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Hedge Fund Report - Summary of Key Developments - Fall 2011

BY THE INVESTMENT MANAGEMENT, SECURITIES LITIGATION & TAX PRACTICES

Since the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") was passed, the Securities and Exchange Commission (the "SEC") and various other regulatory agencies, including the Commodity Futures Trading Commission (the "CFTC"), the Federal Reserve Board (the "Federal Reserve"), and the Department of the Treasury (the "Treasury"), have been busy proposing and finalizing rules to implement provisions of the Dodd-Frank Act. There have also been a number of significant developments in the hedge fund tax area, and the SEC and private plaintiffs have continued at a fast pace in bringing enforcement actions and litigation involving private funds and fund managers. Additionally, Bruce Karpati, co-chief of the SEC Division of Enforcement's Asset Management Unit, announced the Asset Management Unit's priority areas of focus for 2012[1] at HedgeWorld's 2011 Fund Services Conference & Expo held on October 26, 2011.

This Report provides an update since our last Hedge Fund Report in April 2011 and highlights recent regulatory and tax developments, as well as recent civil litigation and enforcement actions as they relate to the hedge fund industry. Paul Hastings attorneys are available to answer your questions on these and any other developments affecting hedge funds and their investors and advisers.

I. SECURITIES-RELATED LEGISLATION AND REGULATION

A. Dodd-Frank Rulemaking

In the wake of the unprecedented financial crisis that caused a significant downturn in the global economy in 2008 and 2009, President Obama on July 21, 2010 signed the Dodd-Frank Act into law. Since then, various agencies have been focusing on the rulemaking process to implement provisions of the Dodd-Frank Act. In recent months, these agencies have begun issuing final rules while continuing to issue proposals of other rules necessary to put Dodd-Frank into effect. Accordingly, although the regulatory framework imposed by the Dodd-Frank Act is becoming more clear, the precise impact of the Dodd-Frank Act on the hedge fund industry remains uncertain. The following summarizes the status of various proposed and finalized rules implementing the Dodd-Frank Act that are most relevant to the hedge fund industry.

1. SEC's Final Rules on Private Investment Fund Adviser Registration and Exemptions

On June 22, 2011, the SEC adopted final rules to implement three new exemptions from registration under the Investment Advisers Act of 1940 (the "Advisers Act") as amended by the Dodd-Frank Act. These are the "venture capital fund exemption" for investment advisers who solely advise "venture capital funds,"[2] the "private fund adviser exemption" for investment advisers who solely advise "private funds"[3] that have less than $150 million in assets under management in the United States, and the "foreign private adviser exemption" for investment advisers who are "foreign private advisers."[4] The final rules are substantially in the form originally proposed on November 19, 2010. The most notable changes include: (i) with respect to the venture capital exemption, the final rule revises the definition of venture capital fund to include funds that invest up to 20% in "non-qualifying investments" rather than requiring funds to invest 100% in qualifying investments as proposed; (ii) with respect to the private fund adviser exemption, the final rule requires an adviser seeking to rely on this exemption to calculate and report its assets under management on an annual basis rather than quarterly as proposed; and (iii) with respect to the foreign private adviser exemption, the final rule does not require non-U.S. advisers to count investors who are "knowledgeable persons" toward the "fewer than fifteen" investor limit as originally proposed, and also expands the definition of "place of business" for the purposes of the requirement that non-U.S. advisers have no "place of business" in the United States.

Also on the same date, the SEC adopted final rules implementing various other provisions of the Dodd-Frank Act related to investment adviser registration. The final rules, among other things, (i) extend the compliance date for an investment adviser that becomes subject to registration under the Advisers Act due to the elimination of the "private adviser" exemption[5] from July 22, 2011 to March 30, 2012; (ii) clarify that advisers with assets under management in excess of $25 million and who have their principal office and place of business in New York, Minnesota or Wyoming are required to register with the SEC (unless an exemption is available); and (iii) amend Form ADV to require advisers to provide additional information to improve the SEC's ability to assess compliance risks and to identify advisers that are subject to the Dodd-Frank Act's requirements concerning certain incentive-based compensation arrangements.

Additional information on the final rules on private fund adviser registration and exemptions is available **here**.

2. *SEC's Approval of Form PF*

On October 26, 2011, the SEC, by a unanimous vote, adopted new Rule 204(b)-1 and Form PF under the Advisers Act to implement certain provisions of Title IV of the Dodd-Frank Act. These provisions require certain advisers to hedge funds and other private funds to report, among other things, risk, leverage, and financial information. The new rule applies to SEC-registered advisers with at least $150 million in private fund assets under management and features "tiered" reporting requirements for private fund advisers. "Large private fund advisers" (*i.e.,* hedge fund advisers with at least $1.5 billion in assets under management, liquidity fund advisers with at least $1 billion in combined assets under management in liquidity funds and registered money market funds, and private equity fund advisers with at least $2 billion in assets under management) must submit more detailed reports and provide additional information for each managed hedge fund valued at $500 million or more. "Small private fund advisers" (*i.e.*, those who do not meet the threshold levels of large private fund advisers) must submit less detailed reports.

The final rule extends the submission deadlines from those in the proposed rule. Large hedge fund advisers must file Form PF within 60 days of the end of each fiscal quarter, while smaller hedge fund advisers have until 120 days from the end of each fiscal year. Most advisers must begin filing Form PF following the end of their first fiscal year or fiscal quarter, as applicable, ending on or after December 15, 2012. However, very large fund advisers (including hedge fund advisers with at least $5 billion in assets under management) have until the end of the first fiscal quarter ending on or after June 15, 2012. Additional information regarding Form PF is available **here**.

3. *SEC's Approval of Filing Fees for Exempt Reporting Advisers Filing Form ADV and Private Fund Advisers Filing Form PF*

On September 30, 2011, the SEC issued a notice of intent to approve filing fees for exempt reporting advisers[6] filing Form ADV and private fund advisers filing Form PF. The notice proposed filing fees for exempt reporting advisers of $150 for each initial and annual report. With respect to Form PF, the SEC determined that the Financial Industry Regulatory Authority ("FINRA") will develop and maintain the filing system for Form PF, and proposed that fees be set at $150 for the proposed quarterly filings and $150 for the proposed annual filings.[7] On October 24, 2011, the SEC issued an order approving the filing fees as set forth in the earlier notice. The filing fees for exempt reporting advisers became effective on October 28, 2011 when the SEC order was published in the Federal Register, and the filing fees for Form PF will become effective on the effective date of Rule 204(b)-1 under the Advisers Act. Additional information on SEC's approval regarding filing fees for exempted reporting advisers and for Form PF is available **here**.

4. *SEC's Order and Proposed Rule Amending Definition of "Qualified Client"*

On May 10, 2011, the SEC published a notice of intent to issue an order increasing the dollar thresholds of the assets under management and net worth tests in the definition of "qualified client" in Rule 205-3 under the Advisers Act. At the same time, the SEC also proposed to amend Rule 205-3 to (i) provide that the SEC will adjust the dollar amount tests for inflation on a five-year basis (as required by the Dodd-Frank Act), (ii) exclude the value of a person's primary residence from the net worth test, and (iii) add certain transition provisions to Rule 205-3. The proposed primary residence exclusion will harmonize the threshold calculation for "qualified client" under the Advisers Act with similar standards under the Securities Act of 1933, as amended (the "Securities Act"), and the Securities Exchange Act of 1934, as amended (the "Exchange Act"),[8] while the transition provisions are intended to prevent retroactive application of amended Rule 205-3 to minimize disruption to existing investments. Comments on the proposed amendments to Rule 205-3 were due on or before July 11, 2011. On July 12, 2011, the SEC published its final order increasing the dollar amount thresholds in the definition of "qualified client" in Rule 205-3 from $750,000 to $1 million for the assets under management test and from $1.5 million to $2 million for the net worth test. The revised dollar amounts reflect inflation from 1998 to the end of 2010. The final order took effect on September 19, 2011. Additional information on the proposed amendments to Rule 205-3 and the revised dollar amount thresholds in the definition of "qualified client" is available **here**.

5. SEC and other Financial Regulators' Joint Proposal to Implement the Volcker Rule

On October 12, 2011 the SEC, by unanimous vote, jointly proposed a rule implementing Section 619 of the Dodd-Frank Act, also known as the "Volcker Rule," with the Federal Reserve, Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency.[9] The Volcker Rule generally prohibits a banking entity from (i) engaging in short-term proprietary trading of any security, derivative, and certain other financial instruments for the banking entity's own account; or (ii) owning, sponsoring, or having certain relationships with a hedge fund or private equity fund. The proposed rule would clarify the scope of the prohibitions and provide certain exemptions.

Specifically, the proposed rule defines various relevant terms, including "proprietary trading," "trading account," "covered financial position," "covered fund," and "ownership interest," and provides various exemptions, including exemptions for underwriting and market making-related activity, an exemption for risk-mitigating hedging, and exemptions for trading in certain government obligations, trading on behalf of customers, trading by a regulated insurance company, and trading by certain foreign banking entities outside of the U.S. The proposed rule would also exempt, among other activities, organizing and offering hedge funds or private equity funds under certain conditions, including limiting investments in such funds to a de minimus amount, and making risk-mitigating hedging investments. Banking entities may also own or sponsor a covered fund if done in the ordinary course of collecting a previously contracted for debt or pursuant to, and in compliance with, the statutory transition periods, both subject to certain back-stop provisions. In order to rely on some of these exemptions, a banking entity may be required to establish an internal compliance program and satisfy certain other requirements. Additionally, under the proposed rule, certain banking entities with significant covered trading activities would be required to furnish periodic reports to a specified relevant agency regarding a variety of quantitative measurements of its covered trading activities and maintain records documenting the preparation and content of these reports.

The public comment period for the proposed rule closes on January 13, 2012. Additional information on the proposed rule implementing the Volcker Rule is available **here.**

6. SEC's Proposed Rule on Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants

On October 12, 2011, pursuant to Title VII of the Dodd-Frank Act, the SEC proposed new Rules 15Fb1-1 through 15b6-1 under the Exchange Act to provide for the registration of security-based swap dealers and major security-based swap participants ("SBS Entities").[10] The proposed rules establish procedures for registration, as well as amendment, withdrawal, and cancellation of such registrations. The proposed registration regime closely mirrors that already in place for broker-dealers.

Under the proposed rules, to register, an SBS Entity must electronically submit the required registration form (Form SBSE) to the SEC. SBS Entities registered or registering with the SEC as broker-dealers or with the CFTC as swap dealers or major swap participants need only submit a shorter registration form (Form SBSE-BD or SBSE-A, respectively). The proposed rules would also require an SBS Entity to certify on Schedule G of Form SBSE, Form SBSE-A, or Form SBSE-BD, as appropriate, that no person associated with it who effects or is involved in effecting security-based swaps on its behalf is subject to statutory disqualification. To avoid potential business disruptions, the proposed rules provide that an SBS Entity seeking SEC registration would first apply for conditional registration by submitting a complete application to the SEC, and then convert its conditional registration to ongoing registration by submitting a certification on Form SBSE-C signed by one of its knowledgeable senior officers (the "Senior Officer Certification").

The Senior Officer Certification must state that, after due inquiry, the senior officer has reasonably determined that the SBS Entity has the operational, financial, and compliance capabilities necessary to act as an SBS Entity and has documented the process by which he or she reached such determination.

Comments on the proposed rule on registration of SBS entities should be received on or before December 19, 2011. Additional information on the proposed rule on registration of SBS Entities is available **here**.

7. Department of the Treasury's Mandatory Cross-Border Ownership Reporting on Form SLT

On June 27, 2011, the Treasury published its notice of mandatory monthly reporting of information on cross-border ownership by U.S. and foreign residents of long-term (*i.e.,* original maturity of more than one year or no contractual maturity) securities for portfolio investment purposes on Form SLT in the Federal Register. The notice imposes reporting requirements on all U.S. persons (i) who are U.S.-resident custodians, U.S.-resident issuers or U.S.-resident end-investors, and (ii) whose consolidated total of all reportable long-term securities has an aggregate fair market value of at least $1 billion on the last business day of the reporting month (the "as-of date").

Reportable securities include certain long-term (i) securities issued by U.S. residents that are held directly by foreign residents, (ii) foreign securities that are held directly by U.S. residents, (iii) U.S. securities managed by U.S.-resident custodians on behalf of foreign residents, and (iv) foreign securities managed by U.S.-resident custodians on behalf of U.S. residents. Such reportable long-term securities include equity interests, such as common stock, preferred stock, restricted stock, and limited partnership interests, and long-term debt securities, such as bonds, notes, convertible bonds and debt with attached warrants, asset-based securities, and floating rate notes. Various types of securities are specifically excluded from the reporting requirement, including short-term securities, derivative contracts, loans and loan participation certificates, and letters of credit. Certain direct investments are also excluded.

Investment advisers generally would report as representatives of U.S.-resident issuers or U.S.-resident end-investors, and should file one consolidated report of the holdings and issuances for all U.S.-resident parts of their own organizations and for all U.S.-resident entities that they advise or manage. Investment advisers who create master-feeder funds with entities both outside and inside the U.S. should report any investments between the U.S. and foreign-resident affiliate funds that the investment adviser sets up.

Form SLT must be submitted quarterly as of September 30 and December 30 in 2011, and monthly beginning with the report as of January 31, 2012. The form must be submitted to the Federal Reserve Bank no later than the 23rd calendar day of the month following the report as-of date. Additional information on Form SLT is available **here**.

B. Other New and Proposed Securities-Related Legislation and Regulation

1. SEC's Final Rule Regarding Large Trader Reporting Requirements

On July 26, 2011, the SEC, by a unanimous vote, adopted Rule 13h-1 and Form 13H under Section 13(h) of the Exchange Act establishing large trader reporting requirements. Rule 13h-1 is intended to, among other things, help the SEC to reconstruct events following market disruptions by identifying significant market participants and to assess the impact of large trader activity on the securities markets. Rule 13h-1 targets "large traders," which are defined as persons (firms or individuals) who effect transactions in NMS securities[11] of at least (i) 2 million shares or shares with a fair market value of at least $20 million during any calendar day or (ii) 20 million shares or shares with a fair market value of at least $200 million during any calendar month.

Specifically, large traders must register with the SEC by making an initial filing on Form 13H by December 1, 2011 and annually within 45 days after the end of each full calendar year thereafter.[12] The information requested by Form 13H includes, without limitation, (i) basic identifying information, (ii) a list of business affiliates, (iii) disclosure of registration status with the CFTC or regulation by any foreign regulators, (iv) an organizational chart, (v) the names of all general and limited partners and (vi) a list of all broker-dealers at which the large trader has accounts. The SEC will keep Form 13H confidential and exempt from Freedom of Information Act requests.[13] Following initial registration, the SEC will issue each large trader a unique identification number, which it must disclose to its registered broker-dealers with whom it has accounts. Rule 13h-1 also imposes certain recordkeeping and reporting requirements on broker-dealers. Additional information on the SEC's final rule regarding large trader reporting requirements is available **here**.

2. *Anti-Spinning Provisions of FINRA's New Rule 5131*

On September 26, 2011, the "anti-spinning" provisions in new FINRA Rule 5131(b) went into effect.[14] These provisions restrict "spinning," which refers to the allocation of new issues (*i.e.*, any initial public offering of any equity security as defined in Section 3(a)(11) of the Exchange Act made pursuant to a registration statement or offering circular) by FINRA members to certain accounts. Specifically, Rule 5131(b) prohibits FINRA members from allocating new issues to certain accounts in which a beneficial interest in excess of 25 percent is held by (i) an executive officer or director of a public company or a covered non-public company[15] or (ii) a person materially supported[16] by such executive officer or director (a "Covered Person"). The Rule 5131(b) applies if (i) the company is currently an investment banking client of the FINRA member; (ii) the FINRA member received compensation from the company for investment banking services in the past 12 months; (iii) the person making the allocation decision knows or has reason to know that the FINRA member expects to provide or to be retained for investment services within the next 3 months; or (iv) the allocation was made on the condition that such executive officer or director, on behalf of the company, retain the FINRA member for future investment banking services. The anti-spinning provisions exempt allocations of new issues to certain types of accounts and permit allocations of new issues to an account, including a collective investment vehicle such as a hedge fund, in which the beneficial interests of Covered Persons do not exceed 25 percent in the aggregate. As a result of Rule 5131(b), hedge fund managers may need to obtain additional information from their investors to ascertain whether the investors are Covered Persons. Additional information on the anti-spinning provisions is available **here**.

3. *DOL's Withdrawal of Proposed Rule Expanding the Definition of "Fiduciary"*

On October 21, 2010, the Department of Labor (the "DOL") issued a proposed rule that would amend a 1975 regulation to define a "fiduciary" for the purposes of the Employee Retirement Income Security Act of 1974, as amended, more broadly as a person who provides investment advice to plans for a fee or other compensation. The DOL received more than 260 comments on the controversial proposed rule, many of which opposed the expansion of the definition. On September 19, 2011, the DOL announced its withdrawal of the proposed rule in its current form and its intention to re-propose the rule in early 2012. The re-proposed rule is expected to contain provisions, among others, (i) limiting the definition of fiduciary advice to individualized advice directed to specific parties; (ii) prohibiting the application of the rule to routine appraisals; (iii) clarifying the limits of the rule's application to arm's length commercial transactions; and (iv) setting forth new or amended exemptions that best preserve beneficial fee practices, while offering protection to plan participants and individual retirement account owners. Additional information on the DOL's withdrawal of its current proposal to expand the definition of a fiduciary and the expected re-proposed rule is available **here**.

4. House Subcommittee's Approval of H.R. 2940 (Access to Capital for Job Creators Act)

On October 26, 2011, the House Financial Services Committee approved H.R. 2940, the Access to Capital for Job Creators Act. The bill, introduced on September 15, 2011, would require the SEC to eliminate the prohibition on general solicitation or general advertising under Rule 506 of Regulation D under the Securities Act, provided that all purchasers of the securities are accredited investors. Rule 506 is utilized by many private funds as a "safe harbor" from the registration requirements of Section 5 of the Securities Act, and allows a private fund to sell an unlimited dollar amount of interests if the conditions to the rule are satisfied. Rule 506 currently prevents companies utilizing the rule from using advertisements or general solicitation activities to market securities to investors. According to Representative Kevin McCarthy (R-CA and House Majority Whip), the bill's sponsor, the removal of this restriction would allow small businesses (including private fund managers) "to widely seek funds from the entire pool of wealthy SEC accredited investors without requiring them to go through the full SEC registration process." The bill was reported to the whole House with an amendment on October 31, 2011. The full text of H.R. 2940 with the amendment is available **here**.

C. Other Updates

1. California Publishes Invitation for Comments on Proposed Changes to Custody Rules

On July 8, 2011, the California Department of Corporations (the "CA DOC") published an invitation for comments on a proposal to amend its investment adviser rules pertaining to custody or possession of funds or securities of clients.[17] The proposed amendments incorporate the proposed North American Securities Administrators Association Model Rule on investment adviser custody and recent changes to federal custody rules under the Advisers Act. Among other things, the proposed amendments (i) define "custody" as holding or having authority to possess or appropriate client funds or assets; (ii) subject to certain limited exceptions, require that advisers with custody of an account maintain the assets with a "qualified custodian," which would include certain (a) banks or savings associations, (b) California- or SEC-registered broker-dealers, (c) CFTC-registered futures commission merchants, and (d) foreign financial institutions; and (iii) specify certain audits or independent verifications respecting custody accounts that must be performed by certified public accountants registered with the Public Company Accounting Oversight Board. The comment period for the proposed amendments closed on August 5, 2011. Additional information on the CA DOC's proposed amendments to the custody rules is available **here**, and the full text of the proposed amendments is available **here**.

2. California Publishes Invitation for Comments on Proposed Private Fund Registration Exemption

On March 15, 2011, the CA DOC published an invitation for comments on a proposal to amend Section 260.204.9 of Title 10 of the California Code of Regulations in response to the elimination of the federal "private adviser" exemption under the Advisers Act. The proposal would exempt from California's registration requirements any private fund adviser that is exempted from registration with the SEC under Section 203(l) (*i.e.,* the venture capital fund exemption) or Section 203(m) (*i.e.,* the private fund adviser exemption) of the Advisers Act, as enacted by the Dodd-Frank Act, and that (i) is not subject to disqualification by the SEC, (ii) acts as an adviser solely to private funds, (iii) files with the CA DOC a copy of each report that an exempt reporting adviser under the Advisers Act would be required to file with the SEC pursuant to Rule 204-4 under the Advisers Act, (iv) pays a $125 application fee, and (v) has assets under management of not less than $100 million or provides investment advice only to venture capital companies. Comments on the proposal were due by March 28, 2011. On July 7, 2011, the CA DOC issued an emergency order effectively extending the former federal private adviser exemption in California through January 17, 2012, in light of a delay in the adoption of successor federal rules. The full text of the invitation for comments on the proposed new

California investment adviser regulations is available **here**, and the full text of the emergency order extending the former federal private adviser exemption is available **here**.

3. Massachusetts Security Division's Final Regulation on the Use of Expert Network Services by Hedge Fund Managers

On August 8, 2011, the Massachusetts Security Division adopted a final regulation addressing the rising use of expert network firms by investment advisers and concerns about the potential misuse of inside information improperly obtained by these firms. In doing so, Massachusetts became the first state to enact such a regulation. The regulation appends 950 CMR 12.205(9)(c) (a non-exclusive list of investment adviser practices deemed to be "dishonest or unethical conduct or practices in the securities business") to require an investment adviser, prior to retaining investment consulting services for compensation that is provided directly by a consultant or indirectly through an expert network service, to obtain a written certification from the consultant. The certification must (i) describe confidentiality restrictions relevant to the potential consultation, (ii) affirmatively state that no confidential information will be provided to the investment adviser, and (iii) be signed and dated by the consultant and be accurate as of the date of the initial and any subsequent consultation(s). The regulation further prohibits an investment adviser that comes into possession of material confidential information through a consultation from trading in the relevant security until the confidential information is made public. In response to concerns about the potential breadth of the regulation, "investment consulting services" covered by the regulation are limited to those obtained "for the purpose of assisting the investment adviser's decision as to whether to buy, sell, or abstain from buying or selling, positions in client accounts." In a policy statement issued on September 8, 2011, the Massachusetts Security Division clarified that the regulation is not applicable to investment advisers who register with the SEC under the Advisers Act. The final regulation will become effective on December 1, 2011. The full text of the regulation is available **here**, and the policy statement is available **here**.

4. SEBI's Draft AIF Regulations

On August 1, 2011, the Securities Exchange Board of India ("SEBI") proposed draft regulations for Alternative Investment Funds ("AIFs"), including, without limitation, private equity funds, venture capital funds, and strategy funds (including hedge funds). These draft regulations would supplant the existing regulatory framework centered on the voluntary Venture Capital Funds ("VCF") registration system. The draft regulations, among other things, (i) establish mandatory registration for all new and existing AIFs (not currently registered as VCFs) and define eligibility criteria for such funds; (ii) impose certain structural requirements on AIFs; (iii) outline certain obligations for the fund sponsor, designated partner, or board of directors; (iv) set guidelines restricting solicitation and requiring certain disclosures to investors; (v) require investor consent before an AIF can change its investment strategy; (vi) dictate termination standards for AIFs; (vii) impose general investment restrictions; and (viii) establish reporting and transparency requirements. The draft regulations also contain grandfather provisions for existing AIFs currently registered as VCFs, which would continue under the terms of the existing framework for the duration of their tenure. The comment period for the draft regulations ended on August 30, 2011. The full text of SEBI's draft regulations for AIFs is available **here**.

II. TAXATION

A. Carried Interest under the American Jobs Act of 2011

One of the recent tax developments since our last Report relates to President Obama releasing the American Jobs Act of 2011 (the "Act") on September 12, 2011. Section 412 of the Act would add a new Section 710 to the Internal Revenue Code of 1986, as amended (the "Code"). Code Section 710 generally treats 100% of the carried interest earned by a partner providing investment management services to an investment services partnership as ordinary income instead of net capital gain. If enacted, Code Section 710 will be effective on January 1, 2013.

Unlike prior proposed carried interest legislation, Code Section 710 does not phase in the new tax treatment of carried interest over time. The proposed legislation also targets "investment service partnership interests," whereas prior proposals generally applied to all partnership interests. The term "investment services partnership interest" generally includes any interest in an investment partnership acquired or held by any person in connection with such person's investment management services.

Taxing carried interest at ordinary income rates has been met with strong resistance. With a Republican-controlled house in 2011 and 2012, it is unlikely that Code Section 710 will be enacted this year or that it will be enacted without modification. However, the proposed legislation indicates that the Obama administration intends to pursue carried interest legislation. If it appears that the proposed legislation or similar legislation will be enacted, fund managers may wish to consider the increased tax burden upon the sale of profits interests in management entities when structuring fund investments. We will continue to monitor the progress of the Act and any other proposed carried interest legislation.

B. Recent FBAR Developments

As discussed in previous issues of our Report, U.S. persons who have an interest in or signatory authority over a foreign account with a value over $10,000 are required to file a Foreign Bank Account Report ("FBAR"). The Internal Revenue Service (the "IRS") has been actively calling for FBAR compliance. Significant civil and criminal penalties await those who fail to file FBARs. The IRS has provided additional guidance on those who are required to file FBARs, filing deadlines and how those who failed to file FBARs may achieve compliance. On February 26, 2010, the IRS issued Announcement 2010-16 and Notice 2010-23. The announcement provides retroactive relief from FBAR filing for foreign entities and persons while the notice extends the FBAR filing deadline for some taxpayers who have signature authority and who own commingled funds to June 30, 2011.

1. Extension of June 30, 2011 Deadline for Certain U.S. Persons

On June 16, 2011, the IRS released Notice 2011-54. The notice extends the FBAR filing deadline from June 30, 2011 to November 1, 2011 for U.S. persons who have signatory authority over, but no financial interest in, a foreign financial account. The relief is limited to foreign financial accounts held during calendar year 2009 or earlier and for which the filing deadline was properly deferred under Notice 2009-62 or Notice 2010-23. The filing deadline for calendar year 2010 remains June 30, 2011.

Notice 2011-54 does not limit the relief provided by the Financial Crimes Enforcement Network ("FinCEN") in Notice 2011-1, which was released on May 31, 2011 and revised on June 6, 2011. As revised, Notice 2011-1 extends the FBAR filing deadline for one additional year to June 30, 2012 for a subset of individuals with only signature authority over, but no financial interest in, certain foreign financial accounts. These individuals include:

- Employees or officers of a regulated entity (as specified in the FBAR regulations) who have signature or other authority over, and no financial interest in, a foreign financial account of another entity more than 50% owned, directly or indirectly, by the regulated entity (a "controlled person"), and

- Employees or officers of a controlled person of a regulated entity who have signature or other authority, and no financial interest in, a foreign financial account of the regulated entity or another controlled person of the regulated entity.

FinCEN also released Notice 2011-2 on June 17, 2011. Notice 2011-2 extends the FBAR filing deadline for one additional year from June 30, 2011 to June 30, 2012 for employees or officers of investment advisors registered with the SEC who have signature or other authority, and no financial interest in, foreign financial accounts of persons that are not investment companies registered under the Investment Company Act of 1940, as amended. The extension applies to FBAR filings for calendar year 2010 or earlier years for which the filing deadline was properly deferred under Notice 2009-62 or Notice 2010-23.

2. Guidance with Respect to Certain Former Employees

On October 11, 2011, FinCEN released guidance in response to questions related to FBAR reporting requirements with respect to former employees who had signature or other authority over, but no financial interest in, a foreign financial account of a former employer during a reportable calendar year.

The guidance states that FinCEN does not expect former employees who had signature or other authority over, but no financial interest in, foreign financial accounts with respect to their duties for former employers during a reportable calendar year to maintain records of the foreign financial accounts of their employers personally. The guidance additionally states that due to proprietary and privacy concerns, FinCEN does not expect a former employer to provide information on foreign financial accounts to a former employee. Instead, in such instances, a former employee should provide as much information as possible when filing an FBAR, including at a minimum, the fact that the former employee had signature or other authority over a foreign financial account and the name of the former employer, as well as his or her title with the former employer. The guidance with respect to current employees who had signature or other authority over a foreign financial account of a current employer during a reportable calendar year is not changed. Further, the guidance does not apply in the case of changes in employment status made for the purpose of evading the FBAR reporting requirements.

C. Recent Foreign Account Tax Compliance Act Developments

The Foreign Account Tax Compliance Act ("FATCA"), which was enacted in March 2010 in the Hiring Incentives to Restore Employment Act, requires foreign financial institutions ("FFIs") to report "U.S. accounts" to the IRS or pay a 30% withholding tax on any "withholdable payments" made to the institutions or their affiliates.

On July 14, 2011, the IRS released Notice 2011-53 (the "Notice") in response to numerous comments concerning the practical difficulties in implementing the reporting and withholding requirements under FATCA within the time frames previously provided. The Notice modifies guidance provided in Notice 2010-60 and Notice 2011-34, discussed in our previous Reports, and provides for a phased implementation of the requirements under FATCA.

1. FFI Agreement with the IRS

Under previous guidance, an FFI was required to enter into an agreement with the IRS prior to January 1, 2013 in order to refrain from withholding. Pursuant to the Notice, that deadline is revised. The Notice states that an FFI must enter into an agreement with the IRS by June 30, 2013 to ensure that it will be identified as a participating FFI in sufficient time to allow U.S. withholding agents to refrain from withholding beginning on January 1, 2014. FFIs that enter into such agreements after June 30, 2013, but before January 1, 2014, will be participating FFIs with respect to 2014, but might not be identified as such in time to prevent withholding beginning on January 1, 2014.

2. Participating FFI Due Diligence Procedures

A participating FFI is required to put into place account opening procedures to identify U.S. accounts among accounts opened on or after the effective date of its agreement with the IRS. Such procedures are described in Notice 2010-60, as implemented by regulations, and include diligent searches of an FFI's electronic and paper records and requests for account holder provision of certain identifying documentation. Such due diligence procedures remain unchanged.

Similar due diligence procedures are required for pre-existing accounts, or those in existence on the effective date of a participating FFI's agreement with the IRS. Such due diligence procedures must generally be carried out within one year of the effective date of a participating FFI's agreement with the IRS. The Notice provides that, with respect to pre-existing private banking accounts that have a balance or value of less than $500,000, an FFI may complete the private banking due diligence procedures described in Notice 2011-34 by the later of December 31, 2014 or the date that is one year after the effective date of its agreement with the IRS. Due diligence requirements and timelines with respect to all other pre-existing accounts remain the same.

3. Private Banking Accounts

The Notice assures that regulations will provide further guidance on the scope of the private banking procedures and associated search of account holder files. As required under Notice 2011-34, private banking relationship managers must identify any client for which such relationship managers have actual knowledge that the client is a U.S. person and request a Form W-9 from such person. However, regulations will provide that the review of account files may be completed by any person designated by the participating FFI. Regulations will also provide that accounts subject to due diligence procedures and identified as either U.S. accounts or non-U.S. accounts under the due diligence procedures will not be subject to additional due diligence procedures in subsequent years unless the account undergoes a change of circumstance.

4. Reporting Requirements

The Notice defers and simplifies certain FFI reporting requirements relating to calendar year 2013. With respect to an account for which a participating FFI has received a From W-9 from the account holder, or from a substantial U.S. owner of a U.S. owned foreign entity, by June 30, 2014, the FFI must report the following simplified information to the IRS by September 30, 2014:

- the name, address and U.S. taxpayer identification number of such account holder;
- the account balance as of December 31, 2013, or if the account was closed after the effective date of the FFI's agreement with the IRS, the balance of the account immediately before closure; and
- the account number.

If an FFI is unable to report the required information because, for example, the account holder has not waived any applicable reporting restrictions, the FFI will be required to report the account as recalcitrant. The reporting with respect to recalcitrant account holders identified by June 30, 2014 will be required to be filed with the IRS by September 30, 2014.

Reporting requirements with respect to calendar year 2014 and subsequent years are not changed by the Notice.

5. Withholding Obligations

Under previous guidance, withholding may have applied to certain accounts as early as January 1, 2013. The Notice delays certain withholding requirements and implements withholding by withholding agents on withholdable payments in two phases. For payments made on or after January 1, 2014, withholding agents (whether domestic or foreign and including participating FFIs) will be obligated to withhold only on U.S. source fixed or determinable annual or periodical ("FDAP") payments. On January 1, 2015, withholding will apply to all withholdable payments, including U.S. source FDAP payments, gross proceeds from the sale or other disposition of property which can produce interest or dividends from sources within the U.S and non-FDAP passthru payments.

6. *Qualified Intermediary and Other Withholding Agreements Expiring in 2012*

The Notice provides that all qualified intermediary agreements, withholding foreign partnership agreements and withholding foreign trust agreements of FFIs that expire on December 31, 2012 will be automatically extended until December 31, 2013.

In addition, any FFI that enters into an agreement with the IRS on or before December 31, 2013 will be considered to have renewed its qualified intermediary agreement, withholding foreign partnership agreement, or withholding foreign trust agreement, as applicable.

7. *Clarification of the Scope of Grandfathered Obligations*

Payments on "obligations" outstanding on March 18, 2012 are not subject to FATCA withholding. The Notice states that the Treasury and the IRS intend to issue regulations clarifying the term "obligation" as any legal agreement that produces or could produce passthru payments (including withholdable payments), but not including any instrument treated as equity for U.S. tax purposes, or any legal agreement that lacks a definitive expiration or term.

8. Next Steps

The Treasury and IRS reaffirmed in the Notice that they anticipate issuing proposed regulations incorporating the guidance provided in the Notice, Notice 2010-60 and Notice 2011-34 by December 31, 2011 and final regulations in the summer of 2012.

D. Tax Court Denies Petitioner was a Trader in Securities

In July 2011, the U.S. Tax Court released *Kay v. Commissioner*, T.C. Memo 2011-159, which addressed trader status. In general, for federal income tax purposes, a person who purchases and sells securities falls into one of three categories: a dealer, trader, or investor. "Dealers" are generally individuals or entities that buy securities for resale to customers. "Traders" generally engage in a "trade or business" of buying and selling securities for their own accounts to take advantage of short-term price changes. "Investors" likewise buy and sell for their own accounts, but generally buy securities for long-term appreciation and are not engaged in a trade or business. Whether one is a "trader" or an "investor" is not determined by a specific formula or objective criteria; it depends on an analysis of all the facts and circumstances involved in one's activities, taken as a whole. This characterization will affect, among other things, the extent to which partners in a partnership may deduct certain items of the partnership's expenses for federal income tax purposes.

In *Kay v. Commissioner*, petitioner, an individual taxpayer, made a mark-to-market election under Code Section 457(f) in order to use the mark-to-market method of accounting for securities held in a business. Petitioner reported ordinary losses with respect to his business as a day trader.

The Tax Court denied the deductions for losses under Code Section 165(f), which generally limits deduction of capital losses to $3,000. The Tax Court noted that while petitioner made a timely election under Code Section 457(f) to use the mark-to-market method of accounting (which would generally allow the taxpayer to offset ordinary income with ordinary losses in excess of the $3,000 capital loss limitation), petitioner was not properly considered a trader in securities. Therefore, the ordinary losses claimed by petitioner were deemed capital losses and subject to the $3,000 limitation.

In determining whether petitioner was a trader, the Tax Court first looked at whether petitioner's trading activities were substantial. The Tax Court held that, among other factors, petitioner's 84 to 313 trades per year were not substantial. Notably, the Tax Court stated that while the total amount of money involved in petitioner's trading was substantial, "managing a large amount of money is not conclusive as to whether petitioner's trading activity amounted to a trade or business."

The Tax Court next looked at whether petitioner sought to profit from short-term swings in the stock market. The Tax Court looked at the length of time petitioner held securities, which was generally over thirty days. Further, petitioner rarely purchased and sold the same stock on the same day. The Tax Court found that petitioner did not hold securities long enough or trade frequently enough to show that he sought to profit from short-term swings.

Funds may wish to consider whether they qualify for trader status, given the continuing scrutiny by the Tax Court of dealers, traders, and investors. The case provides guidance for such determinations. Key factors to examine include number of trades per year, amounts of money traded and the holding period of the securities involved in the trades. A fund that previously determined that it qualifies as a trader should reexamine its trader status each year in which it has a mark-to-market election in place to ensure that the election will not be challenged.

III. CIVIL LITIGATION

Hedge funds are currently involved in litigation, both as defendants and plaintiffs, over a wide variety of issues. Several significant rulings were handed down that affect important questions such as the duties of hedge fund managers and independent directors, and the rights of investors in hedge funds. These rulings include the following:

- The Grand Court of the Cayman Islands ruled that the independent directors of a hedge fund were personally liable for $111 million in excess redemption payments made by the fund due to their intentional breach of their duty of care.
- The Delaware Chancery Court ruled that a hedge fund manager breached her fiduciary duty and her agreement with the fund's sole investor when she raised a "gate" preventing withdrawal from the fund.
- Interview notes and summaries prepared during an internal investigation by a hedge fund's attorneys were held to be protected by attorney-client privilege, even though the hedge fund disclosed portions of those notes to its investors and the SEC.
- The New York Statute of Frauds barred a claim by a hedge fund marketer who alleged that she was promised compensation for brokering a transaction between a hedge fund and an investment corporation.
- An asset manager and its two futures funds filed a complaint against twelve banks responsible for setting LIBOR, alleging that the banks colluded to artificially suppress LIBOR in order to appear financially healthy.
- The Southern District of New York dismissed several securities fraud claims against a defendant hedge fund on the basis that the investors' reliance on alleged misstatements and omissions by the fund were unreasonable in light of disclaimers in the fund's subscription documents.

In brief, hedge fund litigation continues to expand in scope and in the range of issues involved, reflecting both the varied roles of hedge funds and the challenges they face during challenging financial conditions.

A. New Developments in Securities Litigation

1. <u>Independent Directors of Hedge Fund Held Personally Liable for $111 Million in Excess Redemption Payments</u>

On August 26, 2011, the Grand Court of the Cayman Islands ruled that Stefan Peterson and Hans Ekstrom, the independent directors of Weavering Macro Fixed Income Fund Limited ("Weavering"), were personally liable for $111 million in excess redemption payments made by the fund.[18] According to the court, the directors could be held personally liable for the fund's losses because they intentionally neglected their duty of care when they allowed Weavering's founder Magnus Peterson to conceal losses by showing gains on fictitious interest rate swaps. These fictitious swaps caused Weavering's net asset value to be artificially inflated, which in turn caused the fund to pay $111 million more in redemptions than it would have paid if the NAV were accurate.

The court explained that a director can be held personally liable for a fund's losses when he commits a "knowing and intentional breach of duty" or acts recklessly, "not caring whether or not the act or omission is a breach of duty." According to the court, there was an abundance of evidence that showed that the defendant independent directors intentionally breached their duty to supervise the fund, which in turn allowed Magnus Peterson to engage in the fictitious swaps. For example, the defendants: (1) failed to ensure the accuracy of the fund's offering documents, (2) never prepared formal agendas for their meetings, (3) never reviewed monthly or quarterly management accounts at their board meetings, (4) signed sham contracts that gave the impression that Weavering had hired a new investment manager and (5) signed board minutes for meetings that never took place. Such behavior, according to the court, amounted to intentional neglect: "If they knew that they had a duty to supervise – and they both claim to have been aware of this duty – but did nothing, then it seems to me that their neglect must be intentional."

According to the fund's organizational documents, the defendant directors were to be indemnified against liability "other than such liability (if any) that [they] may incur by [their] own willful neglect or default." Because the court found that the defendants "consciously chose not to perform their duties," indemnification was unavailable.

Hedge fund directors should view the Weavering case as a cautionary tale illustrating the types of behavior that the Grand Court of the Cayman Islands will label as intentional neglect. In addition, every hedge fund should ensure that its indemnification policy is well-articulated and understood by all its employees and directors.

2. <u>Hedge Fund Manager Raises Gate In Order to Prevent Withdrawal; Held to Be Breach of Fiduciary Duty</u>

On August 8, 2011, the Delaware Chancery Court ruled that Michele Paige, the founder and manager of four entities and hedge funds bearing her name (collectively, the "Fund"), breached her fiduciary duty to the Fund's sole investor when she raised a "gate" and prevented withdrawal from the Fund.[19] The sole investor was the Lerner Master Fund (the "Lerner Fund"), which entered into a Partnership Agreement and a Seeder Agreement with the Fund in 2007. Among other things, the agreements provided that for a three-year "lockup" period, the Lerner Fund could not withdraw its $40 million investment from the Fund without paying liquidated damages.

Paige's management of the Fund and her relationship with the Lerner Fund soured shortly thereafter. When Paige was unable to attract any additional investors or raise any additional capital, the Lerner

Fund decided to withdraw its investment once the lockup period expired on October 31, 2010. To that end, the Lerner Fund sent a formal redemption notice on March 11, 2010. Paige responded in a letter by threatening to use a “gate” provision in the Partnership Agreement to prevent the Lerner Fund from withdrawing its investment. Paige also threatened to continue to collect management fees on the Lerner Fund’s investment and to “mitigate [ ] damages by investing the portfolio in [ ] high risk, long-term, illiquid, activist securities.” Paige then filed a lawsuit in the Delaware Chancery Court seeking a declaratory judgment that the Fund’s actions were lawful. The Lerner Fund counterclaimed for breach of contract, breach of fiduciary duty, and judicial dissolution of the Fund. Paige raised the Fund’s gates on October 31, 2010, and only returned 20% of the Lerner Fund’s investment.

The court ruled that Paige’s action in “raising the gate” was unauthorized, and that she had breached her fiduciary duty to the Lerner Fund by doing so. The court explained that "[a]s a matter of default law," Paige owed fiduciary duties to the Fund and its investors. Though the RULPA permits the waiver of fiduciary duties, the court found that there was no such provision in the Partnership Agreement. The court explained that while the Fund’s Partnership Agreement (which governed the Fund’s relationship with all investors) contained a gate provision that allowed Paige to reduce the amount of withdrawals from the Fund, the Seeder Agreement (which was specific to the Fund’s relationship with the Lerner Fund) contained no restrictions on withdrawal after the three-year lockup period. After reviewing the two agreements in tandem and considering the parties’ bargaining history, the court ruled that the execution of the more-specific Seeder Agreement constituted an express waiver of the gate provision. Thus, the court ruled that Paige and the Fund had breached their agreement with the Lerner Fund when they refused to return the Lerner Fund’s investment after the three-year lockup period.

The court alternatively ruled that even if the gate provision of the Partnership Agreement had not been waived, Paige breached her fiduciary duty to the Lerner Fund. The court found that Paige had the authority to waive or modify the conditions of withdrawal for certain large or strategic investors, and her decision not to do so was made entirely out of self-interest and was therefore unjustifiable.

4. <u>New York Statute of Frauds Bars Quantum Meruit Claim for Hedge Fund Brokering Services</u>

On September 26, 2011, the Southern District of New York granted summary judgment in favor of defendants American Capital Strategies Ltd. (“American Capital”), Providence Investment Management LLC, and Providence Investment Partners LLC (collectively, “Providence”) against plaintiff Lisa Vioni.[20] Vioni was the founder, president, and CEO of Hedge Connection Inc., which offered marketing tools to hedge funds and investors. In 2006, Vioni was contacted by the managing director of investment corporation American Capital for advice in creating an asset management business. Vioni then introduced American Capital to hedge fund Providence. As a result, American Capital negotiated with Providence in acquiring the latter’s investments, funds, clients, and employees.

Vioni claimed that she was promised orally and through e-mail by both defendants throughout the negotiations that she would be compensated for her role in brokering the transaction. When she was not so compensated, Vioni filed a complaint in the Southern District of New York claiming breach of contract, promissory estoppel, and quantum meruit. Only the quantum meruit claim survived dismissal, and was the subject of defendants’ summary judgment motion.

The court granted summary judgment in favor of American Capital and Providence on the grounds that the evidence showed that the defendants accepted Vioni’s services only with respect to her hedge fund marketing services. According to the court, there was no documentation to indicate that the defendants intended to retain Vioni as a broker for the transaction that eventually ensued between them; rather, the evidence showed that Vioni’s introduction of the defendants to each other was “incidental to Vioni’s interest in securing her own capital-raising role.” Because Vioni could not produce any document that showed that the defendants understood Vioni’s introduction to be a professional service, rather than a courtesy, the court ruled that the New York Statute of Frauds barred Vioni's quantum meruit claim.

As this case illustrates, proactive scrutiny of a hedge fund's marketing agreements with third-party vendors may help avoid future miscommunication and disputes.

5. European Banks Accused of Colluding to Manipulate LIBOR

On April 15, 2011, European asset manager FTC Capital GMBH and two of its futures funds (collectively, "FTC Capital") filed a putative class action complaint in the Southern District of New York.[21] The complaint alleged that during the 2006-2009 period, twelve banks (including Credit Suisse Group AG, Bank of America Corporation, and J.P. Morgan Chase & Co.) conspired to artificially depress the London interbank offered rate ("LIBOR"). LIBOR is a measure for rates that bank charge each other in the London wholesale money market, and is used globally as a short-term rate benchmark. The defendant banks are among the sixteen banks that the British Bankers' Association selected to contribute to the publication of 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 allegations in the complaint appear to rely heavily on a May 29, 2008 Wall Street Journal article by Carrick Mollenkamp and Mark Whitehouse titled "Study Casts Doubt on Key Rate." The analysis published in that article found that the reported LIBOR rates for each of the defendant banks did not correspond to the banks' perceived health as measured in the credit default market, and that the divergence between these two measures ranged from .3 to .87 percent. FTC Capital's complaint alleged that days after the publication of this article, the LIBOR rate suddenly jumped.

FTC Capital filed a putative class action in the Southern District of New York, alleging that the defendant banks "collectively agreed to artificially suppress the Libor rate" and sold LIBOR-based derivatives at those artificial prices in order to obtain an unfair market advantage. FTC Capital alleged that this alleged misconduct was in violation of Section 1 of the Sherman Antitrust Act, as amended, and several sections of the Commodity Exchange Act, as amended. This action is currently in its early stages, and an updated summary will be provided in the next Hedge Fund Report issued by Paul Hastings.

6. Securities Fraud Claims Dismissed Due to Disclaimers in Subscription Agreement

On March 14, 2011, the Southern District of New York dismissed all securities fraud claims against asset manager and hedge fund sponsor RAM Capital Resources, LLC ("RAM Capital").[22] The plaintiff investors alleged that RAM Capital's principals misrepresented that plaintiffs could redeem their investments after six months, that one of the principal's sisters was an investor in the fund, and that the principals were themselves heavily invested in the fund. The complaint also alleged that the fund's principals wrongfully withheld the information that they were under investigation by the SEC, and that they were not registered broker-dealers.

The district court dismissed all of plaintiffs' securities fraud claims on the grounds that it was not reasonable for plaintiffs to rely on those alleged misrepresentations and omissions. According to the court, "no reasonable investor would make an investment in any venture based on the representation that the promoter's sister, who was a close friend of the investor's wife, was also an investor." Moreover, "[n]ot only could the information easily have been verified by the childhood friends speaking to one another, the alleged representations to the Accredited Investors fly in the faces of the disclaimers in the Subscription Agreements." The court also explained that the fund's principals were under no duty to disclose "uncharged, unadjudicated wrongdoing or mismanagement," and that the plaintiffs could have easily availed themselves of the omitted information had they carefully read the fund's subscription documents.

The RAM Capital case confirms the value to a hedge fund of including clear disclaimers in its subscription documents. Such disclaimers can offer substantial protection in the event that an investor asserts claims based on oral or written statements of a fund representative.

IV. REGULATORY ENFORCEMENT

Recent SEC enforcement actions relating to hedge funds and hedge fund advisors have focused on insider trading, fraudulent misrepresentations and omissions, and Ponzi schemes. The SEC also remains interested in improper conduct relating to side pockets and Private Investments in Public Equity ("PIPE") offerings. The Commission is also still working to define and implement the extensive rulemaking with which it has been charged under the Dodd-Frank Act. As one SEC Commissioner noted earlier this year, "the agency cannot rush. The scope and complexity of the rulemaking is daunting and unprecedented,"[23] as it affects registration, reporting, adviser compensation, derivatives trading, and short sale disclosure, among other things.[24]

Some additional avenues of SEC inquiry with respect to hedge funds advisors are also beginning to take shape and should be monitored. These include preferential redemption practices,[25] the structuring of CDOs in ways that create conflicts of interest,[26] and alleged misconduct through the use of computer models to execute investment strategies.[27]

A. Insider Trading

The SEC's crackdown on insider trading continues. Indeed, SEC Chairman Mary Schapiro recently called insider trading a problem of "tremendous magnitude."[28] Not only has the SEC been investigating insider trading through the use of expert networking firms, but it was also recently reported that the SEC has subpoenaed hedge funds in connection with an investigation concerning possible insider trading ahead of S&P's downgrade of the U.S. government's long-term credit rating.[29] The SEC has reportedly asked FINRA to search for "bearish trades" that are "unusually large or were made by investment firms that wouldn't normally make such trades."[30]

Where the SEC suspects that individuals or entities are trading on material, non-public information, it has sought – and obtained – asset freezes and other emergency relief on short notice, and in some extreme cases with little more evidence than "highly profitable and suspicious purchases" of securities.[31] Moreover, in certain situations, the Department of Justice has shown a readiness to use other investigative techniques more commonly associated with the investigation of organized and violent crimes, such as search warrants, wiretaps, and undercover sting operations. In a recent high-profile trial, *US v. Rajaratnam*,[32] prosecutors used 45 wiretap recordings in support of their insider trading case against Raj Rajaratnam, former general partner of Galleon Management LLC. According to Greg Andres, acting deputy director of the Department of Justice's Criminal Division, speaking at the Practising Law Institute *White Collar Crime 2011* conference in New York: "You have to think of all these techniques together as tools for prosecutors . . . . They will be used more and more."[33] We discuss several insider trading cases below.

1. SEC v. Feinblatt

On January 10, 2011, the SEC filed a complaint against Robert Feinblatt, co-founder and former principal of Trivium Capital Management LLC, a New York-based hedge fund adviser, charging him with insider trading.[34] The SEC alleged that a senior executive at a telecommunications company tipped inside information to Feinblatt in connection with a going-private transaction, a corporate acquisition, and two quarterly earnings announcements. The information was allegedly passed through an individual with various sources inside the relevant companies as well as from a Moody's rating agency analyst. The SEC alleged that Feinblatt was liable for the trading that occurred in the hedge funds he managed because he "effectuated the trades on behalf of the funds, controlled the funds, and/or unlawfully tipped the inside information to the funds."[35] On July 17, 2011, Feinblatt settled the

SEC charges by consenting to the entry of a permanent injunction and an order requiring him to pay disgorgement, plus prejudgment interest, and a civil penalty.[36] Feinblatt also separately consented to a bar from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent.[37]

2. *SEC v. Scolaro*

On August 31, 2011, the SEC filed a settled civil insider trading action against Anthony Scolaro, a former portfolio manager at the hedge fund adviser Diamondback Capital Management, LLC ("Diamondback"). The SEC alleged that Scolaro obtained material non-public information concerning the acquisition of a pharmaceutical company, and then placed trades on behalf of the hedge fund.[38] According to the SEC's complaint, two former lawyers at the law firm Ropes & Gray learned that a firm client was one of the bidders for the pharmaceutical company.[39] The night before the deadline for potential purchasers to indicate their interest, the two former lawyers allegedly called another lawyer in New York, who the same night called a proprietary trader, and allegedly gave him the information about the takeover in exchange for kickbacks.[40] According to the SEC, the proprietary trader then tipped a colleague, who traded in the securities of the pharmaceutical company, and who tipped the information to Scolaro.[41] To settle the SEC's charges, Scolaro consented to the entry of a final judgment ordering him to disgorge $125,980, and to pay prejudgment interest of $14,420 and a civil penalty of $62,945. Diamondback, as a relief defendant, consented to a judgment ordering it to disgorge $962,486 in illicit gains, and to pay prejudgment interest of $110,246. Scolaro also consented to a bar from associating with any investment adviser, broker, dealer, municipal securities dealer, municipal adviser, transfer agent, or nationally recognized statistical rating organization.[42] Scolaro's monetary payment and bar from the securities industry may come on top of a possible prison sentence that he faces in a related criminal case in which he pled guilty.[43]

3. *SEC v. Clay Capital Management, LLC*

On August 31, 2011, the SEC filed an insider trading complaint against James F. Turner II ("Turner") and his New Jersey-based hedge fund advisor, Clay Capital Management, LLC ("Clay Capital").[44] In its complaint, the SEC alleged that a close friend of Turner's learned that the company for which the friend worked was interested in potentially acquiring another company. The friend allegedly tipped Turner about the planned tender offer in advance of the public announcement. The SEC alleged that Turner traded on this information in his personal accounts, his family members' accounts and the account of a hedge fund that he managed, Clay Capital Fund, LP. He also allegedly tipped several of his friends. According to the SEC, illicit gains from the insider trading amounted to approximately $2.3 million. The complaint further alleged that Turner's friend provided inside information about his company's 2008 fourth quarter earnings, which generated an additional $1.1 million in illicit gains. According to the complaint, Turner also received material non-public information about another company's performance in advance of the company's public earnings announcement, and trades based on this information generated illicit profits of nearly $500,000. In total, the traders are alleged to have made illicit gains of nearly $3.9 million. The case is ongoing.

B. Fraudulent Misrepresentations to Investors

The SEC continues to investigate and bring actions against hedge funds and their employees for allegedly making false representations to investors in order to induce the investors to invest or remain invested in the funds that they manage. Although the actions described below involve extreme examples of misrepresentations, they highlight the regulatory focus on accuracy when hedge funds make representations about performance track records, the existence of other investors, personal investments by managers, and internal safeguards.

1. *SEC v. Faruki*

On August 31, 2011, the SEC obtained emergency relief in the form of a temporary restraining order and an asset freeze against Belal Faruki and the hedge fund advisor, Neural Markets, LLC ("Neural Markets").[45] The SEC had earlier filed suit against Faruki and Neural Markets for allegedly lying to prospective investors in order to induce them to invest in the fund that Faruki managed.[46] In its complaint, the SEC alleged that Faruki falsely told investors that he had a history of successful trading and that Neural Markets would utilize a proprietary algorithm to carry out an arbitrage strategy involving trading in liquid ETFs.[47] Faruki also allegedly lied to investors about his track record, the existence of other investors in his fund, his personal investments in the fund and his use of a well-known reputable auditor to prepare financial statements.[48] The SEC charged Faruki and Neural Markets with violations of the antifraud provisions of the federal securities laws. The case is ongoing.

2. *SEC v. Folin*

On July 12, 2011, the SEC charged Sam Folin, the hedge fund advisor, Benchmark Asset Managers LLC ("Benchmark"), and its parent holding company, Harvest Managers LLC ("Harvest"), with allegedly misappropriating $8.7 million from clients through false statements.[49] In its complaint,[50] the SEC alleged that Folin promised investors that their money would be invested in hedge funds that make investments in companies with "socially responsible" goals and purposes. The SEC alleged that after the failure of certain investments in several South African businesses, Folin began raising funds from new investors, in a Ponzi-like scheme, to pay off prior investors. As the scheme continued, Folin allegedly promised certain investors a guaranteed, above-market rate of return in order to entice them to invest. He also allegedly misrepresented the actual value of the funds' assets to investors.[51] In consenting to the entry of a final judgment, Folin, Benchmark, and Harvest were enjoined from future violations of the antifraud provisions of the federal securities laws. Further, Folin, Benchmark, and Harvest consented to pay disgorgement of $8,706,620, and prejudgment interest of $1,454,177. Folin also agreed to pay a civil penalty of $150,000, and separately to a bar from the securities industry. Harvest and Benchmark each agreed to pay a $750,000 civil penalty.

3. *SEC v. Clement*

On May 12, 2011, the SEC filed an emergency enforcement action against John Clement and hedge fund advisor Edgefund Capital, LLC ("Edgefund") to halt the alleged misappropriation of investors' funds.[52] The SEC accused Clement, a day trader, of raising $2.1 million from twenty-two investors in San Diego, California by falsely promising returns of 1 to 2% per month, with risk being limited because of a "5% stop-loss rule."[53] The SEC alleged that, instead of acting as promised, Clement misappropriated and spent all of the investor funds. In order to conceal the alleged fraud, Clement allegedly sent fabricated account statements reflecting an inflated hedge fund value of $8.2 million, when in fact the hedge fund's accounts were never funded.[54] The SEC charged Clement and Edgefund with violating the antifraud provisions of the federal securities laws. In addition to the emergency relief, which the Court granted,[55] the SEC is seeking preliminary and permanent injunctive relief, disgorgement, prejudgment interest, and civil penalties.

4. *SEC v. Butler*

On May 5, 2011, the SEC obtained an emergency asset freeze and court order to halt an ongoing securities fraud allegedly being committed by Robert Butler and his unregistered hedge fund, Butler Private Investment Fund.[56] According to the SEC's complaint, Butler raised $3.3 million from seventeen investors during the time period 2009 to 2011.[57] The SEC alleged that Butler falsely claimed to investors that he could produce returns of 2 to 10% per month by utilizing a proprietary trading program.[58] Instead, Butler allegedly stole half of the fund's money and lost the other half trading.[59] According to the SEC's complaint, to conceal the fraud, Butler sent falsified account statements and inflated the hedge fund's value. One statement indicated that the value of the hedge fund was $8.9 million, when in reality it was worth a mere $22.[60] Butler was charged with violating the antifraud provisions of the federal securities laws. The SEC is seeking preliminary and permanent injunctive relief, disgorgement, prejudgment interest, and civil penalties.

C. Side Pockets and Valuations of Illiquid Assets

Hedge fund advisors often utilize side pockets to separate illiquid assets from more liquid investments. In the event an investor wishes to redeem his or her investment in a hedge fund that utilizes a side pocket – *i.e.*, a segregated account used to set aside thinly traded or illiquid assets – the investor is generally not permitted to redeem the *pro rata* portion of his investment allocated to the side pocket until the asset is liquidated or released from the side pocket. Not surprisingly, due to the opportunity for abuse, the SEC has taken an interest in how hedge funds utilize side pockets. At a Practising Law Institute panel in October 2011, Bruce Karpati, co-chief of the SEC enforcement team responsible for policing hedge funds, told participants that the SEC is looking at how hedge funds value illiquid assets and whether managers are improperly using side pockets to hide underperforming assets.[61] As demonstrated by the judicial opinion discussed below, even though misrepresentations to investors concerning the value of assets in a fund's side pocket may be fraudulent, the SEC must still take care to properly plead the elements of the violations it seeks to charge in its efforts to curtail such abuses.

In October 2010, the SEC charged hedge fund advisor PEF Advisors LLC and hedge fund managers Paul Mannion, Jr. and Andrew Reckles for making false statements regarding the value of side pocket investments.[62] At issue was the decision of Mannion and Reckles to invest more than 20% of the fund's assets in a medical staffing company that later declared bankruptcy. In its complaint, the SEC cited an e-mail allegedly written by Reckles after an investment had been made in the medical staffing company, wherein he noted that financial irregularities at the medical staffing company all but guaranteed "a HUGE loss to [the fund's] investors."[63] Reckles allegedly went on to write that if news of the company's increasingly precarious financial situation became public, the fund "fear[ed] large scale redemptions [that] could cause the end of our fund . . . ." According to the SEC, to avoid "large scale redemptions," defendants decided to place the investment in a "side pocket."[64] Once the assets were in the side pocket, the SEC alleged that the defendants assigned a value to the medical staffing company's securities that was substantially higher than the defendants' own internal valuation assessment.

The defendants filed a motion to dismiss the complaint, arguing among other things that the SEC had failed to demonstrate that any alleged misstatements regarding the value of the securities were made "in connection with the purchase or sale of a security." In opposition to the motion to dismiss, the SEC argued that the "in connection with" requirement in the statute could be met simply by showing that defendants made "assertions . . . in a manner reasonably calculated to influence the investing public."[65] In other words, the SEC argued that because NAV statements were sent to investors and were designed to influence investors' decisions whether to continue to hold or redeem the investment, the "in connection with" standard had been met.

On June 1, 2011, the United States District Court for the Northern District of Georgia denied defendants' motion to dismiss, but rejected the SEC's argument on the "in connection with" issue. The court held that the fund's distribution of NAV statements to investors would not necessarily "occur in connection with the purchase or sale of any security," and would therefore not necessarily satisfy the statutory requirement. However, the court ruled that the SEC's allegation that one new investor actually invested after receiving the NAV statement was sufficient to withstand the motion to dismiss.[66] The court wrote, "[i]f the alleged misrepresentation was material to the investing decision and was provided to the new investor as the Court understands the Complaint to allege, then the SEC has adequately alleged a misrepresentation 'in connection with the purchase or sale of any security.'"[67] The case is ongoing.

D. Ponzi Schemes

Ponzi schemes continue to receive a high level of regulatory attention. According to the SEC, in each of the past two fiscal years the Commission has filed more than twice as many Ponzi scheme cases as were filed in fiscal year 2008.[68]

Criminal prosecution of these cases can sometimes result in stiff sentences, such as the 30-year prison term – the statutory maximum – imposed on Matthew Pizzolato by the United States District Court for the Eastern District of Louisiana in July 2010. The case against Pizzolato involved a $20 million Ponzi scheme that targeted senior citizens. Pizzolato claimed that he would safeguard investors' "nest eggs," and offered a supposed guarantee against loss of principal. Instead of properly investing investor funds, Pizzolato used new investor money to pay lulling payments to other investors in an effort to conceal the true nature of the Ponzi scheme. He also used investor money to pay his personal expenses.[69] On September 9, 2011, the Fifth Circuit upheld the sentence, finding that prosecutors had not broken a plea agreement that called for a shorter sentence.[70]

In a Ponzi scheme case that we have previously discussed, *SEC v. Illaramendi*, the SEC recently amended its complaint to add three hedge funds as relief defendants. In January 2011, the SEC filed suit against Illarramendi and two other individuals, Juan Carlos Zerpa and Juan Carlos Napolitano, charging them with violations of the antifraud provisions of the federal securities laws.[71] The complaint alleged that Illarramendi had run a Ponzi scheme between 2006 and 2011, and had created bogus documents, such as a bank letter and an asset verification letter purporting to show that one of the funds he managed had at least $275 million in credits, when in fact such credits did not exist. In March 2011, Illarramendi pled guilty to two counts of wire fraud, one count of securities fraud, one count of investment advisor fraud, one count each of conspiracy to obstruct justice, to obstruct an official proceeding, and to defraud the SEC.[72] Also, on May 4, 2011, Juan Carlos Zerpa pled guilty to one count of conspiracy to obstruct the SEC's investigation for helping create false documents purporting to verify the existence of hedge fund assets during the SEC's investigation.[73]

On May 10, 2011, the SEC filed an amended complaint adding Highview Point Partners, LLC ("Highview"), a Connecticut-based investment adviser, as a defendant in the action, charging it with the same violations as Illarramendi.[74] The SEC alleged that Illarramendi conducted his alleged fraud while he was a partial owner of Highview, and that Highview misappropriated money from three hedge funds it advised. These three hedge funds were named as relief defendants because they allegedly received funds tainted through the Ponzi scheme. On June 28, 2011, the SEC announced that, pursuant to a Court order, the assets of the three relief defendant hedge funds that were held in offshore accounts had been returned to the United States from overseas and would remain frozen until completion of the SEC's case.[75]

E. PIPE Transactions

PIPE offerings also remain of interest to the SEC. As noted in our last update, PIPE transactions typically involve a public company offering unregistered, restricted shares to investors at a discount to the market price of the company's publicly traded shares. The issuer often agrees to file a subsequent registration statement within an agreed upon period of time so that investors can sell their shares.

In *SEC v. The NIR Group, LLC*, the SEC charged hedge fund manager Corey Ribotsky and the hedge fund advisor, The NIR Group, with violations of the antifraud provisions of the federal securities laws for allegedly lying to investors about the performance of the hedge funds that they managed.[76] The NIR Group invested in various PIPE transactions and held the securities from these investments in the portfolios of the funds it managed. According to the SEC's complaint, during the financial crisis, many of these portfolio companies became defunct or verged on bankruptcy. As the fund's PIPE investments were losing value, Ribotsky repeatedly told investors that the funds were performing well and that all of the PIPE investments could be liquidated in 36 to 48 months, even though the funds' outside auditor had calculated that it would take decades to liquidate the funds' PIPE investments, if it could be done at all.[77] The SEC complaint also alleged other fraudulent conduct and the misappropriation of investor funds for personal use, and is seeking injunctive relief against Ribotsky and The NIR Group, as well as disgorgement, prejudgment interest, and civil penalties.

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[1] These priority areas (in order of priority) are: (1) Valuation/Performance Issues (aberrational performance; fraudulent or weak valuation procedures or practices; lax valuation committees; the use of side pockets to conceal losing or illiquid positions); (2) Conflicts of Interest (commonly managed accounts (*e.g.*, side-by-side management of separate accounts with fund accounts); allocation practices; undisclosed compensation arrangements/loans; use of affiliated broker-dealers; soft dollar/best execution violations; preferential treatment/redemptions (including side letters that give investors preferential treatment); and private equity fund fees, deal allocations, cross-fund investing, capital deployment, and relationships with potential deal sources); (3) Compliance/Controls (managers with a weak compliance and control environment; controls around "quant" funds; controls around insider trading, particularly use of expert networks); (4) Offering Issues (unregistered broker-dealers that sell fund interests; offering fraud and misappropriation of client assets); and (5) Third-Parties/Service Providers (*e.g.*, deficient auditors, administrators, and fund boards of directors).

[2] New Rule 203(l)-1 under the Advisers Act defines a “venture capital fund” as a private fund that: (i) holds no more than 20 percent of the fund’s capital commitments in non-qualifying investments (other than short-term holdings); (ii) does not borrow or otherwise incur leverage, other than certain limited short-term borrowing; (iii) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (iv) represents itself as pursuing a venture capital strategy to its investors and prospective investors; and (v) is not registered under the 1940 Act, and has not elected to be treated as a business development company. Rule 203(l)-1 also contains a grandfathering provision for pre-existing funds that satisfy certain criteria.

[3] A “private fund” includes any issuer that would be an investment company as defined in Section 3 of the 1940 Act but for Sections 3(c)(1) or 3(c)(7) of that act. The definition includes hedge funds, private equity funds, certain real estate funds, and venture funds.

[4] New Section 202(a)(30) of the Advisers Act, as added by the Dodd-Frank Act, defines a “foreign private adviser” as any investment adviser that: (i) has no place of business in the United States; (ii) has, in total, fewer than 15 clients and investors in the United States in private funds advised by the investment adviser; (iii) has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser of less than $25 million, or such higher amount the SEC may, by rule, deem appropriate; and (iv) neither holds itself out generally to the public in the United States as an investment adviser nor acts as (I) an investment adviser to any investment company registered under the 1940 Act; or (II) a company that has elected to be a business development company pursuant to Section 54 of the 1940 Act, and has not withdrawn its election.

[5] The “private adviser” exemption set forth in the now repealed Section 203(b)(3) of the Advisers Act exempted any investment adviser from registration if the investment adviser (i) had fewer than 15 clients in the preceding 12 months, (ii) did not hold itself out to the public as an investment adviser, and (iii) did not act as an investment adviser to a registered investment company or a company that has elected to be a business development company.

[6] Exempt reporting advisers are those investment advisers exempted from registration under Section 203(l) or 203(m) of the Advisers Act.

[7] The quarterly filing fees only apply to private fund advisers managing $1 billion or more in hedge fund assets, combined liquidity fund and registered money market fund assets or private equity fund assets.

[8] Specifically, the Dodd-Frank Act requires the SEC to exclude a natural person’s primary residence from the threshold net worth calculation for “accredited investor” under the Securities Act, and Regulation R under the Exchange Act excludes a natural person’s primary residence from the threshold calculation for “high net worth customers.”

[9] The Commodity Futures Trading Commission is working on its own “Volcker Rule” which it plans to propose shortly.

[10] The Exchange Act defines "security-based swap dealers" as ones who (i) hold themselves out as a dealer in security-based swaps; (ii) make a market in security-based swaps; (iii) regularly enter into security-based swaps with counterparties as an ordinary course of business for its own account; or (iv) engage in any activity causing them to be commonly known in the trade as a dealer or market maker in security-based swaps. "Major security-based swap participants" are defined by the Exchange Act as any person who is not a security-based swap dealer and (i) who maintains a substantial position in security-based swaps for certain major security-based swap categories, (ii) whose outstanding security-based swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets, or (iii) who is a financial entity that is highly leveraged relative to the amount of capital such entity holds, is not subject to Federal capital requirements, and maintains a substantial position in outstanding security-based swaps in any major security-based swap category. Sections 721(b) and 761(b) of the Dodd-Frank Act provide that the SEC may further define the terms "security-based swap dealer," and "major security-based swap participant," to include transactions and entities that have been structured to evade the requirements of subtitles A and B, respectively, of Title VII of the Dodd-Frank Act.

[11] An "NMS security" is any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options. The term refers generally to exchange-listed securities, including equities and options.

[12] If a person becomes a large trader after December 1, 2011, such person must register "promptly" (*i.e.,* within 10 days) after satisfying the threshold activity level.

[13] However, the SEC is still required to share the information if requested by Congress or by any other federal department or agency requesting information for purposes within the scope of its jurisdiction, or to comply with federal court orders in actions brought by the United States or the SEC.

[14] The other provisions of Rule 5131 became effective on May 27, 2011.

[15] A "covered non-public company" means any non-public company with: (i) income of at least $1 million in the last fiscal year or in two of the last three fiscal years and shareholders' equity of at least $15 million; (ii) shareholders' equity of at least $30 million and a two-year operating history or (iii) total assets and total revenue of at least $75 million in the last fiscal year or in two of the last three fiscal years.

[16] "Material support" means directly or indirectly providing more than 25 percent of a person's income in the prior calendar year. FINRA deems persons living in the same household as providing each other with material support.

[17] The proposed changes supersede an earlier proposal to amend the custody rule that was part of the invitation for comments on the "Investment Adviser Omnibus Rulemaking: Custody, Advertising, Unethical Practices, and Books" (the "Omnibus Rulemaking"), published in December 2010. In addition to changes to the custody rule, the Omnibus Rulemaking proposed amending several provisions in Title 10 of the California Code of Regulations including, among others, those pertaining to advertisements (Section 260.235), minimum financial requirements (Section 260.237.2), and books and records to be maintained by investment advisers (Section 260.241.3), as well as adopting new provisions including, among others, those pertaining to deliveries of brochures and brochure supplements, investment adviser codes of ethics, and payment for client solicitations. The comment period for the Omnibus Rulemaking closed on January 7, 2011.

[18] *Weavering Macro Fixed Income Fund Limited v. Stefan Peterson and Hans Ekstrom*, Cause No. FSD 113 of 2010, Cayman Islands Grand Court, Financial Services Division (Aug. 26, 2011).

[19] *Paige Capital Management, LLC, et al. v. Lerner Master Fund, LLC*, *et al.,* C.A. No. 5502-CS (Del. Ch. Aug 8, 2011).

[20] *Lisa Vioni, et al. v. American Capital Strategies Ltd., et al.,* Case No. 08 Civ. 02950 (S.D.N.Y. Sep 26, 2011).

[21] *FTC Capital GMBH, et al., v. Credit Suisse Group AG, et al.*, Docket No. 11 Civ. 2613 (S.D.N.Y. Apr. 15, 2011).

[22] *Mario Frati, Stacy Frati and Banco Popolare (Luxembourg) S.A., v. Stephen E. Saltzstein, et al.,* Case No. 10 Civ. 3255 (S.D.N.Y. Mar. 14, 2011).

[23] Speech by SEC Commissioner: Remarks at the Symposium on "Hedge Fund Regulation and Current Developments," Commissioner Troy A. Paredes, U.S. Securities and Exchange Commission, The Center for Law, Economics & Finance (C-LEAF), The George Washington University Law School, New York, New York (June 8, 2011).

[24] *Id.*

[25] Joshua Gallu, *SEC Scrutinizes Algorithmic Traders*, Bloomberg (Oct. 3, 2011) (noting that the SEC stated it "will likely bring more cases against hedge funds that engaged in preferential redemption, where the owners of the firm or selected investors are able to liquidate their investments before other clients").

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[26] *SEC Eyes End To Hedge Funds' Role In Building CDOs, FINalternatives*, available at http://www.finalternatives.com/node/18105.

[27] Joshua Gallu, *SEC Scrutinizes Algorithmic Traders*, Bloomberg (Oct. 3, 2011).

[28] Steve Eder, *SEC Chief Draws a 'Bright Line' on Insider Trading*, The Wall Street Journal (Oct. 21, 2011).

[29] Jean Eaglesham, *U.S. Probes Rating-Cut Trades*, The Wall Street Journal (Sept. 20, 2011).

[30] *Id.*

[31] In *SEC v. Compania Internacional Financiera S.A.*, No. 11-CV-4904, (S.D.N.Y.), the SEC obtained an asset freezing order simply on "information and belief" that the defendants were in possession of non-public information at the time they purchased their securities. *See* SEC Press Release No. 2011-149 (July 17, 2011), http://www.sec.gov/news/press/2011/2011-149.htm. In its complaint, filed only days after the alleged insider trades occurred, the SEC only alleged higher than average trading volume prior to the public announcement of the acquisition (*Id.* at ¶ 14), a rise in the stock price prior to the public announcement (*Id.* at ¶ 14), no publicly-available news stories about the proposed acquisition prior to the public announcement (*Id.* at ¶ 15), and sales by the defendants of their shares after the public announcement. *Id.* at ¶¶ 16-17. However, the SEC alleged that the defendants were foreign entities that placed the trades for overseas accounts, and that the freeze was justified to prevent the proceeds from being transferred outside the jurisdictional reach of the United States courts as soon as the trades cleared and settled. *Id. at* ¶ 3.

[32] *US v. Raj Rajaratnam*, 09 cr. 01184 (S.D.N.Y.).

[33] *See Undercover Agents, Wiretaps a Reality for White Collar Investigations, Experts Say*, BNA White Collar Crime Report, Oct. 7, 2011.

[34] *SEC v. Feinblatt*, *et al.,* No. 11-CV-0170 (S.D.N.Y.). *See also* SEC Litig. Release No. 21802 (Jan. 10, 2011), http://www.sec.gov/litigation/litreleases/2011/lr21802.htm.

[35] *Id.*

[36] SEC Litig. Release No. 22085 (Sept. 7, 2011), http://www.sec.gov/litigation/litreleases/2011/lr22085.htm.

[37] *Id.*

[38] *SEC v. Scolaro*, No. 11-CV-6112 (S.D.N.Y.).

[39] Complaint at ¶¶ 5-6.

[40] *Id.*

[41] *Id.* at ¶ 6.

[42] *Id.*

[43] SEC Litig. Release No. 22078 (Aug. 31, 2011), http://www.sec.gov/litigation/litreleases/2011/lr22078.htm.

[44] *SEC v. Clay Capital Management*, No. 2:11-CV-05020 (D.N.J.).

[45] SEC Litig. Release No. 22079 (Aug. 31, 2011), http://www.sec.gov/litigation/litreleases/2011/lr22079.htm.

[46] *SEC v. Faruki et al.*, No. 11-CD-05406 (N.D.Ill.).

[47] Complaint at ¶ 18.

[48] *Id.* at ¶¶ 33-34.

[49] SEC Litig. Release No. 22036 (Jul. 12, 2011), http://www.sec.gov/litigation/litreleases/2011/lr22036.htm.

[50] *SEC v. Folin et al.*, No. 11-CV-4447 (E.D.Pa.).

[51] *Id.* at ¶ 4.

[52] *SEC v. Clement et al.*, No. 11-CV-1034 (S.D.Ca.).

[53] SEC Litig. Release No. 21971 (May 16, 2011), http://www.sec.gov/litigation/litreleases/2011/lr21971.htm.

[54] *Id.*

[55] *Id.*

[56] SEC Litig. Release No. 21959 (May 5, 2011), http://www.sec.gov/litigation/litreleases/2011/lr21959.htm.

[57] *SEC v. Butler*, No. 11-03792 MMM (C.D.Ca.). Complaint at ¶¶ 1, 14.

[58] *Id.* at ¶ 9.

[59] *Id.* at ¶ 17.

[60] *Id.* at ¶ 18.

[61] Joshua Gallu, *SEC Scrutinizes Algorithmic Traders*, Bloomberg (Oct. 3, 2011) ("In his remarks today, Karpati said his team is also looking at how hedge funds value illiquid assets and whether some investment managers have used so-called side pockets to hide underperforming assets.").

[62] SEC Litig. Release No. 21699 (Oct. 19, 2010), http://www.sec.gov/litigation/litreleases/2010/lr21699.htm.

[63] *SEC v. Mannion et al.*, No. 10-3374 (N.D.Ga.). Complaint at ¶ 28.

[64] *Id.* at ¶ 29.

[65] Opinion and Order in *SEC v. Mannion et al.*, No. 10-3374, at 18.

[66] *Id.* at 19.

[67] *Id.* at 20.

[68] Testimony on "Fixing the Watchdog: Legislative Proposals to Improve and Enhance the Securities and Exchange Commission" by Chairman Mary L. Schapiro, U.S. Securities and Exchange Commission, Before the U.S. House of Representatives Committee on Financial Services (Sept. 15, 2011).

[69] *U.S. v. Pizzolato*, No. 2:09-CR-00378 (E.D.L.).

[70] *U.S. v. Pizzolato*, No. 10-30729 (5th Cir.).

[71] *SEC v. Illarramendi*, No. 3:11-CV-00078 (D.Conn.).

[72] SEC Litig. Release No. 21970 (May 16, 2011), http://www.sec.gov/litigation/litreleases/2011/lr21970.htm.

[73] *Id.*

[74] *Id.*

[75] SEC Litig. Release No. 22015 (June 28, 2011), http://www.sec.gov/litigation/litreleases/2011/lr22015.htm.

[76] *SEC v. The NIR Group, LLC et al.*, No. 2:11-cv-04723 (E.D.N.Y.).

[77] SEC Litig. Release No. 22106 (Sept. 28, 2011), http://www.sec.gov/litigation/litreleases/2011/lr22106.htm.