gain execution priority, generate higher rebates, and lower fees; and (2) engaged in spoofing in an effort to manipulate trading and generate liquidity rebates from an options exchange.

According to the SEC, the Respondents mismarked options orders to avoid having their orders labeled as "professional." If a non-broker-dealer places more than 390 orders in listed options per day (on average)—whether executed or not—on any listed options exchange during any calendar month in a quarter, that person or entity will be designated as a "professional" for the next quarter. On the other hand, if a non-broker-dealer does not exceed the 390-order threshold, that person or entity is designated a "customer." "Customer" orders are given priority of execution, and earn higher rebates and incur lower fees than "professional" orders at the same price.

The Respondents continually placed "customer" orders by shifting their trading between accounts: if an account exceeded the trading threshold and was marked as "professional" for an upcoming quarter, the Respondents changed to another account.[47] The Respondents falsely represented the ownership of these accounts to evade detection. By maintaining "customer" status, the Respondents received a total of more than $2 million in transaction fees avoided and rebates improperly received.

The SEC also alleged that the Respondents operated the spoofing scheme from May 2011 to December 2012 to manipulate the market, earn rebates, and avoid fees under the Nasdaq OMX PHLX exchange's ("PHLX") "maker-taker" model.[48] Under the PHLX's "maker-taker" model, PHLX offered rebates for the initial order posted to the exchange and charged fees for orders that executed immediately against previously received orders.

The SEC alleged that the Respondents operated their scheme by placing All-Or-None ("AON") orders, which are undisplayed orders that must be executed in their entirety or not at all, in options on the PHLX to generate rebates.[49] Then the Respondents placed smaller, displayed orders corresponding to the same options series and prices as the larger AON order. The SEC alleged that these smaller orders were fraudulent because the Respondents never intended to execute them and only placed them to induce or "spoof" other market participants to submit orders, which they then executed against the pre-existing AON orders. As a result, the AON orders generated rebates because they were posted first, whereas the other market participants who traded against the AON orders were assessed a "take" fee. The SEC alleged that once the AON orders were executed, the Respondents cancelled any of their displayed orders which were still open. According to the SEC, the Respondents received over $225,000 from this scheme through rebates in the maker-taker program.

The SEC alleged that the "customer-priority" scheme violated Sections 17(a)(1) and 17(a)(2) of the Securities Act, as well as Sections 10(b) and 20(b) of the Exchange Act, and Rules 10b-5(a)-(c) thereunder, and that the "spoofing" scheme violated Sections 17(a)(1) and 17(a)(3) of the Securities Act, as well as Sections 9(a)(2), 10(b), and 20(b) of the Exchange Act, and Rule 10b-5(a) and (c) thereunder. The SEC is seeking a cease-and-desist order of the above violations, disgorgement, a civil penalty, and any remedial action as appropriate.

Our prior Reports are available here:

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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1 Commission Delegated Regulations (EU) No 148/2013, supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards on the minimum details of the data to be reported to trade repositories.

2 Directive 2011/61/EU of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 and available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32011L0061.

3 The "EEA" is the European Economic Area and includes the EU plus Iceland, Norway, and Liechtenstein, which are covered by AIFMD. Switzerland is neither EU nor EEA but has adopted AIFMD.

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5 https://www.esma.europa.eu/press-news/esma-news/esma-publishes-letter-european-commission-aifmd-passport.

6 Article 13 (1), Directive 2011/61/EU of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

7 Article 13 (2), Directive 2011/61/EU of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

8 https://www.esma.europa.eu/sites/default/files/library/2016411_final_report_on_guidelines_on_sound_remuneration_policies_under_the_ucits_directive_and_aifmd_0.pdf.

9 Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC and available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013L0036.

10 https://www.esma.europa.eu/sites/default/files/library/2016-568_qa_aifmd_april_2016.pdf.

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16 IPR2015-01993.

17 *Aurelius Capital Master Ltd. v. Republic of Argentina*, No. 16-628 (Second Circuit).

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[26] CFTC Whistleblower Award Determination No. 16-WB-06, Mar. 28, 2016 at 1-2, http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfwbawardorder032816.pdf.

[27] Steven A. Cohen Barred From Supervisory Hedge Fund Role, Exchange Act Release No. 2016-3 (Jan. 8, 2016), https://www.sec.gov/news/pressrelease/2016-3.html.

[28] In the Matter of Steven A. Cohen, Investment Advisers Act of 1940 Release No. 4307 (Jan. 8, 2016) Order Making Findings and Imposing Remedial Sanctions Pursuant to Section 203(f) of the Investment Advisers Act of 1940 at ¶20, https://www.sec.gov/litigation/admin/2016/ia-4307.pdf.

[29] *Id.* at ¶21.

[30] *Id.* at ¶¶71-74.

[31] *Id.* at ¶77.

[32] Order and Judgment at p. 2, 12-civ-0409 (SAS), ECF No. 141.

[33] Decl. of Thomas F. Munno at ¶5, 12-civ-0409 (SAS), ECF No. 138.

[34] In the Matter of Equinox Fund Mgmt, LLC, Administrative Proceeding File No. 3-17057, Order Instituting Administrative and Cease-And-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Section 21C of the Securities Exchange Act of 1934, and Section 203(e) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-And-Desist Order at ¶1, https://www.sec.gov/litigation/admin/2016/33-10004.pdf.

[35] *Id.* at ¶7.

[36] *Id.* at ¶8.

[37] *Id*.

[38] In the Matter of Marco Investment Mgmt, LLC et al., Administrative Proceeding File No. 3-17150, Order Instituting Administrative and Cease-And-Desist Proceedings Pursuant to Sections 203(e), 203(f), and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and Cease-And-Desist Orders at ¶4, https://www.sec.gov/litigation/admin/2016/ia-4348.pdf.

[39] *Id.* at ¶11.

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[45] In the Matter of Blackstreet Capital Management, LLC, Administrative Proceeding File No. 3-17267, Order Instituting Administrative and Cease-And-Desist Proceedings Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934, and Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-And-Desist Order at ¶¶15-32, https://www.sec.gov/litigation/admin/2016/34-77959.pdf.

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[47] *Id.* at ¶4.

[48] *Id.* at ¶¶7-8.

[49] *Id.* at ¶8.