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Hedge Fund Report—Summary of Key Developments—Spring 2015

By The Investment Management, Securities Litigation & Tax Practices

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

This Report provides an update since our last **Hedge Fund Report** in Fall 2014, 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.

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I. SECURITIES-RELATED LEGISLATION AND REGULATION

A. Dodd-Frank Updates

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

1. *SEC Advisory Committee Approves Recommendations Regarding the Accredited Investor Definition*

As discussed in our **Spring 2014** Report, Section 413(b) of the Dodd-Frank Act requires the SEC to undertake a review of the definition of "accredited investor" in Regulation D of the Securities Act of 1933, as amended (the "Securities Act"), as it applies to natural persons, at least once every four years. As previously reported in our **Fall 2014 Report**, on October 9, 2014, in connection with the SEC's statutorily mandated review, the SEC's Investment Advisory Committee adopted recommendations encouraging the SEC to "consider alternative approaches" to the financial thresholds in the current accredited investor definition.

On March 4, 2015, the SEC's Advisory Committee on Small and Emerging Companies (the "Advisory Committee") approved their own recommendations regarding the Accredited Investor definition, which were set forth in a letter to SEC chair Mary Jo White dated March 9, 2015. The Advisory Committee recommended that (i) any modifications to the accredited investor definition should expand, rather than contract, the pool of accredited investors; (ii) on a going forward basis, the SEC should adjust the accredited investor thresholders according to the consumer price index; (iii) the SEC should focus on "enhanced enforcement efforts and increased investor education" rather than raising the threshold for accredited investor status; and (iv) the SEC should continue to gather data on this subject for ongoing analysis. The full text of the Advisory Committee's letter to Ms. White is available **here**.

2. *SEC Proposes Amendments to Form ADV*

On May 20, 2015, the SEC published a proposed rule (the "Proposed Rule") which would, among other things, amend Part 1A of Form ADV (the "Form ADV Amendments") to (i) require advisers to provide certain aggregate information on the advisers' separately managed accounts, including information on regulatory assets under management, investments and use of derivatives and borrowings; (ii) require advisers to provide additional information on their business, including but not limited to information on the advisers' use of social media and the adviser's other offices; (iii) incorporate "umbrella registration" for private fund advisers; and (iv) add clarifying, technical and other amendments to existing items and instructions.

The SEC noted in its proposing release for the Form ADV Amendments that the Form ADV Amendments "are designed to improve the depth and quality of the information [the SEC] collect[s] on investment advisers and to facilitate [the SEC's] risk monitoring initiatives."

Comments are due on the Proposed Rule sixty days from the date the publication of the Proposed Rule in the Federal Register. The SEC's proposing release for the Proposed Rule is available **here**.

3. *SEC Chair Supports SEC's Development of Fiduciary Standard for Broker Dealers*

On March 17, 2015, SEC Chair Mary Jo White, speaking at a Securities Industry and Financial Markets Association seminar in Phoenix, Arizona, expressed her support for a uniform fiduciary standard that would hold broker-dealers to the same fiduciary standard as SEC-registered investment advisers. Such rulemaking would be pursuant to Section 913(f) of the Dodd-Frank Act, which authorizes (but does not require) the SEC to promulgate rules which would hold broker-dealers providing investment advice about securities to retail customers to the same standard of conduct applicable to investment advisers.

Currently, SEC-registered investment advisers are held to a fiduciary standard, which requires them to act in the best interest of the client,[1] while registered broker-dealers must comply with FINRA's lower "suitability" standard. The suitability standard requires only that the broker-dealer have a "reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence" of the broker-dealer.[2]

Ms. White's remarks followed an announcement by President Obama on February 23, 2015 that he was directing the Department of Labor (the "DOL") to move ahead with a proposed rule (which the DOL published on April 14, 2015 (the "2015 Proposed Rule")) that would raise investment-advice standards for brokers handling retirement accounts. Under the 2015 Proposed Rule any individual receiving compensation for providing advice that is individualized or specifically directed to a particular plan sponsor (e.g., an employer with a retirement plan), plan participant, or IRA owner for consideration in making a retirement investment decision will be considered a fiduciary. Fiduciaries under the 2015 Proposed Rule can include broker-dealers, registered investment advisers, insurance agents, or other types of advisers. The 2015 Proposed rule includes various carve-outs from the fiduciary standard, including, among others, (i) providing retirement education, (ii) order-taking, (iii) marketing or making available a platform of investment alternatives to be selected by a plan fiduciary for an ERISA participant-directed individual account plan and (iv) statements or recommendations made to a "large plan investor with financial expertise" by a counterparty acting in an arm's length transaction.

Comments were initially due on the 2015 Proposed Rule on July 6, 2015. On May 15, 2015, the DOL extended the deadline for the comment period until July 21, 2015. The full text of the 2015 Proposed Rule is available **here**.

4. *Volcker Rule Conformance Deadline Set for July 21, 2015 for Funds Established After December 31, 2013; Extension for Legacy Covered Funds*

On December 18, 2014, the Federal Reserve announced that, pursuant to Section 619 of the Dodd-Frank Act, commonly known as the "Volcker Rule," it is allowing banking entities (i.e., insured depository institutions and any company affiliated with an insured depository institution) until July 21, 2016, to conform investments in and relationships with covered funds and foreign funds that were in place prior to December 31, 2013 ("Legacy Covered Funds") to the Volcker Rule. The Federal Reserve also announced its intention to act in 2015 to grant banking entities an additional one-year extension of the conformance period until July 21, 2017, to conform ownership interests in and relationships with Legacy Covered Funds. To date, formal action on this latter extension has not occurred.

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

By statute, the Volcker Rule provided banking entities a grace period until July 21, 2014 to conform to its requirements and authorized the Federal Reserve to extend the conformance period for three additional one-year periods. The Federal Reserve previously extended the conformance period for one year to July 21, 2015. The Federal Reserve also previously issued a statement in April 2014 indicating that it intended to grant two additional one-year extensions of the conformance period for banking entities to conform ownership interests in and sponsorship activities of collateralized loan obligations ("CLOs") that are backed in part by non-loan assets and that were in place as of December 31, 2013.

The Federal Reserve's announcement on December 18, 2014 is consistent with the agency's previous announcement regarding CLOs and extends the conformance period for other types of Legacy Covered Funds. Importantly, the extension permits banking entities additional time to divest or conform Legacy Covered Fund investments only. Thus, at this time, all investments and relationships in a covered fund made after December 31, 2013, i.e., covered funds other than Legacy Covered Funds, must be in conformance with the Volcker Rule requirements and restrictions by July 21, 2015. Moreover, the extension does not apply to proprietary trading activities, and thus, banking entities must also conform their proprietary trading activities to the Volcker Rule and implementing regulations by July 21, 2015.

5. *Volcker Rule FAQs*

In June 2014, the Federal Reserve, OCC, FDIC, SEC, and CFTC (collectively, the "Agencies") issued coordinated guidance on Volcker Rule implementation issues in the form of responses to Frequently Asked Questions ("FAQs"). The FAQs address topics relating to all aspects of the Volcker Rule, including the restrictions on proprietary trading activities and covered fund activities, as well as compliance program requirements. Since the initial release of the FAQs in June 2014, the Agencies have updated the guidance with additional FAQs on a rolling basis (most recently, on February 27, 2015). Such FAQs currently address several notable topics relating to fund activities, including but not limited to namesharing prohibitions and marketing restrictions relating to exempt foreign funds.

Substantively identical versions of the FAQs (although formatted differently) and responses are available on each Agency's website, which may be accessed **here** (Federal Reserve), **here** (OCC), **here** (FDIC), **here** (SEC), and **here** (CFTC).

B. JOBS Act Updates

1. SEC Publishes Guidance on Handling of 'Bad Actor' Waivers

On March 13, 2015, the staff of the SEC Division of Corporation Finance ("Corp Fin") published its policy on granting waivers from "bad actor" disqualification pursuant to Rule 506(d)(2)(ii) under the Securities Act of 1933, as amended (the "Waiver Policy"). As discussed in our prior **Report**, Rule 506(d) prohibits an issuer from relying on the safe harbor provision for private offerings under the Securities Act if "covered persons" of the issuer are or have been subject to certain disqualifying events[3] (a "Bad Actor Disqualification"); provided, that the SEC may determine upon a showing of good cause that the prohibition "is not necessary under the circumstances" (a "Bad Actor Waiver").

The Waiver Policy sets forth the factors that Corp Fin will consider, among other facts and circumstances, when determining whether granting a Bad Actor Waiver is appropriate in any given case. Specifically, Corp Fin will consider (i) the nature of the violation or conviction, (ii) whether it involved the offer and sale of securities and (iii) whether the conduct involved a criminal conviction or scienter based violation, as opposed to a civil or administrative non-scienter based violation. The Waiver Policy notes that the burden on the party seeking a Bad Actor Waiver to show good cause that a Bad Actor Waiver is justified is significantly greater "[w]here there is a criminal conviction or a scienter based violation involving the offer and sale of securities." Corp Fin will also consider (i) who was responsible for the misconduct and what role the bad actor or actors have or had with respect to the party seeking the Bad Actor Waiver, (ii) whether the misconduct occurred over an extended period or whether it was an isolated instance, (iii) what remedial measures the party seeking the Bad Actor Waiver has taken to address the misconduct, the duration of those remedial measures, and the likelihood that those measures will prevent a recurrence of the misconduct and mitigate the possibility of future violations and (iv) the severity of the impact on the issuer or third parties (e.g., investors, clients or customers) if the waiver request is not granted and whether disqualification would be a disproportionate hardship in the light of the parties involved in, and the nature of, the misconduct. The Waiver Policy states that no single factor is dispositive.

Parties seeking a Bad Actor Waiver are required to include in their waiver request appropriate justification for granting the Bad Actor Waiver, addressing the factors described in the Waiver Policy and describing why a waiver should be granted. The full text of Corp Fin's Waiver Policy is available **here**.

C. Other Securities-Related Updates

1. SEC 2015 Examination and Enforcement Priorities

On January 13, 2015, the SEC Office of Compliance Inspections and Examinations ("OCIE") published its 2015 National Exam Program ("NEP") priorities for examinations of SEC-registered entities, including private fund advisers (the "Priorities List"). The purpose of the Priorities List is to communicate with investors and registrants about areas perceived by the NEP to have potentially heightened risk to investors and/or the integrity of capital markets. For 2015, the Priorities List focuses on three thematic areas:

- Protecting retail investors and investors saving for retirement. OCIE states that its focus on retirement investments stems from the increasing number of products and services that were formerly characterized as alternative or institutional, including, but not limited to, private funds, now being offered by registrants. The NEP's examination initiatives to assess risks related to this trend include, among others, a review of alternative fee arrangements, sales practices, suitability determinations and a registered entity's supervision of branch offices.

- Assessing market-wide risk. OCIE intends to examine for structural risks and trends that may involve multiple firms or entire industries, including but not limited to monitoring the largest U.S. broker-dealers and asset managers and continuing OCIE's previously announced cybersecurity examination initiative (which we previously discussed in our **Spring 2014 Report**).

- Using data analytics to identify potential illegal activity. OCIE intends to use its enhanced capabilities in data analytics to focus on registrants and firms that appear to be potentially engaged in fraudulent and/or other potential illegal activity, including, among others, registrants with a history of misconduct.

In addition to the three thematic areas described above, OCIE expects to allocate additional examination resources to other areas that may be relevant to private fund advisers, such as examinations of fees and expenses of private equity fund advisers and the practices of transfer agents involved with private offerings.

The Priorities List is not exhaustive and OCIE staff intends to conduct additional examinations in 2015 focused on risks, issues, and policy matters that are not addressed in the Priorities List. The full Priorities List is available **here**.

On February 26, 2015, Julie M. Riewe, Co-Chief of the Asset Management Unit (the "AMU") of the SEC's Division of Enforcement, speaking at the IA Watch 17th Annual IA Compliance Conference in Washington, DC, disclosed the AMU's 2015 enforcement priorities for private funds (including both hedge funds and private equity funds).

The AMU's private fund enforcement priorities for 2015 include conflicts of interest (including principal transactions and hedge fund side-by-side management conflicts such as trade allocations and cherry picking), valuation, and compliance and controls. Ms. Riewe stated that the AMU anticipates cases "involving undisclosed fees; all types of undisclosed conflicts, including related-party transactions; and valuation issues, including use of friendly broker marks." Ms. Riewe also noted that the AMU will continue to refine its Aberrational Performance Inquiry ("API"), which uses proprietary risk analytics to identify hedge funds with suspicious returns.[4] Ms. Riewe also highlighted recent enforcement actions involving principal transactions without the required written disclosure and consent.

The full text of Ms. Riewe's remarks are available **here**. The API is discussed further in Section IV, Regulatory Enforcement, below.

2. *SEC Continues to Address Cybersecurity Issues*

On February 3, 2015, OCIE published a risk alert (the "Cybersecurity Risk Alert") summarizing the results of OCIE's sweep of more than 50 registered broker-dealers and investment advisers to assess cybersecurity preparedness in the securities industry (the "Cybersecurity Initiative"). As discussed in our prior **Report**, the Cybersecurity Initiative focused on firm practices for: (i) identifying risks related to cybersecurity; (ii) establishing cybersecurity governance, including policies, procedures, and oversight processes; (iii) protecting firm networks and information; (iv) identifying and addressing risks associated with remote access to client information and funds transfer requests; (v) identifying and addressing risks associated with vendors and other third parties; and (vi) detecting unauthorized activity.

Among other findings, the Cybersecurity Risk Alert discloses that a large majority of examined firms (88% of broker dealers and 74% of investment advisers) reported that they had been the subject of a cyber-related incident (either directly or through one or more of their vendors), and that most of these incidents were related to malware or fraudulent emails. The losses to the firm from these incidents varied, with one adviser reporting a loss in excess of $75,000 related to a fraudulent email. The Risk Alert also notes investment advisers lag behind broker dealers in incorporating requirements relating to cybersecurity risk into their contracts with vendors and business partners, as well as in maintaining insurance for cybersecurity incidents. The full text of the Risk Alert is available **here**.

On February 4, 2015, Vincente Martinez, the Chief of the Office of Market Intelligence in the SEC's Enforcement Division, speaking SIFMA/FINRA Cybersecurity Conference in New York City, indicated that the SEC is investigating how it can use its existing regulatory authority to bring more enforcement actions against firms for failing to provide sufficient protection for the confidentiality and integrity of customer information. For example, Regulation SP requires broker-dealers and investment advisers to, among others, adopt policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and data.

On April 28, 2015, the SEC Division of Investment Management (the "IM Division") published a Guidance Update on cybersecurity (the "Cybersecurity Guidance Update") describing measures that, in the SEC staff's view, registered investment advisers may wish to consider when addressing cybersecurity risk. These measures generally include (i) conducting periodic assessments of the nature of the firm's information and technology systems, the internal and external cybersecurity threats to these systems, security controls currently in place and the potential impact of any breach to these systems; (ii) developing strategies to prevent, detect and respond to cybersecurity threats; and (iii) implementing their cybersecurity strategy through written policies and procedures and training for officers and employees and, in some cases, investors and clients.

The Cybersecurity Guidance Update encourages advisers to assess whether they (and any relevant service providers) have adequate measures in place to mitigate exposure to cybersecurity risk and to tailor their compliance programs based on the nature and scope of their business. The full text of the Cybersecurity Guidance Update is available **here**.

3. SEC's No-Action Relief from Custody Rule for Principals-only Funds

On March 23, 2015, the staff of the IM Division issued a no-action letter (the "No-Action Letter") to 16th Amendment Advisors LLC ("16th Amendment") addressing the applicability of certain provisions of Rule 206(4)-2 under the Advisers Act (the "Custody Rule") to private investment funds whose investors consist solely of the fund manager's "Principals" (as defined below), their spouses and minor children.

In the No-Action Letter, the staff of the IM Division gave assurance that it would not recommend enforcement action to the SEC under the Custody Rule against 16th Amendment if 16th Amendment did not comply with the annual audit or a surprise examination that would otherwise be required under the Custody Rule with respect to private funds where the only investors in the funds were: (a) individuals who (i) have plenary access to information (which could be statutory, contractual or a combination of the two) concerning the management of 16th Amendment, the funds and each of the fund's general partners (or equivalent), (ii) are listed as "control persons" in 16th Amendment's Form ADV because of their status as 16th Amendment's officers or directors with executive responsibility (or having a similar status or function) and (iii) have a material ownership in 16th Amendment (the "Principals"); and (b) the Principals' spouses and minor children, as well as investment vehicles established for the individual or joint benefit of the 16th Amendment Principals, their spouses or minor children.

Investment advisers to private funds in which the only investors are control persons of the investment adviser should consider reviewing the No-Action Letter to determine whether the no-action relief may apply. However, given the narrow scope of the definition of "Principals," the no-action relief may not apply to most employee or "friends-and-family" funds. The full text of the No-Action Letter is available **here**.

4. *SEC Discusses Investment Adviser Initiatives for 2015*

On March 6, 2015, in remarks at the 2015 IAA Investment Adviser Compliance Conference in Arlington, Virginia, David Grim, then acting director of the IM Division,[5] discussed the SEC's rulemaking initiatives for investment advisers in 2015, which include rules regarding enhanced data reporting, transition plans and stress testing.

Mr. Grim stated that SEC staff have been considering whether there is additional information on Form ADV and Form PF "that would be useful for risk assessment purposes." By way of example, Mr. Grim noted that further information about separately managed accounts could be used by the SEC to "inform examination priorities and the assessment of the risks associated with those accounts, which are a significant portion of the business of many investment advisers." Mr. Grim reported that SEC staff is also developing a recommendation to require investment advisers to create transition plans for major disruptions in their business and that such transition plans would be "designed to complement existing compliance programs" required by the Advisers Act. Lastly, Mr. Grim noted that the SEC staff was working to implement the new requirements for annual stress testing by large investment advisers and large funds, as required by the Dodd-Frank Act.

The full text of Mr. Grim's speech is available **here**.

On May 20, 2015, the SEC proposed amendments to Form ADV. These proposed amendments are described further in Section I.A.2, above.

5. *SEC Considering Third Party Examinations of Investment Advisers*

In March 24, 2015 testimony before the United States House of Representatives Committee on Financial Services and April 9, 2015 opening remarks to the SEC Investor Advisory Committee, SEC Chair Mary Jo White indicated that in 2015 the SEC will discuss rulemaking to "require a program of third party examinations of investment advisers" to increase the SEC's examination coverage. These third party examinations would "supplement, but not replace, examinations conducted by [OCIE]."

The full text of Ms. White's March 24 remarks are available **here**, and the full text of Ms. White's April 9 remarks are available **here**.

6. *National Futures Association Requiring CPOs to State 'Delegated' Status*

On April 8, 2015 the National Futures Association (the "NFA") issued Notice I-15-13 (the "Notice") requiring commodity pool operators ("CPOs") who have been delegated investment management authority over any other commodity pool to report this status on the NFA's Background Affiliation Status Information Center system ("BASIC") when filing the pool's annual financial statement.

The Notice follows no-action relief extended by CFTC staff in two no-action letters in 2014, which were discussed in our **Fall 2014 Report** (the "CFTC Letters"). Under the CFTC Letters, CFTC staff stated that registration relief will automatically be granted to CPOs that delegate investment management authority to another CPO that is registered as a CPO, as long as the delegating CPO does not engage in the solicitation of participants for the applicable commodity pool.

Because the no-action relief granted in the CFTC Letters is self-executing, the NFA is not notified when a CPO has delegated its authority. As a result, the NFA was not able to disclose the information on BASIC.

The NFA indicated in the Notice that it is "actively working" to provide an alternative notification method for instances for which an annual financial statement is not required. The full text of the Notice is available **here**.

7. *Cayman Update*

Cayman Islands FATCA Portal

In March 2015, the Department for International Tax Cooperation of the Cayman Islands government (the "DITC") announced the launch of its Automatic Exchange of Information Portal (the "Portal"). The Portal enables Cayman Islands reporting financial institutions to satisfy their notification and reporting obligations under Cayman Islands regulations that implement provisions of the intergovernmental agreements entered into between the Cayman Islands and each of the United States and the United Kingdom. The intergovernmental agreement between the Cayman Islands and the United States sets out the terms under which the Foreign Account Tax Compliance Act ("FATCA") will be implemented. The intergovernmental agreement between the Cayman Islands and the United Kingdom sets out the terms under which provisions similar to FATCA regarding the automatic exchange of information will be implemented.

Broadly, "financial institutions" are defined in the relevant Cayman legislation and guidance notes under the categories of investment entities, custodial institutions, depositary institutions and specified insurance companies. A Cayman Islands financial institution is any financial institution organized under the laws of or resident in the Cayman Islands. All Cayman Islands financial institutions will be reporting financial institutions unless they fall within a narrow range of exemptions which will be relevant in very few cases. Therefore, for instance, the vast majority of hedge and private equity funds will be reporting financial institutions.

Cayman Islands reporting financial institutions have until May 29, 2015 to notify the DITC via the Portal of their name, FATCA classification, global intermediary identification number ("GIIN") and point of contact.

The deadline for submission of FATCA reports by Cayman Islands reporting financial institutions to the DITC is June 26, 2015 (and annually thereafter). The reporting format is consistent with currently published Schemas by the U.S. Internal Revenue Service (the "IRS") for U.S. FATCA and by the

Organisation for Economic Co-operation and Development (OECD) for the Common Reporting Standard and will be in XML format. Cayman Islands reporting financial institutions will have the option of submitting reports to the DITC individually, by entering information manually on the website, or via bulk submission by uploading an XML file(s). Cayman Islands reporting financial institutions that have registered as a sponsoring entity will have the ability to upload an XML file containing information for multiple financial institutions.

Cayman Islands government approval has been granted to remove the requirement to file a nil return if a reporting financial institution has no relevant clients/investors/customers. However, there will be a facility for reporting financial institutions to submit nil returns if they so wish.

The Cayman Islands Court of Appeal Reverses Earlier Decision on Directors' Liability in Weavering

On February 12, 2015, the Cayman Islands Court of Appeal delivered its judgment in Weavering Macro Fixed Income Fund Limited (in Liquidation) v Stefan Peterson and Hans Ekstrom.

Weavering Macro Fixed Income Fund Limited (the "Weavering Fund") collapsed in 2009 following the discovery that most of the assets on its balance sheet were fictitious and the Weavering Fund subsequently went into liquidation. The liquidators' case against the directors was that had they carried out the required high level supervision in accordance with their duties as independent non-executive directors, the fictitious nature of the assets would have been detected sooner and the Weavering Fund would not have continued to make redemption payments on the basis of, what later turned out to be, grossly inflated net asset values ("NAVs"). The directors sought to rely upon exculpatory provisions in the Weavering Fund's articles of association that provided that they would only be liable to the fund for loss or damage arising out of their willful neglect or default.

At first instance, the Grand Court had concluded that, because the directors knew that they had a duty of supervision but consciously chose not to perform in any meaningful way, they were guilty of willful neglect or default. The Grand Court observed that they would have been protected by the exculpatory provisions had they failed to perform their duties as a result of their carelessness, no matter how gross; in other words that even if they had merely done their "incompetent best" they would have been protected. In consequence of the directors' total failure to perform their duties, the Grand Court made an award of damages against them of $111 million, representing the minimum value of irrecoverable redemption payments made by the Fund during the extended period of its trading on the basis of falsely inflated NAV calculations.

The Grand Court judgment attracted considerable attention by confirming that long established legal principles governing directors' duties applied to directors of Cayman Islands funds. The judgment contained some (largely obiter) comments regarding the practical steps that directors of Cayman Islands funds would often need to take in order to discharge those duties. Many of the points raised in the Grand Court judgment relating to directors' duties were subsequently given regulatory force by the Cayman Islands Monetary Authority in its Statement of Guidance for Regulated Mutual Funds issued, following consultation, in December 2013 (available **here**).

The directors appealed the Grand Court judgment, particularly in relation to the finding that they had acted in "willful neglect or default" of their duties, asserting that the Judge could not properly have reached that conclusion on the evidence put before the Court at trial. The liquidators applied for affirmation of the Grand Court decision on the directors' liability but on additional grounds.

While affirming the original findings of breach of duty by the directors, the Court of Appeal held that the exculpatory provisions in the Fund's articles of association nonetheless operated to relieve the directors from liability for their actions (and inaction) in the discharge of their duties as directors—and would do so unless it was demonstrated that their actions were so egregious as to amount to "wilful neglect or default" of their obligations. The Court of Appeal held that the evidence available to the Grand Court in the earlier hearing was insufficient to support the finding that the directors' conduct amounted to "willful neglect or default", and as a result, the directors were entitled to the protection of the exculpatory provisions. The Court of Appeal accordingly set aside the earlier judgments against the directors for $111 million.

The Court of Appeal's decision can, on one level, be read as simply a difference of opinion from the Grand Court as to the value to be attributed to the evidence which was before it. The Court of Appeal accepted that the directors had breached their duties, although the effect of the decision is that to establish liability on the part of directors who, like the Weavering directors, discharged their duties negligently or grossly negligently, but who are protected by broadly worded exculpation clauses, it will in future also be necessary to prove that the directors knew that they were acting negligently.

Proposed legislation

The Cayman Islands remain an innovative and responsive jurisdiction in terms of cutting edge legislation. This has been borne out in recent years by the various technical enhancements made to the Companies Law. Consideration is currently being given to the introduction of a new law for the formation of Cayman limited liability company (“LLC”) vehicles. This initiative has been driven by a number of requests from U.S. counsel and from U.S. fund promoters that Cayman offer them a vehicle more closely aligned with the LLC vehicles that they use for their onshore funds (i.e., a vehicle along the lines of a Delaware LLC, having separate legal personality like a Cayman Islands exempted company, but with features of a Cayman Islands exempted limited partnership, in the sense that such company would not be limited by shares nor by guarantee but rather by reference to members’ capital accounts and capital commitments, with freedom of contract among the members as to the internal workings of the company). Some advantages of a Cayman LLC would be to allow for simplified fund administration (i.e., easier tracking/calculation of the value of a member's investment in the LLC), more flexible governance concepts, and possibly a closer matching of the legal framework applicable between the “onshore” and “offshore” investors (e.g., where there are parallel “onshore” and “offshore” funds in a structure).

8. Update on AIFMD—latest developments in Europe

In Europe, most countries have not implemented the European Union (“EU”) Alternative Investment Fund Managers Directive[6] (the “AIFMD” or the “Directive”) and regulators have been publishing guidance and taking other steps in connection with the national implementation of the Directive. Set out below is a brief overview of the implications for alternative investment fund managers (“AIFMs”) marketing or considering marketing alternative investment funds (“AIFs”)[7] to EEA[8]-based investors.

Where are we now?

The AIFMD came into force on July 22, 2013 (the “AIFMD Effective Date”). The AIFMD contains provisions regulating the management and marketing of AIFs. For non-EEA AIFMs the provisions related to management (including, among various other requirements, restrictions on and disclosure of remuneration, maintenance of a minimum amount of capital, delegation requirements and appointment of a depositary) are limited to the management of EEA AIFs and other AIFs which are also marketed to professional investors in the EEA. Some member states opted to implement transitional provisions permitting the continuation of marketing activities that had already commenced prior to the AIFMD Effective Date for one year, until July 22, 2014. However, all new non-EEA AIFs established after the AIFMD Effective Date do have to comply with the AIFMD marketing provisions if marketed in the EEA.

Marketing funds in the EEA through private placement regimes

Non-EEA AIFs (whether managed by EEA AIFMs or non-EEA AIFMs), and EEA AIFs and non-EEA AIFs that are managed by non-EEA AIFMs can presently only be marketed into a member state in the EEA if and to the extent that such member state maintains a national private placement regime (the "NPPR"). There are three pre-conditions to using NPPRs to market AIFs under the Directive:

- a co-operation agreement must be in place between the local regulator of the relevant EEA member state and each of the AIF's and the AIFM's domicile authority;
- the domicile of each of the AIF and the AIFM must not be listed as a 'Non-Cooperative Country and Territory' by the Financial Action Task Force; and
- the AIFM domicile and the relevant EEA member state must enter into a tax information exchange agreement ("TIEA").

Marketing

The scope of AIFMD has intentionally been drafted very broadly, yet many key concepts have been left without specific definitions, resulting in different member states implementing, and their regulators interpreting, AIFMD in differing ways. For example, AIFMD defines "marketing" as a direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares of an AIF it manages to or with investors domiciled or with a registered office in the EU. However, whether an activity (such as circulating teaser documentation or draft documentation) constitutes marketing is subject to the particular interpretation adopted in the relevant member state and so may be caught by the restrictions in one member state but not in another.

Notification to local regulator

AIFMs marketing AIFs to EEA investors in jurisdictions where there is an NPPR will invariably be required to notify the local regulator in respect of their marketing activity. Some member states (such as the UK and the Netherlands) permit non-EEA AIFs to be marketed in their territory immediately upon submission of the relevant notification to the local regulator; while others (such as Belgium and Finland) prohibit marketing taking place in respect of a particular non-EEA AIF until approval has been received from the regulator following an application by the non-EEA firm. A few member states (such as Denmark and Germany) have either "gold-plated" their private placement regiments with a requirement for a "depositary" to be appointed in addition to having to wait for marketing approval; or chosen (most notably France and Spain) to effectively require non-EEA firms to comply with the equivalent of the full scope of the AIFMD requirements. While Switzerland is not a part of the EEA, it has also implemented comparable regulations which must be taken into account when considering marketing to Swiss investors. Italy, which has only recently completed its implementation of AIFMD, is unlikely to be accessible to non-EEA firms prior to any extension of the marketing passport to such firms as discussed below.

The regulatory environment is continuing to develop in most EEA jurisdictions and it is important to seek up-to-date advice in respect of each jurisdiction into which any form of marketing of non-EEA AIFs (or response to unsolicited inquiries) is contemplated. Some regulators, which do not permit marketing of non-EEA AIFs until specifically approved, are also facing noticeable delays in granting such permission.

The result is that, in addition to taking account of the costs and specific requirements of each jurisdiction, it is vital to understand the timeframe for being able to begin marketing a non-EEA AIF in each member state.

Ongoing disclosure and reporting

In addition to the notifications described above, AIFMs will also be subject to 'transparency' requirements in respect of the relevant AIF that has been sold in the EEA, which vary depending on the AIF's assets under management ("AUM"). In summary, an AIFM may be required to ensure in relation to AIFs sold or marketed in the EEA the following:

- periodic publication of an annual report and audited financial statements for each AIF marketed in the EEA (including disclosures as to the remuneration of the AIFM);
- certain disclosures to prospective investors in advance of any investment and upon any material change to such information, in respect of each AIF marketed in the EEA;
- periodic disclosures to investors, including details of any illiquid assets, any changes to the AIF's liquidity or risk profile and, for leveraged funds, the total leverage of each AIF marketed along with any changes to maximum leverage and re-hypothecation rights; and
- periodic reporting to the local regulator in the EEA member state in which the AIF is marketed.

Another area of divergence between member states is the form and manner in which the regulators require the periodic reports to be submitted to them. It is important to ensure that the persons involved in satisfying these obligations (whether in-house or outsourced to professional service providers) are aware of the requirements and deadlines as well as being able to gather and submit the information as required.

Marketing Passport

By no sooner than July 2015 (although we consider it more likely to be in late 2015 or early 2016), subject to the anticipated extension of the passport regime by the European Securities and Markets Authority ("ESMA"), non-EEA AIFMs may be able to apply for a passport for cross-border marketing of their AIFs in the EEA. If the passport regime is extended to non-EEA AIFMs (and it is not clear it will be at all), these non-EU AIFMs will need to select a 'Member State of reference' and apply for authorization and supervision from the local regulator in that EU Member State. This would come at the cost of submitting to the full scope of the management requirements of the AIFMD.

If the passport regime is extended to non-EEA AIFMs, then NPPRs may be phased out in 2018, subject to further review by ESMA and decision by the Commission in 2017, and all AIFMs would have to apply for an AIFMD passport in order to market any AIF in the EEA. However, given that member states maintain their NPPRs at their own discretion, there is always the possibility that they may amend or remove such regimes before that date. If the marketing passport is optionally made available to non-EEA AIFMs in 2015 or 2016, then some member states might choose to do this.

Reverse Solicitation

Based on the “marketing” definition set out above, non-EEA AIFMs may respond to, and ultimately accept subscriptions from, EEA-based investors that initiate contact with the non-EEA AIFM without any prior solicitation, without being engaged in “marketing.”

The approach to reverse solicitation may also differ between member states and it is important to take precautions against the risk of communications later being determined not to have been entered into pursuant to a genuine reverse solicitation. There is also some uncertainty as to how marketing would be viewed, for example, where it occurs in the U.S. offices of an investor which also has registered offices in EEA member states. This is again, ultimately, a question for local counsel to confirm in light of the interpretation adopted in the relevant member state. As a guiding principle however, it may be helpful to consider the location of the decision maker with respect to that investor, rather than considering the location where the specific act occurs in isolation. There has been significant discussion about the parameters of the reverse solicitation exemption on which Paul Hastings has developed some detailed protocols.

Third Party AIFM

There are possibilities in respect of appointing an EEA AIFM to an AIF, with certain functions delegated back to a non-EEA “adviser.” Great care must be taken in the analysis and structuring of such arrangements in order to avoid the non-EEA “adviser” being exposed to the management requirements of the AIFMD. This may not be the most desirable option for sponsors (and ultimately investors) who may feel uncomfortable with giving any risk or portfolio management powers over to an unconnected third party.

9. Form BE-10 Deadline for Private Funds and Private Fund Managers

U.S.-domiciled private funds and private fund managers meeting certain asset, income and revenue thresholds are required to report their foreign affiliates on Form BE-10, the Bureau of Economic Analysis (the “BEA”) 5-year Benchmark Survey of U.S. Direct Investment Abroad, by May 29, 2015. “Foreign affiliates” include foreign business enterprises (which could include offshore private funds, foreign portfolio companies, foreign holding vehicles, foreign subsidiaries, and foreign sub-advisers) in which, at any during a U.S. person’s 2014 fiscal year, the U.S. person had “direct or indirect ownership or control of at least ten percent (10%) of the voting stock” (a “U.S. Reporter”). General partners are presumed to control a limited partnership and limited partners are presumed to have zero voting interest in a partnership. Accordingly, a private fund’s ownership or management of an offshore fund, including by serving as general partner of an offshore limited partnership, could trigger the Form BE-10 reporting requirements.

The Form BE-10 reporting requirements apply to a U.S. Reporter’s “fully consolidated U.S. domestic business enterprise,” which includes the full chain of ownership (greater than 50% owners only) of the U.S. Reporter, but does not include any greater than 50% owners that are individuals, estates, trusts, or nonprofit organizations.

The deadline for U.S. Reporters filing 50 or more forms is June 30, 2015. On May 28, 2015 the BEA extended the deadline for new filers until June 30, 2015. The BEA will consider reasonable requests for an extension of the filing deadline. Extension requests must be received no later than the original due date of the Form BE-10 and must enumerate substantive reasons necessitating the extension.

The Form BE-10 and the instructions to Form BE-10 are available **here** and **here**, respectively. BEA has also published a Private Fund Frequently Asked Questions in connection with Form BE-10, which is available **here**.

II. TAXATION

Since our last Report, the U.S. Internal Revenue Service (the "IRS") and the U.S. Treasury Department have continued to focus significant efforts on offshore tax evasion. Reporting dates for certain offshore financial institutions under the "Foreign Account Tax Compliance Act" ("FATCA") are imminent, as further discussed below, and alternative investment fund managers are well advised to review their compliance obligations.

Further, over the past few months, the IRS has released guidance on a number of significant issues that affect the alternative investment industry, including with respect to deferred compensation and funds engaged in lending or loan activities, each of which is discussed below.

The legislature has been active in recent months in proposing extensive tax overhauls. The House Republican budget resolution for the fiscal year beginning October 1 calls for lower corporate and individual tax rates and repeal of the alternative minimum tax, among other items. This budget is expected to provide the opportunity for negotiation with the administration, although it is unclear what will result. We will continue to monitor the budget and other legislative developments on an ongoing basis and report on the same.

A. Recent FATCA Developments

FATCA, which was enacted in March 2010 in the Hiring Incentives to Restore Employment Act, generally requires a foreign financial institution ("FFI") to enter into an agreement with the IRS (or an applicable non-U.S. jurisdiction with which the U.S. Treasury Department has entered into an intergovernmental agreement) and report U.S. accounts to the IRS (or such jurisdiction) or pay a thirty percent (30%) withholding tax on any "withholdable payment" made to the institution or their affiliates.[9] FATCA also requires certain non-financial foreign entities to provide withholding agents information on their substantial U.S. owners or pay the withholding tax.

1. Developments Regarding IGAs

Early in 2012, the U.S. Treasury Department began negotiating and entering into intergovernmental agreements ("IGAs") with foreign governments. The IGAs are intended to provide an alternative means by which financial institutions located within participating jurisdictions may comply with FATCA. The IGAs generally should be of primary importance for most FFIs because most jurisdictions have entered into IGAs as of the date of this Report. Most recently, Singapore, Kosovo and Qatar have been added to the U.S. Treasury Department list of IGA jurisdictions. The list can be found **here**.

FFIs in jurisdictions that have not signed IGAs will generally comply with FATCA by registering with the IRS and executing a so-called FFI agreement, which sets forth the required withholding and reporting obligations for FFIs not covered under IGAs.

2. *FATCA Information Reporting Has Begun*

FFIs in non-IGA jurisdictions and in so-called “Model 2” IGA jurisdictions were required to file information reports under FATCA with the IRS by March 31, 2015. The information report to be filed by this deadline included information with respect to 2014 only (such as account holder names, names of substantial U.S. owners of passive non-financial foreign entities, account balances and certain additional identifying information with respect to reportable accounts). FFIs in so-called “Model 1” IGA jurisdictions (which include the Cayman Islands, among others) have more time to file their first information reports under FATCA with respect to 2014 with their home jurisdictions. Applicable IGAs should be reviewed to confirm these deadlines.

3. *Next Steps*

The IRS continues to release guidance on FATCA on a rolling basis. We expect this to continue as FATCA reporting is undertaken for the first time this year. We will continue to monitor and report developments in this area.

U.S. withholding agents and offshore investment vehicles should be meeting their compliance burdens under FATCA this year. Any alternative investment funds that have not yet taken steps to comply with FATCA are strongly encouraged to review their compliance obligations as soon as possible.

B. IRS Holds that Certain Stock Rights Are Not Nonqualified Deferred Compensation under Code Section 457A

On June 10, 2014, the IRS issues a revenue ruling (2014-18), which held that neither nonstatutory stock options nor stock-settled stock appreciation rights granted to service provider with respect to common shares of a service recipient would be treated as “nonqualified deferred compensation” subject to tax under Section 457A of the Internal Revenue Code of 1986, as amended (the “Code”).

Code Section 457A generally provides that any compensation that is deferred under a “nonqualified deferred compensation plan” (which is generally any plan or arrangement pursuant to which a service provider has a legally binding right to compensation during a taxable year that is or may be payable to the service provider in a subsequent taxable year) of a “nonqualified entity” (which are generally certain foreign corporations and partnerships) shall be includible in gross income when there is no substantial risk of forfeiture of the rights to such compensation. Code Section 457A effectively ended offshore hedge fund fee deferrals because offshore hedge funds typically constitute “nonqualified entities,” and the fee payments typically are “nonqualified deferred compensation plans.” Therefore, the relevant fee income would be generally includable in a service provider’s income when earned, whether or not paid in the year earned (*i.e.*, even if payment is deferred to a subsequent taxable year). Some exceptions apply with respect to grandfathered arrangements (which arrangements may be deferred until no later than the end of the 2017) and arrangements that include service-based risk of forfeiture.

In the ruling, the service recipient at issue was a foreign entity which was a nonqualified entity for purposes of Code Section 457A and a partnership for U.S. federal income tax purposes (the “Foreign Partnership”). The income of the Foreign Partnership was allocated to U.S. taxpayers. The Foreign Partnership provided services to a service recipient (the “Service Recipient”).

As compensation for the Foreign Partnership’s services, the Service Recipient granted a nonstatutory stock option and a stock appreciation right (in each case, a “stock right”) to the Foreign Partnership, each with respect to a fixed number of common shares of the Service Recipient. The IRS held in the ruling that the stock rights were structured in a manner that did not cause them to constitute "nonqualified deferred compensation" for purposes of Code Section 457A. Therefore, the stocks rights were not subject to the anti-deferral rules under Code Section 457A. Specifically, the IRS provided that the following factors caused the stock rights not to fall under Code Section 457A as "nonqualified deferred compensation".

- The stock rights' terms provided that they had to be settled (and it in fact was settled) in stock of the Service Recipient (*i.e.*, this was not a cash-settled stock right);
- The exercise price of the stock rights were at all times not less than the fair market value of the underlying stock on the date of grant of the stock rights;
- The stock rights did not otherwise provide any feature of deferral beyond the exercise date;
- The stocks rights were granted with respect to a fixed number of shares of the Service Recipient stock; and
- Upon exercising the stock rights, the Foreign Partnership had the same redemption rights with respect to the stock as any other shareholder.

This is a welcome clarification for offshore alternative investment funds that wish to issue stock rights without falling under the Code Section 457A deferral rules. However, it should be noted that stock rights may give rise to adverse U.S. tax consequences other than those under Code Section 457A. For example, offshore corporations that issue stock rights could cause the shareholder at issue to become subject to anti-deferral regimes under the "passive foreign investment company" rules or "controlled foreign corporation" rules. As a result, it is unclear how helpful this ruling will be in practice and whether it will result in a change in the compensation structures for offshore funds.

The complete text of the ruling may be found **here**.

C. IRS Ends Moratorium on Private Letter Rulings Related to Qualifying Income for Master Limited Partnerships

On March 6, 2015, the IRS announced that, effective immediately, it would re-commence the ruling process with respect to private letter rulings regarding activities that generate qualifying income under Code Section 7704 for publicly traded partnerships ("MLPs"). This announcement marks the end of the IRS's one-year moratorium on providing guidance for qualifying income through private letter rulings, and it may cause an increased investment interest in MLPs. More information on this development may be found in our recent **Client Alert**.

D. IRS Finds Fund's Lending Activities Constitute a U.S. Trade or Business

Whether or not an offshore fund that invests in various debt investments in the U.S. is engaged in a U.S. lending trade or business is a matter of ongoing debate. The IRS recently released non-binding guidance on this issue. The positions in the guidance should be considered by any offshore funds that intend to make any debt investments in the U.S.

Under the Code, merely trading in "securities" (including notes, bonds, debentures or other evidences of indebtedness) through a resident broker, commission agent, custodian, or other independent agent for a taxpayer's own account is not a U.S. trade or business. This safe harbor is available to any foreign person, including a dealer in stocks or securities, that does not have an office or fixed place of business in the U.S. at any time during the year through which the transactions in stocks or securities are effected. A second safe harbor exists that provides that U.S. trade or business status does not result from trading in stocks or securities for the taxpayer's own account, whether by the taxpayer or his employees or through a resident broker, commission agent, custodian, or other agent, and whether or not any such employee or agent has discretionary authority to make decisions in effecting the transactions. Dealers in stocks or securities cannot rely on this second safe harbor; however, other persons who have an office or place of business in the U.S. can rely on this safe harbor. These safe harbors are often referred to as the "Trading Safe Harbors". Under the Trading Safe Harbors, a foreign person who limits his activities in the U.S. to trading activities will avoid net basis taxation in the U.S. with respect to any income or gain derived from the trading activities under these Trading Safe Harbors. However, no similar exemption or safe harbor from U.S. trade or business status exists with respect to a banking, financing or similar business in the U.S. Therefore, a foreign person who engages in these types of activities will be subject to net basis taxation in the U.S. on income derived from the lending activities.[10]

It is not unusual for offshore hedge funds and other alternative investment vehicles to make debt investments and engage in some lending activities. For example, funds may enter into participation agreements for debt instruments or even in some cases originate loans. However, these types of investments and activities can raise significant U.S. tax issues. Specifically, if the offshore investment entity is deemed to be engaged in a lending business for U.S. federal income tax purposes, the entity becomes subject to graduated federal income tax on all income and gain derived from the lending activities at the same rates imposed on U.S. taxpayers and will be required to file U.S. federal income tax returns. This is often an unwelcome economic result (and may also lead to unwelcome disclosure issues because the activities must be disclosed on U.S. federal income tax returns), and funds will in some cases go to extremes to avoid being characterized as in a lending business for this reason. Because the determination of what constitutes a lending activity is a factual one without any "safe harbor" or "bright line" guidelines, it is unclear how significant an entity's lending-type activities must be before the entity will be treated as in a lending business.

The IRS has issued non-binding guidance on these issues in the past, and most recently in CCA 201501013 (the "CCA"), issued non-binding guidance on January 2, 2015, that advised that a fund was engaged in a U.S. trade or business as a result of lending and stock underwriting activities undertaken by an independent management company on its behalf. The CCA is consistent with prior IRS positions in this area based on similar facts. In the CCA, the IRS held that, absent treaty protection, a foreign person (including, for this purpose, a foreign entity) may be deemed to be engaged in a U.S. trade or business as a result of actions undertaken by its U.S. agent, regardless of whether the U.S. agent is independent or dependent or whether it has the power to bind the foreign principal. To arrive at this conclusion, the IRS looked at three issues, each of which is discussed below.

The facts at issue in the CCA included an offshore limited partnership (the "Fund") resident in a country that does not have an income tax treaty with the U.S. The Fund vested all its management in a manager (the "Fund Manager") pursuant to a management agreement. Under the management agreement, the Fund Manager was appointed as the Fund's agent and was given full power to buy, sell and otherwise deal in securities for the Fund's account and to take all actions related thereto. Pursuant to this authority, the Fund Manager conducted extensive lending and stock distribution activities on behalf of the Fund through a U.S. office.

On behalf of the Fund, the Fund Manager negotiated directly with borrowers concerning all key terms of loans funded by the Fund. Before agreeing to make a loan, the Fund conducted extensive due diligence on a potential borrower. Often, the Fund lent borrowers money in return for debt instruments that were convertible into the borrowers' stock at a future date. Typically, the conversion prices were discounted from the trading prices of the borrowers' stock, determined at the time of conversion. After converting a debt instrument into stock at a discount, the Fund sought to earn a spread by quickly disposing of the stock. The Fund often received other property in connection with its lending agreements, including warrants to purchase additional shares of the borrowers' stock. Borrowers also paid the Fund various fees.

The Fund also entered into "Distribution Agreements" with unrelated issuers. On behalf of the Fund, the Fund Manager negotiated the terms of each Distribution Agreement directly with the issuers. A typical Distribution Agreement entitled an issuer to periodically issue and sell to the Fund shares of stock in an amount equal to a total specified purchase price (referred to as the Fund's "commitment amount"). However, an issuer could typically only request a portion of the commitment amount (referred to as an "advance") at any given time. The issuer was prohibited from requesting an advance until the issuer had filed with the U.S. Securities and Exchange Commission a registration statement registering the issuer's stock for resale by the Fund, and the registration statement had become effective. An issuer requested an advance by providing the Fund with a written notice. After the issuer provided notice, the Fund was irrevocably bound to purchase stock from the issuer after a specified number of business days. During this period, the Fund would endeavor to pre-sell an amount of the issuer's stock that would generate enough cash to fund the advance requested by the issuer. Typically, the Fund succeeded. The Fund's sales of stock included sales to U.S. purchasers. At the end of this period, the issuer sold stock to the Fund at a discounted price. Because the Fund sold the stock at the current market price, but received stock from the issuer at a discount, the Fund earned a spread on each share sold. Usually, an issuer also paid fees to the Fund, including commitment, structuring, and due diligence fees.

1. *Issue One: Did the Fund engage in a U.S. trade or business (before considering possible application of the Trading Safe Harbors)?*

The Fund argued that its lending and stock distribution activities constituted mere investment activity, and thus did not constitute a trade or business within the U.S. The IRS disagreed, stating that the Fund's lending and underwriting activities were profit-oriented activities that the Fund conducted on a considerable, continuous, and regular basis in the U.S. Based on the facts and circumstances, such activities rose to the level of a U.S. trade or business. Further, the IRS attributed the Fund Manager's activities to the Fund. This attribution provided further argument that the Fund was engaged (through its agent, the Fund Manager) in a U.S. lending business.

2. *Issue Two: Were the Fund's activities within the Trading Safe Harbors?*

The Fund took the alternate position that even if it was engaged in a U.S. trade or business, its lending and stock distribution activities constituted "trading in stocks or securities," and that Fund therefore qualified for the Trading Safe Harbors. The IRS also disagreed with this position. The IRS stated that regulations under the Trading Safe Harbors and judicial decisions establish that certain activities may entail the "effecting of transactions in stocks and securities," but nonetheless exceed the scope of the trading activities protected by the Trading Safe Harbors. These characteristics may include the conduct of one or more activities typical of a banking, financing or similar business; interaction with customers; the attempt to generate profit from merchandising rather than market appreciation; or the extent of an underwriter's involvement in the U.S. markets. The IRS determined that the Fund's lending and underwriting activities demonstrated these characteristics. To support this conclusion, the IRS pointed out that when the Fund engaged in lending and underwriting, it did not profit from taking on risk or identifying advantageous purchases. Rather, in exchange for performing lending and underwriting activities, the Fund received compensation in the form of fees, discounted property, and spreads. Both the activities performed and the compensation received by the Fund demonstrated, in the IRS's opinion, that the Fund's activities are not properly characterized as trading in stocks or securities. Therefore, the Trading Safe Harbors did not apply to the Fund's activities.

3. *Issue Three: If the Fund's activities were within the Trading Safe Harbors, is the Fund eligible for the Trading Safe Harbors?*

The IRS further stated that even if the Fund's lending and underwriting activities had constituted trading in stocks or securities, the Fund was ineligible for the Trading Safe Harbors because it had delegated discretionary authority over such activities to a U.S.-resident agent, the Fund Manager. Further, the CCA infers, although the IRS does not explicitly state, that the Fund is a dealer for tax purposes, and therefore not eligible for the Trading Safe Harbors.

The conclusions reached in the CCA are not surprising in light of other recent positions taken in by the IRS in non-binding guidance. However, the CCA should serve to put investment managers and sponsors of offshore fund on notice that the IRS is actively pursuing taxpayers engaged in these types of U.S. lending activities.

The complete text of the CCA may found be found **here**.

E. Have You Properly Solicited Consent for Electronic Consent of Schedules K-1?

Alternative investment managers that manage funds that are treated as partnerships for U.S. federal income tax purposes should be aware of their obligation to properly solicit consent in order to provide Schedule K-1, *Partner's Share of Current Year Income, Deductions, Credits, and Other Items* ("Schedules K-1") electronically to partners. Guidance was issued in 2012 in Revenue Procedure 2012-17 on this issue, and we understand that some partnerships have yet to incorporate this guidance into their tax reporting practices.

Specifically, Revenue Procedure 2012-17 provides that a partnership must receive a partner's consent before providing Schedules K-1 electronically rather than on paper. These rules are similar to the rules governing the electronic furnishing of IRS Forms 1099 and W-2.

The revenue procedure provides specific examples of how the consent can be provided electronically—including through secure e-mail and through the partnership's internet page. The revenue procedure also addresses how partners should be informed about changes in software, defines how a partnership should provide instructions about accessing and printing electronic Schedules K-1 and a partnership's responsibility if the Schedule K-1 is electronically undeliverable.

Generally, Schedules K-1 must be provided to partners by the due date of a partnership's IRS Form 1065, *U.S. Return of Partnership Income*, which is April 15th for calendar year partnerships. We encourage any managers of partnerships to review their compliance with respect to electronically furnished Schedules K-1 annually.

Revenue Procedure 2012-17 may be found **here**.

F. FBAR Reminder

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 IRS has been actively calling for FBAR compliance and has instituted significant civil and criminal penalties for those who fail to file FBARs.

As a reminder, all FBARs must be filed electronically through the Bank Secrecy Act E-filing system on FinCen Form114, the successor to the previously-used TD F90-22.1. Paper copies will not be accepted. Further, any taxpayer filing a delinquent FBAR must file the delinquent FBAR electronically. FBARs must be filed by June 30.

Investment funds are encouraged to review the FBAR requirements in light of the upcoming June 30 deadline.

III. CIVIL LITIGATION

Recently, in litigation matters involving hedge funds, courts have addressed several interesting issues. Significant recent case rulings include the following:

- The Supreme Court held that an order disposing of one case in an MDL proceeding in which hedge funds and others sued banks for artificially depressing LIBOR was a final appealable order despite the fact that other MDL cases were still ongoing.
- The co-founder of a now-defunct hedge fund manager sued officials in the U.S. Attorney's Office for the Southern District of New York and the FBI, alleging that their insider trading investigation into the manager was based on fabricated evidence and caused the manager to close.

A. Update on Previously Reported Cases

Supreme Court Rules That LIBOR Plaintiffs Can Appeal Immediately

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

A group of plaintiffs whose complaint had solely alleged the dismissed antitrust claim appealed. The Second Circuit held in a brief opinion that it had no jurisdiction over any appeal until all claims in the consolidated litigation were resolved. On January 21, 2015, the Supreme Court reversed the Second Circuit's decision and remanded the case.[12] The Court reasoned that although the MDL proceedings were consolidated for pretrial purposes, a decision completely resolving one of the individual cases could be appealed while the MDL proceedings continued.

Following the Supreme Court's ruling, the MDL court on February 5, 2015, allowed two other groups of investors—over-the-counter and exchange-based plaintiffs, including the hedge fund plaintiffs—to dismiss their remaining claims and join the appeal to the Second Circuit.

B. New Developments in Securities Litigation

Co-Founder of Closed Hedge Fund Manager Sues Government Officials for Fabricating Evidence

David Ganek, co-founder of now-defunct hedge fund manager Level Global Investors, L.P. ("Level"), recently filed a complaint accusing government officials of fabricating evidence used to obtain a warrant to search Level, which ultimately led to Level's demise.[13]

In October of 2010, a former Level analyst, Sam Adondakis, agreed to cooperate with the government's investigation of insider trading in the hedge fund industry. Adondakis admitted that he had provided inside information to Level, including giving information about Dell to Ganek. However, according to Ganek, Adondakis made it clear to the FBI that Ganek was not aware of the source of the information.

On November 22, 2010, the FBI executed a search warrant at Level's offices. The supporting affidavit named Ganek and others and was based on Adondakis's statements, but did not disclose that Ganek was innocent of wrongdoing. The search was publicized, which Ganek alleges was done to "ensur[e] maximum harm to targets." When Level's investors sought reassurance that Ganek was not a target, federal authorities allegedly "would not provide any statement or assurance that might prevent the firm from going under," and Ganek closed Level in February of 2011. Ganek was never charged, although Level's co-founder, Anthony Chiasson, was convicted of insider trading; his conviction was reversed on appeal.

Ganek filed suit on February 26, 2015, naming Preet Bharara, U.S. Attorney for the Southern District of New York, and others in the U.S. Attorney's office and FBI. The complaint includes a cause of action for violation of Ganek's Fifth Amendment due process rights, alleging that the defendants "deliberately fabricated inculpatory evidence" against him and understood the effect the investigation would have on Level, including injuring Ganek's reputation and destroying Level. The complaint also includes claims for unreasonable search and seizure in violation of the Fourth Amendment, failure to intercede to prevent violation of Ganek's constitutional rights, and supervisory liability against the supervisor defendants. Ganek seeks monetary and punitive damages, including $400 million for the loss of his business.

IV. REGULATORY ENFORCEMENT

Enforcement actions against hedge funds continue to be an area of focus for the SEC. In a recent speech by Julie Riewe, Co-Chief of the AMU, the AMU reaffirmed its commitment to bringing enforcement actions against hedge fund managers, particularly with respect to conflicts of interest, valuation, and hedge fund compliance and controls.[14] Ms. Riewe also noted that the SEC is continuing to refine the API to identify hedge funds with suspicious returns. Mark Flannery, the Chief Economist and Director for the SEC's Division of Economic and Risk Analysis ("DERA"), made similar statements at a Global Association of Risk Professionals convention. Mr. Flannery noted that one of the SEC's "core mission[s]" is to identify and remedy market misconduct by hedge fund managers, and touted DERA's modeling tools in aiding in this mission by identifying the smoothing of returns and misvaluing of assets.[15]

In addition, the SEC continues to devote an enormous amount of attention to its whistleblower program. We noted in our last report that the SEC announced in the second half of 2014 a number of record and first-ever awards and actions under the whistleblower program. In another groundbreaking development, the SEC just announced its first enforcement action against a company for using improperly restrictive language in confidentiality agreements with the potential to stifle the whistleblowing process.[16] This underscores the importance of the whistleblower program to assist the SEC in uncovering wrongful conduct.

The SEC is also seeking additional manpower to carry out its priorities. President Barack Obama's fiscal 2016 budget, released in February, would increase the SEC's budget by 15% and allow the agency to hire 431 additional staffers.[17] Of those 431 additional staffers, 225 would be added to OCIE, 93 to enforcement, and 37 for market oversight. As the SEC further seeks to strengthen its resources, hedge funds should expect enforcement actions to steadily increase throughout 2015.

A. SEC's Whistleblower Program

The SEC's whistleblower program is increasing in popularity and leading to an increase in enforcement actions. In the 2014 fiscal year, the SEC whistleblower program received 3,620 tips, a 21% increase over two years.[18] The increase in tips has continued in the first quarter of 2015 with the SEC receiving 20% more tips than it did for the same quarter in 2014.[19] Enforcement actions generated by the program have resulted in larger fines and more criminal referrals than those obtained without whistleblower involvement.[20] Fines against firms involved in a whistleblower case were, on average, $76.96 million larger than non-whistleblower cases. Similarly, cases involving whistleblowers saw an average increase in prison sentences by 21.55 months.

To date, the SEC has awarded payouts totaling nearly $50 million to 15 whistleblowers.[21] Given its pronounced impact and the SEC's vision of itself "as the whistleblower's advocate", the SEC is likely to continue strengthening the whistleblower program by promoting whistleblower awards and protecting whistleblowers from retaliation, as the cases below demonstrate.[22]

SEC Actions to Protect Whistleblowers

Regulations promulgated under the Dodd-Frank Act prohibit companies from taking actions to impede employees from reporting possible securities violations to the SEC.[23] Recently, the SEC sent letters to companies asking for employment agreements, such as nondisclosure agreements, confidentiality agreements, severance agreements, settlement agreements, and employment contracts to determine whether those agreements contain clauses that prevent employees from providing tips or information to the government.[24]

In a first of its kind action, on April 1, 2015, the SEC instituted cease-and-desist proceedings against an international engineering firm (the "Firm") for allegedly violating whistleblower protection Rule 21F-17 enacted under the Dodd-Frank Act. According to the SEC, the Firm "required witnesses in certain internal investigations interviews to sign confidentiality statements with language warning that they could face discipline and even be fired if they discussed the matters with outside parties without the prior approval of the Firm's legal department."[25] These investigations included inquiries into alleged securities law violations. The SEC found that the confidentiality statement's blanket prohibition against discussing the substance of interviews without first obtaining approval of the Firm's legal department undermined the purpose of Rule 21F-17, which is to "encourage[e] individuals to report to the [SEC]."[26]

Without admitting or denying the charges, the Firm agreed to cease and desist from committing or causing any future violations of Rule 21F-17. The Firm also agreed to pay a $130,000 penalty and "voluntarily amended its confidentiality statement by adding language making clear that employees are free to report possible violations to the SEC and other federal agencies without the Firm's approval or fear of retaliation."[27]

On April 28, 2015, the SEC demonstrated further commitment to protecting whistleblowers when it announced its first-ever award to a whistleblower based on retaliation in connection with *In the Matter of Paradigm Capital Management, Inc. and Candace King Weir*.[28] The whistleblower in this case will receive $600,000, the maximum award from the amount collected. According to the SEC, Paradigm Capital Management, Inc. ("Paradigm" retaliated against the whistleblower for reporting to the SEC. Paradigm's retaliatory actions included removing the whistleblower from his or her current position, tasking the whistleblower with investigating the very conduct the whistleblower reported to the SEC, relieving the whistleblower of his or her supervisory responsibilities, and otherwise marginalizing the whistleblower.

First Ever Award to a Company Officer

On March 2, 2015, the SEC announced an award to a former company officer, who learned of a fraud from another employee and provided original, high-quality information that resulted in an SEC enforcement action.[29] Ordinarily, a company's officers, directors, trustees, or partners are not eligible for the SEC's whistleblower program if they learn about the fraud through another employee raising the issue. However, an exception exists for an officer if he or she reports the information to the SEC more than 120 days after other responsible compliance personnel failed to address the issue after it came to their attention. The policy behind the exception rewards corporate executives who come forward when the company's internal compliance procedures and personnel fail to take action. This was the first ever award under this exception and the whistleblower payout totaled between $475,000 and $575,000.

Whistleblower Award to Compliance Professional

On April 22, 2015, the SEC announced its second-ever whistleblower award to a compliance professional who provided information to the SEC in an enforcement action against the whistleblower's company.[30] According to the SEC, the whistleblower chose to disclose information "to prevent imminent misconduct from causing substantial financial harm to the company or investors" after reporting the misconduct to management at the company and management failed to take preventative action. This whistleblower payout will total between $1.4 million and $1.6 million.

B. Insider Trading

In December 2014, the Court of Appeals for the Second Circuit in *United States v. Newman*[31] held that for a tippee to be liable for insider trading, the government must prove beyond a reasonable doubt that the tippee knew that the insider disclosed confidential information and that he did so in exchange for a personal benefit.[32] Since then, courts have been grappling with insider trading defendants seeking to vacate guilty pleas and have new trials based on *Newman's* heightened legal standard. One such example is below.

U.S. v. Riley, et al.

On March 3, 2015, Judge Valerie Caproni of the U.S. District Court for the Southern District of New York denied David Riley's ("Riley") motion for a new trial and for a judgment of acquittal despite the developments in the *Newman* case.[33] At trial, the government presented evidence showing that Riley, a former executive at a computer networking company, passed material, nonpublic information to Matthew Teeple ("Teeple"), an analyst who worked for a hedge fund. Riley challenged his conviction, arguing that the jury instruction that a personal benefit could be found where the tip was passed for the purpose of "maintaining or furthering a friendship was erroneous in light of *Newman.*"[34]

The court found that, under *Newman*, a benefit exists when there is a potential *quid pro quo* relationship between the insider and the recipient.[35] Specifically, the court observed "[i]f a tip maintains or furthers a friendship, and is not simply incidental to the friendship, that is circumstantial evidence that the friendship is a *quid pro quo* relationship."[36] The court also held that, even if the instruction was improper, the government proved that Teeple helped Riley with Riley's side business, obtaining a new job, and investment advice, satisfying the personal benefit requirement.[37]

C. Conflicts of Interest

One of the SEC's primary enforcement focuses is undisclosed conflicts of interest. As the below case demonstrates, conflicts do not need to directly result in investor harm for institutions to be held liable.

In re Stilwell Value LLC

On March 16, 2015, the SEC instituted an administrative and cease-and-desist order settling allegations against investment adviser Stilwell Value LLC ("Stilwell Value") and owner and hedge fund manager Joseph Stilwell ("Stilwell") that they failed to properly disclose loans made between certain private funds (the "Stillwell Funds") that they controlled.[38]

According to the SEC, Stilwell and Stilwell Value caused certain of the Stillwell Funds to loan or transfer more than $11 million to certain other Stillwell Funds in undocumented loans on at least eight occasions from 2003 through mid-2010.[39] In addition, $7.8 million in loans were made to support one of the Stillwell Funds' investments in a public company.[40] The SEC maintained that the loans represented a conflict of interest between the Stillwell Funds and their investors because Stilwell and Stilwell Value determined the loan terms and directed the Stillwell Funds to make and repay the loans at their sole discretion.[41] Stilwell Value collected management fees paid by the Stillwell Funds for managing assets that included the above referenced loans.[42]

Stilwell and Stilwell Value, without admitting or denying the findings, consented to violations Sections 206(2), 206(4) and 207 of the Advisers Act, and Rules 206(4)-7 and 206(4)-8 thereunder.[43] Stilwell Value and Stilwell consented to a cease-and-desist from future violations of the above securities laws.[44] Stilwell Value agreed to hire an independent monitor at its own expense to review cash management functions, affiliated transactions, conflicts of interest and related disclosures, and the distribution of annual audited financial statements of advisory clients to limited partners. Stilwell Value consented to distribute $239,157 to investors representing prorated management fees paid by the Stillwell Funds to Stilwell Value for the percentage of each loan in the lender's portfolio.[45] Stillwell Value will also provide notice of the SEC proceeding to its investors, preserve any records of its compliance with the above undertakings for six years, and certify its compliance with the above terms.[46] The SEC also ordered Stilwell and Stilwell Value to pay civil penalties of $100,000 and $250,000 respectively.[47] Stilwell was also suspended from the securities industry for one year.

D. Ponzi Schemes

The SEC continues to root out illegal schemes that prey on investors' desires for large returns. Two new examples, and an update on a case we previously reported on, are provided below.

In re Gregory W. Gray

On February 27, 2015, the SEC charged Gregory W. Gray Jr. ("Gray"), "a purported venture capital fund manager in Buffalo, New York, with fraudulently using money from three investment funds to pay fictitious returns to investors in a different fund."[48] The SEC obtained an emergency asset freeze to halt the alleged Ponzi-like scheme.

According to the SEC's complaint, filed in the U.S. District Court for the Southern District of New York, Gray and his firms Archipel Capital LLC and BIM Management LP raised approximately $5.3 million from investors for a fund created to invest in pre-IPO shares of Twitter Inc. ("Twitter"). While the funds Gray raised were enough to purchase 230,000 pre-IPO shares of Twitter, only 80,000 shares were actually purchased before Twitter went public.[49]

The SEC contends that in order to deliver the promised profits to investors in his fund, Gray stole from three other unrelated funds. According to the SEC's complaint, the majority of the money Gray used to make these Ponzi-like payments came from one investor who was told he had bought the entirety of a fund purported to have invested $5 million in Uber Technologies stock. The SEC maintains that Gray forged stock purchase agreements in order to convince said investor that Gray had invested his money in Uber Technologies.[50]

The SEC's complaint charges Gray and his firms with violation Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, as well as Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. The SEC's complaint seeks, in addition to preliminary relief and a temporary restraining order, permanent injunctions and disgorgement against all defendants and a financial penalty.[51]

SEC v. Malik

On February 13, 2015 the SEC charged Moazzam "Mark" Malik ("Malik"), in the U.S. District Court for the Southern District of New York, with stealing money from his investors.[52] According to the SEC, while Malik "claimed to be operating a hedge fund with approximately $100 million in [AUM]," he had only raised $840,774 from investors and never held more than $90,177 in assets.

The SEC maintains that Malik continually withdrew the cash he raised and spent it as his own. According to Andrew M. Calamari, Director of the SEC's New York Regional Office, "[b]esides luxury travel, dining, and jewelry, investor funds paid for Malik's continuing education courses at Harvard and his subscription to a matrimonial matching website."[53] While Malik returned approximately $83,000 to investors between 2011 and 2013, he later began ignoring redemption requests. In one instance, Malik allegedly sent an e-mail to an investor from a fictitiously created account claiming that Malik had died.[54]

The SEC further alleges that Malik created another fictitious employee, "Amanda Ebert," who was identified with a title of 'Investor Relations, Wolf Hedge LLC' in e-mail communications with several investors. Malik included in the email a purported photograph of Ebert that he obtained from the Internet. The real-life woman in the photo does not know Malik and never authorized the use of her image in the e-mails.[55]

Malik allegedly enticed investors with awards he was given by a hedge fund information service, BarclayHedge, which awarded Malik a "gold star" based on his self-reported investment returns. The President and Founder of BarclayHedge said his firm did not verify Malik's performance claims, just as it does not verify any of the other information given to it by the 6,000 or so hedge funds that disclose performance data through his service.[56]

The SEC's complaint charges Malik and his fund with violating Sections 5(a), 5(c) and 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10-5 thereunder. The complaint also charges Malik with violations of Sections 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. On April 21, 2015, Judge Richard Sullivan entered a preliminary injunction to freeze the assets of Malik and his fund and prohibit them from committing further violations of the federal securities laws.[57] The SEC is pursuing a final judgment ordering Malik and his fund to disgorge their alleged ill-gotten gains plus prejudgment interest and penalties.[58] New York State's Attorney General has also announced criminal charges against Malik.

U.S. v. Illarramendi

On January 29, 2015, former hedge fund manager, Francisco Illarramendi ("Illarramendi") was sentenced to 13 years in prison after pleading guilty to charges that he orchestrated a $723 million Ponzi scheme, the largest in Connecticut history.[59] Illarramendi pled guilty to two counts of wire fraud, one count of securities fraud, one count of investment adviser fraud, and one count of conspiracy to obstruct justice.[60]

In late 2005, one of the hedge funds Illarramendi advised lost approximately $5 million. Rather than disclose this loss, Illarramendi concocted a large Ponzi-scheme to conceal the loss to investors. The scheme included "using money provided by new investors to the funds to pay out the returns he promised to earlier investors, making false representations to his investors and creditors in an effort to obtain new investments from them and to prevent them from seeking to liquidate their investments, improperly commingling the investments in each individual hedge fund with investments in other hedge funds, and engaging in transactions that were not in the best interests of the funds."[61] During an SEC investigation in December 2010 and January 2011, Illaramendi attempted to hide the fact that his hedge funds were missing assets by providing the SEC staff with a false letter from an accountant in Venezuela who purported to verify the existence of approximately $275 million in assets held by one of the funds.[62]

E. Fraudulent Misrepresentations and Omissions

Fraudulent misrepresentations and omissions continue to be on the SEC's radar. Below, we discuss two recent cases where investors were allegedly misled about funds' investment strategies and past performance through both affirmative misstatements and omissions.

In re Acamar Global Investments, LLC

On March 18, 2015, the SEC settled administrative and cease-and-desist proceedings against Acamar Global Investments, LLC ("Acamar"), a formerly SEC-registered investment adviser, and its principal, Rudolph A. Martin ("Martin"), for making material misstatements about Acamar's AUM, the past performance of its proprietary investment models, and the strategy and amount of investor subscriptions for a hedge fund Acamar managed.[63] Acamar advised the Acamar Global Growth Master Fund (the "Acamar Fund") and its two feeder funds, as well as funds for an individual client in a separately managed account (the "SMA Client").

Acamar claimed that it had assets under management valued in excess of $180 million from October 2011 to May 2014 in order to qualify for SEC registration, when, in fact, it never managed more than $200,000 at any time.[64] In addition, Acamar's marketing materials on its website included a detailed report for two of its model portfolios. Both reports suggested the performance figures were based on actual trading and directed potential investors to the Morningstar website "for information current to the most recent month-end."[65] However, Acamar's reports were based on hypothetical trading and the Morningstar website has no information regarding the hypothetical value of the model portfolios. Finally, Martin induced the SMA Client to invest his entire account with the Acamar Fund based upon representations that the Fund would be equity based and not begin trading until it secured at least $5 million in aggregate investor subscriptions. In reality, the Fund began trading mainly options with only the funds secured from the SMA client.

Acamar and Martin, without admitting or denying the findings, consented to violations of Sections 203A, 206(1), 206(2), 206(4), 207 of the Advisers Act, and Rules 206(4)-1(a)(5), 206(4)-7 and 206(4)-8 thereunder. Acamar and Martin were not assessed a civil penalty because they demonstrated their inability to pay.[66] Acamar and Martin agreed to cease-and-desist from any future violations of the above securities laws. Martin was also barred from the securities industry.

In re Mark Evan Bloom

On March 2, 2015, a former BDO Seidman LLP partner and hedge fund owner, Mark Bloom ("Bloom"), pled guilty to securities fraud and agreed to pay $26 million to settle CFTC allegations that he misappropriated at least $13 million in customer assets.[67]

In its 2009 complaint, the CFTC alleged that as the sole owner of hedge fund North Hills Management LLC (the "North Hills Fund"), Bloom stole money from a commodities interest pool controlled by the North Hills Fund to support a lavish lifestyle for himself and his wife that included a bevy of luxury homes, cars, and boats. The complaint alleged Bloom violated Sections 4b, 4c(b), 4o(1), 4m(1), and 4k(2) of the Commodity Exchange Act of 1936, as amended.[68]

According to the CFTC's complaint, Bloom started the North Hills Fund around 1995 and converted it into a "fund of funds" in 2001, ensuring investors that he would employ a diversified approach to managing their money.[69] In 2004, however, Bloom invested $17 million, more than half of his investors' money, in a high-risk fund managed by Philadelphia Alternative Asset Management Company ("Philadelphia Alternative Asset Management"). The CFTC maintains that Bloom concealed the fact that he received $1.6 million in commission from Philadelphia Alternative Asset Management through a client referral and fee-sharing program. The CFTC also contends that Bloom hid from investors the $13 million he claimed to have loaned to his wife with fictitious performance reports.[70]

On July 30, 2009, Bloom pled guilty to securities fraud, mail fraud, wire fraud, money laundering, and corruptly obstructing internal revenue laws in the criminal case filed against him by the U.S. Attorney's Office for the Southern District of New York.[71]

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Our prior Reports are available here:
Fall 2014, Spring 2014, Fall 2013, Spring 2013, Fall 2012, Spring 2012, Fall 2011, Spring 2011 and Fall 2011

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[1] The fiduciary standard applicable to registered investment advisers is derived from the "anti-fraud" provisions in Section 206 of the Investment Advisers Act of 1940, as amended. *See* SEC Division of Investment Management, Regulation of Investment Advisers by the U.S. Securities and Exchange Commission (March 2013), pp 22-28, *available at* http://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf.

[2] *See* FINRA Rule 2111.

[3] Disqualifying events include (i) certain relevant criminal convictions, court injunctions and restraining orders; (ii) certain relevant SEC disciplinary orders, cease-and-desist orders and stop orders; (iii) final orders of certain relevant state and federal regulators; (iv) suspension or expulsion from membership in a self-regulatory organization (e.g., the Financial Industry Regulatory Authority, Inc. ("FINRA")) or from association with a member of a self-regulatory organization; and (v) U.S. Postal Service false representation orders.

[4] We previously discussed the API in our **Fall 2012**, **Spring 2013** and **Fall 2014** Reports.

[5] On May 8, 2015 the SEC announced that David Grim had been named as Director of the Division of Investment Management. *See* http://www.sec.gov/news/pressrelease/2015-83.html.

[6] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02011L0061-20130620&from=EN.

[7] An "alternative investment fund" is defined as a non-exempt collective investment undertaking which raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors. Exempt "collective investment undertakings" under the AIFMD are as follows: (i) UCITS funds; (ii) hedge funds with AUM of €100 million or less; (iii) private equity funds with AUM of €500 million or less; (iv) certain qualifying securitization special purpose companies; (v) single investor funds (this allows managers to run managed accounts for single investors based in the EU outside of the scope of the Directive); (vi) funds whose only investors are the manager or the manager's group companies (provided that none of those investors is itself a fund); (vii) "true" joint ventures; and (viii) non-EU funds sold in the EU by a non-EU manager solely on a reverse solicitation basis (noting the warning above).

[8] The "EEA" is the European Economic Area and includes the EU plus Iceland, Norway and Liechtenstein, which countries are covered by the Directive. Switzerland is neither EU nor EEA but has adopted the Directive as described above.

[9] A withholdable payment is defined to mean, subject to certain exceptions: (i) any payment of interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income, if such payment is from sources within the U.S.; and (ii) beginning January 1, 2017, any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends from sources within the U.S.

[10] Under the "portfolio interest exemption," a typical offshore alternative investment vehicle may invest in the debt of a U.S. borrower and avoid U.S. tax on the interest remitted under the debt if it otherwise qualifies for this exemption. This exemption, however, is not available to a bank, as defined under the Code (which definition will generally not encompass a typical offshore alternative investment vehicle).

[11] *In Re: Libor-Based Financial Instruments Antitrust Litigation*, No. 11-md-2262 (S.D.N.Y.).

[12] *Gelboim v. Bank of Am. Corp.*, 135 S. Ct. 897 (2015).

[13] *Ganek v. Leibowitz*, Case No. 15-cv-1446 (S.D.N.Y. Feb. 26, 2015).

[14] Julie Riewe, *Conflicts, Conflicts Everywhere*, Remarks at the IA Watch 17th Annual IA Compliance Conference: The Full 360 View (Feb. 26, 2015), *available at* http://www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html.

[15] Mark J. Flannery, *Insights into the SEC's Risk Assessment Programs*, Global Association of Risk Professionals 16th Annual Risk Assessment Convention (Feb 25, 2015), *available at* http://sec.gov/news/speech/insights-into-sec-risk-assessment-programs.html.

[16] SEC Press Release No. 2015-54, *Agency Announces First Whistleblower Protection Case Involving Restrictive Language*, (Apr. 1, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-54.html#.VRxikvnF9IQ.

17 *SEC Would Hire 431 Under Obama's 2016 Budget*, ThinkAdvisor (Feb. 2, 2015), *available at* http://www.thinkadvisor.com/2015/02/02/sec-would-hire-431-under-obamas-2016-budget.

18 Rachel Louise Ensign, *SEC Probes Companies' Treatment of Whistleblowers*, The Wall Street Journal (Feb. 25, 2015).

19 Mary Jo White, *The SEC as the Whistleblower's Advocate*, Ray Garrett, Jr. Corporate and Securities Law Institute-Northwestern University School of Law (April 30, 2015), *available at* http://www.sec.gov/news/speech/chair-white-remarks-at-garrett-institute.html.

20 Mark Melin, *Study Points to SEC Whistleblower Success*, ValueWalk (March 5, 2015), *available at* http://www.valuewalk.com/2015/03/study-points-to-sec-whistleblower-success/.

21 SEC Press Release 2015-45, *Former Company Officer Earns Half-Million Dollar Whistleblower Award for Reporting Fraud Case to SEC* (March 2, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-45.html#.VWmFZ47F9IQ.

22 Mary Jo White, *The SEC as the Whistleblower's Advocate*, *supra* note 19.

23 *Id.*

24 Rachel Louise Ensign, *SEC Probes Companies' Treatment of Whistleblowers*, The Wall Street Journal (Feb. 25, 2015), *available at* http://www.wsj.com/articles/sec-probes-companies-treatment-of-whistleblowers-1424916002.

25 SEC Press Release No. 2015-54, *Agency Announces First Whistleblower Protection Case Involving Restrictive Language*, (Apr. 1, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-54.html#.VRxikvnF9IQ.

26 *In the Matter of KBR, Inc.*, Administrative Proceeding File No. 3-16466, at ¶7 (Apr. 1, 2015).

27 SEC Press Release No. 2015-54, *Agency Announces First Whistleblower Protection Case Involving Restrictive Language*, (Apr. 1, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-54.html#.VRxikvnF9IQ.

28 SEC Press Release 2015-75, *SEC Announces Award to Whistleblower in First Retaliation Case* (April 28, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-75.html.

29 SEC Press Release 2015-45, *Former Company Officer Earns Half-Million Dollar Whistleblower Award for Reporting Fraud Case to SEC* (March 2, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-45.html#.VQmFZ47F9IQ.

30 SEC Press Release No. 2015-73, *SEC Announces Million-Dollar Whistleblower Award to Compliance Officer* (April 22, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-73.html.

31 *United States v. Newman*, No. 13-1837-CR (2d Cir. Dec. 10, 2014).

32 On April 3, 2015, the United States Court of Appeals for the Second Circuit denied the United States Attorney for the Southern District of New York, Preet Bharara's request for an *en banc* rehearing of the *Newman* decision.

33 Opinion & Order at 1, *United States v. Riley*, 13-CR-00339-VEC (S.D.N.Y. March 3, 2015).

34 *Id.* at 7.

35 *Id.* at 9.

36 *Id.* at 9.

37 *Id.* at 10-14.

38 Administrative Proceeding File No. 3-16444, Order Institute Administrative and Cease-and-Desist Proceedings (Mar. 16, 2015), p. 2.

39 *Id.* at ¶8.

40 *Id.* at ¶14.

41 *Id.* at ¶9-10, 14.

42 *Id.* at ¶44.

43 *Id.* at ¶¶ 49-52.

44 *Id.* at IV.

45 *Id.* at ¶¶ 54.

46 *Id.* at ¶¶ 55-58.

47 *Id.* at IV.

48 SEC Press Release No. 2015-43, *SEC Announces Fraud Charges Against Purported Hedge Fund Manager* (Feb. 27, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-43.html#.VRCSmY7F9IQ.

[49] Complaint, *SEC v. Gray, et al.*, 15-cv-1465 (Feb. 27, 2015), ¶¶3-4, 39.

[50] *Id.* at ¶¶ 4-9.

[51] SEC Press Release No. 2015-43, *SEC Announces Fraud Charges Against Purported Hedge Fund Manager* (Feb. 27, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-43.html#.VRCSmY7F9IQ.

[52] SEC Press Release No. 2015-34, *SEC Announces Fraud Charges Against Purported Hedge Fund Manager* (Feb. 13, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-34.html#.VRCMFo7F9IQ.

[53] *Id.*

[54] *SEC v. Malik*, 1:15-CV-01025, S.D.N.Y. (February 13, 2015), *available at* http://www.sec.gov/litigation/complaints/2015/comp-pr2015-34.pdf, ¶ 5.

[55] *Id.* at ¶¶ 56-61.

[56] *Id.* at ¶¶ 24-29.

[57] SEC Litig. Release No. 23244, *SEC Obtains a Preliminary Injunction Order, Including Asset Freeze, Against Purported Hedge Fund Manager, Moazzam "Mark" Malik* (April 21, 2015), *available at* http://www.sec.gov/litigation/litreleases/2015/lr23244.htm.

[58] SEC Press Release No. 2015-34, *SEC Announces Fraud Charges Against Purported Hedge Fund Manager* (Feb. 13, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-34.html#.VRCMFo7F9IQ.

[59] SEC Litigation Release NO. 23185, *Court Sentences Connecticut-Based Hedge Fund Manager to Thirteen Years in Prison*, *available at* https://www.sec.gov/litigation/litreleases/2015/lr23185.htm.

[60] FBI Release, *Connecticut Hedge Fund Adviser Sentenced to 13 Years in Federal Prison for Running Massive Ponzi Scheme* (Jan. 29, 2015), *available at* http://www.fbi.gov/newhaven/press-releases/2015/connecticut-hedge-fund-adviser-sentenced-to-13-years-in-federal-prison-for-running-massive-ponzi-scheme.

[61] *Id.*

[62] First Amended Complaint, *SEC v. Illarramendi, et al.*, D. Conn. (Mar. 7, 2011), ¶¶ 3, 24-25.

[63] Administrative Proceeding File No. 3-16448, Order Institute Administrative and Cease-and-Desist Proccedings (Mar. 18, 2015), p. 2.

[64] *Id.* at ¶¶ 18.

[65] *Id.* at ¶¶ 12.

[66] *Id.* at ¶¶ 26.

[67] CFTC Press Release No. 7130-15, *Federal Court in New York Imposes a $26 Million Civil Monetary Penalty against Mark Evan Bloom and his Company, North Hills Management, LLC, for Commodity Pool Fraud*, *available at* http://www.cftc.gov/PressRoom/PressReleases/pr7130-15.

[68] Complaint, *CFTC v. Bloom, et al.*, 09-cv-1751 (Feb. 25, 2009), ¶¶68-100.

[69] *Id.* at ¶3.

[70] *Id.* at ¶¶3-4, 42, 53.

[71] CFTC Press Release No. 7130-15, *Federal Court in New York Imposes a $26 Million Civil Monetary Penalty against Mark Evan Bloom and his Company, North Hills Management, LLC, for Commodity Pool Fraud*, *available at* http://www.cftc.gov/PressRoom/PressReleases/pr7130-15.