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Hedge Fund Report - Summary of Key Developments - Spring 2013

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 Federal Reserve Board (the "Federal Reserve") and the Department of the Treasury (the "Treasury"), continue to propose and finalize rules to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). There have also been a number of significant developments in the hedge fund tax area, and the SEC and private plaintiffs have continued 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 2012, 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 Rulemaking

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 Adopts Identity Theft Rules

On April 10, 2013, the SEC voted unanimously to adopt, jointly with the CFTC, identity theft rules pursuant to Section 615(e) of the Fair Credit Reporting Act, as amended by the Dodd-Frank Act (the "FCRA") (the "Identity Theft Rules"). The Identity Theft Rules, adopted as new Regulation S-ID by the SEC and as Subpart C under part 162 of the CFTC rules, will require "covered entities" that offer or maintain one or more "covered accounts" to develop and implement a "written identity theft prevention program" (a "Program") designed to detect, prevent and mitigate identity theft in connection with such accounts.

"Covered entities" include certain SEC- and CFTC-regulated entities (including, among others, SEC-registered investment advisers and CFTC-registered CPOs and CTAs) that meet the definition of "financial institution" or "creditor" under the FCRA. A "covered account" is an account that a covered entity "offers or maintains, primarily for personal, family, or household purposes, that involves or is designed to permit multiple payments or transactions" or any other account maintained by the entity which poses a reasonably foreseeable risk to customers or to the entity from identity theft, including financial, operational, compliance, reputation or litigation risks. In accordance with the foregoing definitions, a registered investment adviser that advises a private fund could be covered by the Identity Theft Rules if natural persons invest in the fund and the adviser has the authority, pursuant to an arrangement with the fund or the individual, to direct the individual's investment proceeds to third parties. A registered investment adviser to a private fund that regularly, and in the ordinary course of business, lends money to permit investors to make an investment in the fund, pending the receipt or clearance of an investor's check or wire transfer, could qualify as a creditor.

Each Program must include reasonable policies and procedures to (i) identify patterns, practices or activities that indicate the possible existence of identity theft ("Red Flags") within a covered account and incorporate those Red Flags into the Program, (ii) detect Red Flags that have been incorporated into the Program, (iii) respond appropriately to any Red Flags detected under the Program, and (iv) periodically update the Program. The board of directors of the covered entity must initially approve the Program and, following adoption of the Program, the covered entity must involve its board of directors, or a designated employee at the senior management level, in the oversight, development, implementation and administration of the Program. The Identity Theft Rules incorporate guidelines to assist covered entities in the formulation and maintenance of Programs.

The Identity Theft Rules will become effective thirty (30) days after publication in the Federal Register. Covered entities will have six (6) months from the effective date to achieve compliance with the Identity Theft Rules. The SEC's press release announcing the adoption of the Identity Theft Rules is available **here** and the full text of the SEC's release adopting the Identity Theft Rules is available **here**. Our recent Client Alert discussing the Identity Theft Rules in more detail is available **here**.

2. SEC Extends Exemptions for Security-Based Swap Agreements

On January 29, 2013, the SEC extended for one year (until February 11, 2014), the interim final rules (the "Interim Final Rules") providing exemptions under the Securities Act of 1933, as amended (the "Securities Act"), the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and the Trust Indenture Act of 1939, as amended, for certain security-based swap agreements ("exempt swaps"). "Exempt swaps" are security-based swap agreements that, as of July 16, 2011, are defined as "securities" under the Securities Act and the Exchange Act due solely to the provisions of Title VII of the Dodd-Frank Act. The Interim Final Rules exempt offers and sales of exempt swaps from all provisions of the Securities Act (other than the anti-fraud provisions), the registration requirements of the Exchange Act and the provisions of the Trust Indenture Act, provided certain conditions are met. The SEC stated that it was extending the expiration date of the Interim Final Rules because it did not expect to complete its evaluation of the implications for security-based swaps as a result of their inclusion in the definition of "securities," including consideration of comments received on the Interim Final Rules, and implement any appropriate regulatory relief before the earlier expiration date of the Interim Final Rules. The full text of the SEC's adopting release extending the exemptions for security-based swap agreements is available **here**.

3. SEC Offers Additional Guidance on Form PF

On November 20, 2012 and March 8, 2013, the staff of the SEC's Division of Investment Management updated its Frequently Asked Questions on Form PF (the "FAQs"). The updated FAQs address, among other topics, general filing information, calculating regulatory assets under management and a reporting fund's gross asset value. The FAQs also provide additional interpretative guidance for liquidity funds, fund of funds and master-feeder arrangements. The updated FAQs address specific questions in Form PF, including but not limited to those relating to trading and clearing mechanisms, exposure of hedge fund assets, hypothecation of collateral, derivatives positions, restrictions on investor withdrawals/redemptions and investor liquidity. The FAQs are available **here**.

B. Other Securities-Related Updates

1. SEC Publishes 2013 Priorities for National Examination Program

On February 21, 2013 the SEC's Office of Compliance Inspections and Examinations ("OCIE") published its 2013 National Examination Program (the "NEP") priorities for examinations of investment advisers (including private fund advisers) and other regulated entities (the "Priorities List"). The purpose of the Priorities List is to communicate with investors and registrants about areas perceived by the NEP to have heightened risk. The Priorities List identifies both market-wide and program-specific priorities. The NEP's market-wide initiatives for 2013 include (i) fraud detection and prevention (including the continued use of "quantitative and qualitative tools and analyses" to identify fraudulent or unethical behavior), (ii) corporate governance and enterprise risk management (under which NEP staff will continue to meet with senior management and boards of SEC-registered entities), (iii) conflicts of interest (focusing on, among others, the sufficiency of disclosures made to investors), and (iv) governance and supervision of information technology systems.

The Priorities List also identifies ongoing risks and new and emerging issues with respect to investment advisers. The ongoing risks include (i) the safety of client assets and compliance with custody requirements, (ii) conflicts of interest related to undisclosed compensation arrangements, (iii) marketing and advertising practices, including the accuracy of advertised performance, (iv) the allocation of an adviser's investment opportunities among accounts that pay performance fees (*e.g.*, many private funds) and those that do not, and (v) fund governance, in particular, "the tone at the top."

The new and emerging risks identified in the Priorities List emphasize the NEP's focus on newly registered advisers. The Priorities List discusses the NEP's ongoing "presence exam initiative" under which the NEP expects to examine "a substantial percentage of the new registrants" over the next two years, prioritizing examinations where the SEC's "analytics indicate higher risks to investors relative to the rest of the registrant population, or there are indicia of fraud or other serious wrongdoing." The Priorities List also addresses, among others, (i) coordinated and joint examinations with dually-registered investment adviser/broker dealers, and (ii) compliance with, and the practical application of, the SEC's "pay to play" rule, Rule 206(4)-5 under the Investment Advisers Act of 1940, as amended (the "Advisers Act").

The Priorities List is not exhaustive and the NEP will conduct additional examinations in 2013 focused on risks, issues, and policy matters that are not addressed in the Priorities List. The full Priorities List is available **here**, and OCIE's October 2012 letter regarding the presence exam initiative is available **here**.

2. *National Examination Program Risk Alert on Compliance with Custody Rule*

On March 4, 2013, OCIE published its risk alert on "Significant Deficiencies Involving Adviser Custody and Safety of Client Assets" under Rule 206(4)-2 under the Advisers Act (the "Custody Rule"). The alert describes widespread custody deficiencies observed by NEP staff in recent examinations. The risk alert identifies four categories of custody-related deficiencies: (i) failure by an adviser to recognize that it has "custody" under the Custody Rule (including, for example, when an adviser serves as the general partner of a limited partnership or holds a comparable position for a different type of pooled investment vehicle ("PIV")); (ii) failure to undergo an annual "surprise examination" (such as by conducting the examination at the same time each year so it can no longer be considered a "surprise"); (iii) failure to adhere to the Custody Rule's "qualified custodian" requirement (for example, by holding client assets in an account in the adviser's name and not as agent or trustee for the client, or by commingling client assets and adviser assets in an account in the adviser's name); and (iv) for PIVs, failure to comply with the "audit approach" to the Custody Rule.

The "audit approach" is an exception to certain Custody Rule requirements available to advisers to PIVs (including private funds) that choose to distribute annual audited fund financial statements to PIV investors. The risk alert identifies deficiencies in these advisers' compliance with the audit approach, including, among others, (i) the accountant that conducted the financial statement audit was not "independent," PCAOB-registered and subject to PCAOB inspection as required by the Custody Rule, (ii) the audited financial statements were not prepared in accordance with U.S. GAAP, (iii) the adviser failed to demonstrate that the audited financial statements were distributed to all investors (*e.g.*, the adviser made the statements available only "upon request"), (iv) the audited financial statements were not sent to investors within the required timeframe, and (v) a final audit was not performed on a liquidated PIV.

Advisers should review their policies and procedures and their compliance with the Custody Rule in light of the deficiencies identified in the risk alert. The full text of OCIE's risk alert on compliance with the Custody Rule is available **here**.

3. *U.S. Department of Labor Advisory Opinion on Application of ERISA to "Cleared Swap" Transactions*

On February 7, 2013, the U.S. Department of Labor (the "DOL"), in response to a request by the Securities Industry and Financial Markets Association ("SIFMA"), issued Advisory Opinion 2013-01A regarding the application of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), to certain "cleared swap" transactions conducted pursuant to provisions of the Dodd-Frank Act (the "DOL Advisory Opinion").

Specifically, SIFMA requested guidance on the following questions: (i) whether a Clearing Member (through which, pursuant to the Dodd-Frank Act, certain swaps must be cleared (a "Clearing Member")) would be considered a fiduciary to an ERISA-covered pension plan under Section 3(21)(A)(i) of ERISA upon the exercise of its contractual liquidation rights in the event of a default by the plan or other specified events; (ii) whether Clearing Members or central counterparties ("CCPs") are parties in interest, under Section 3(14)(B) of ERISA, to plans engaging in swaps as persons "providing services" to such plans; and (iii) whether a Clearing Member's exercise of liquidation rights or a Clearing Member's or CCP's status as a party in interest would constitute a "prohibited transaction" under Section 406 of ERISA.

The DOL noted that its opinion is formed by recent changes to the manner of conducting cleared swap transactions under the Dodd-Frank Act, and that its position was consistent with the principle that Dodd-Frank did not contemplate that ERISA-covered accounts engaging in swaps would be treated differently from other types of customer accounts. In keeping with this principle, DOL expressed its view that margin held by the Clearing Member or CCP in connection with a swap transaction would not be considered a "plan asset" for the purposes of Title I of ERISA, and a Clearing Member exercising its contractual liquidation rights would not be considered a plan fiduciary under ERISA solely by reason of exercising those rights. The DOL based its opinion on the assumption that the Clearing Member's contractual liquidation rights resulted from negotiations with an independent plan fiduciary, and that the parties to the agreement understood that the Clearing Member would not be acting in a fiduciary capacity with respect to actions taken in liquidating the account.

In addressing the question of "party in interest" status of the Clearing member and CCPs, the DOL opined that a Clearing Member representing a plan engaging in swaps is providing services to the plan through a direct contractual agreement and would thus be considered by the DOL to be a "party in interest" to the plan. On the other hand, a CCP would not be considered a "party in interest" with respect to the plan solely by reason of performing its services in relation to the swap through the CCP's arrangements with the Clearing Member.

Finally, because the DOL concluded that Clearing Members are "parties in interest," a swap transaction between a plan and a Clearing Member would result in a prohibited transaction unless an exemption applies. The DOL indicated that one such exemption could be Prohibited Transaction Exemption (PTE) 84-14 (the "QPAM Exemption"), which would provide exemptive relief for such swap transactions (including both the initial transaction and any "subsidiary" transactions that might arise under the swap agreement in connection with liquidation of the position) provided that, among other conditions, the agreement entered into by the qualified plan asset manager (the "QPAM") sets forth all the material terms of the arrangement including, but not limited to, the provision of services and guarantees by the Clearing Member.

The DOL Advisory Opinion should reduce much uncertainty about application of the new swaps regime to private ERISA "plan asset" funds. The full text of the DOL Advisory Opinion is available **here**.

4. Chief of SEC Asset Management Unit Speaks on Private Fund Enforcement Priorities

On December 18, 2012, Bruce Karpati, Chief of the Asset Management Unit (the "AMU") of the SEC's Division of Enforcement, identified the enforcement and risk management areas in the private fund space that are of the most interest to the SEC. Mr. Karpati spoke at the Regulatory Compliance Association's Compliance, Risk & Enforcement 2012 Symposium in New York City. Mr. Karpati noted that certain characteristics of the hedge fund industry demonstrate the need for SEC oversight and described the specific risks of fraud and "misalignment of incentives" between fund advisers and investors. By way of example, he noted that the compensation of private fund advisers by both management and performance fees creates a temptation for advisers to overvalue assets; the investment strategies utilized by private funds may drive advisers to "get an informational edge in the

market," including through illicit means such as insider trading; and the lack of independent governance for many private funds make them "more susceptible to conflicts of interest, insider trading and other fraudulent practices." Mr. Karpati explained that these incentives are in tension with a private fund adviser's role as fiduciary to private fund investors.

Mr. Karpati also discussed the AMU's continued use of the SEC's Aberrational Performance Inquiry (the "Inquiry") to detect suspicious or improbable performance returns posted by private fund advisers, which to date has resulted in seven enforcement actions against hedge fund advisory firms and managers.[1] He stated that the Inquiry is "now focused on a subset of hedge fund strategies that have high incidences of suspicious returns." Mr. Karpati also noted that the registration of private fund advisers following the Dodd-Frank Act, including SEC examinations of newly registered advisers, has provided the AMU with "more information than ever before to mine for use in its risk initiatives."

Mr. Karpati concluded by identifying three best practices for private fund advisers to ensure that they fulfill their fiduciary duties to their clients. First, Mr. Karpati emphasized that managers should set "the tone at the top" to "create a culture of compliance within the firm," including supervision of employees and internal controls. Second, Mr. Karpati stated that advisers should adopt and implement compliance programs and controls tailored specifically to the risks and investment strategy of the firm. Lastly, Mr. Karpati emphasized that private fund advisers should be alert and prepared for SEC examinations and should cooperate with examination staff both during and after the examinations. The full text of Mr. Karpati's speech is available **here**.

5. Chief Counsel of SEC Division of Trading and Markets Speaks on Broker-Dealer Registration in the Private Fund Space

On April 5, 2013, David Blass, Chief Counsel of the SEC's Division of Trading and Markets, addressed topics on broker-dealer registration in the private fund space. Mr. Blass noted that private fund advisers should be aware of activities that could trigger a requirement for the private fund adviser to become registered as a broker-dealer under the Exchange Act. Examples of activities that might require a private fund adviser or its personnel to register as a broker-dealer include (i) marketing private fund securities to investors, (ii) soliciting or negotiating securities transactions, or (iii) handling customer funds and securities. Mr. Blass stated that another important element is whether there is "transaction-based compensation" (*i.e.*, compensation that depends on the outcome or size of the securities transaction), which the SEC has "long viewed . . . [as] a hallmark of being a broker."

Mr. Blass recommended that private fund advisers review their practices with respect to obtaining new investors and retaining existing investors to determine whether these practices may trigger any broker-dealer registration requirements. The determination is fact-intensive, and Mr. Blass provided examples of the kind of inquiries a private fund adviser may want to make when evaluating its practices, including:

- How does the adviser solicit and retain investors? This is an important consideration because a dedicated sales force of employees working within a "marketing" department may strongly indicate that they are in the business of effecting transactions in the private fund, regardless of how the personnel are compensated.
- Do employees who solicit investors have other responsibilities? If so, consider what those responsibilities are (*i.e.*, are the primary functions of these employees to solicit investors).
- How are personnel who solicit investors for a private fund compensated? Do those individuals receive bonuses or other types of compensation that is linked to successful investments? A critical element to determining whether one is required to register as a broker-dealer is the existence of transaction-based compensation.

- Is a transaction fee charged in connection with a securities transaction? In addition to considering compensation of employees, advisers also need to consider the fees they charge and in what way, if any, they are linked to a security transaction.

With respect to exemptions from broker-dealer registration available to private fund advisers, Mr. Blass noted that Rule 3a4-1 under the Exchange Act, the "issuer exemption," is generally not available to private fund advisers but that private fund advisers have a "wide array of options available to [them] to raise funds without triggering broker registration concerns." The full text of Mr. Blass' speech is available **here**. Our recent Client Alert discussing Mr. Blass' speech in more detail is available **here**.

6. Cayman Islands Monetary Authority Proposals to Apply Revised Governance Standards to Regulated Private Funds

On January 14, 2013, the Cayman Islands Monetary Authority ("CIMA") released a Corporate Governance Consultation Paper (the "Consultation Paper") seeking comment from the industry on enhancing corporate governance for all CIMA-registered financial entities, including hedge funds. CIMA stated that it considers these enhancements as "necessary and beneficial to the continued international standing of the jurisdiction." The Consultation Paper sets forth four separate proposals: (i) to extend the Cayman Islands Statement of Guidance on Corporate Governance (the "SOG") to all CIMA-registered entities, including private funds, (ii) to establish an online public database for access by interested stockholders to facilitate the due diligence process involved during investment or capital injection decisions; (iii) to require the registration of all "professional" directors (*i.e.*, persons acting as director for six or more entities for profit or reward), irrespective of such directors' geographical locations; and (iv) to require all directors of CIMA-registered entities (not just "professional" directors) to register with CIMA. CIMA is also surveying the industry for its views on limiting the number of directorships held by individuals. Comments to the proposals in the Consultation Paper were due on March 18, 2013. The Consultation Paper is available **here** and the SOG, as amended, is available **here**.

7. Compliance with NFA Bylaw 1101 for CFTC-Registered CPOs and CTAs

As discussed in prior Reports, as of January 1, 2013, operators of private funds may no longer rely on the exemption from registration as commodity pool operators ("CPOs") under repealed CFTC Rule 4.13(a)(4), and must either have qualified for the *de minimis* exemption from registration under CFTC Rule 4.13(a)(3), or registered with the CFTC as a CPO, become a member of the National Futures Association (the "NFA"), and comply with all applicable CFTC and NFA rules. Among those rules, NFA Bylaw 1101 (the "Bylaw") prohibits NFA members from doing business with any non-NFA members that are required to be registered with the CFTC as a futures commission merchant ("FCM"), introducing broker ("IB"), CPO or commodity trading advisor ("CTA"), subject to certain limited exceptions. In the private fund context, the Bylaw requires all registered CPOs and CTAs to confirm that, for each fund for which it is acting as CPO or CTA, all investors in the fund, sub-advisers to the fund, counterparties with which the fund enters into commodity transactions and solicitors for the fund are properly registered with the CFTC as FCMs, IBs, CPOs or CTAs, as applicable, and are NFA members, or properly exempt from such registration and membership requirements.

NFA Interpretative Notice 9007 sets forth "certain minimal steps which should be taken to reduce the possibility of a violation" of the Bylaw. These include (i) reviewing the list of CFTC registrants with which the CPO does business to determine if they are NFA members; (ii) reviewing the CPO's customer list and, if a customer's name indicates that it might be engaged in the futures business, inquiring as to its registration and membership status; (iii) confirming that any customer operating a commodity pool but claiming to be exempt from CPO registration has made the required filings with

the CFTC and the NFA; and (iv) ensuring that the CPO's branch offices are not separately incorporated entities, which would require separate registration with the CFTC.

Private fund registered CPOs should consider revising their subscription documents to secure the representations from investors necessary to comply with the Bylaw. The full text of the Bylaw is available **here** and the full text of NFA Interpretative Notice 9007 is available **here**.

8. Lawmaker Questions SEC's Continued Ban on General Solicitation

On April 17, 2013, Representative Patrick McHenry (R-N.C.), chair of the House Committee on Financial Services oversight panel, questioned the continued viability of the SEC's ban on general solicitation following the expiration of the rulemaking deadline for lifting the ban imposed by the 2012 Jumpstart Our Business Startups (JOBS) Act. The JOBS Act required the SEC, by July 4, 2012, to lift the ban on advertising the sale of securities, including private offerings, without SEC registration. The SEC issued its proposed rule on the "Elimination of Prohibition Against General Solicitation And General Advertising in Certain Offerings" on September 5, 2012 but, as of the date of this Report, has not issued final rules as required by the JOBS Act. The SEC received nearly 200 comments on the proposed rule before the comment period ended on October 5, 2012. Industry participants were generally supportive of the proposal, though some trade associations supported the addition of one or more non-exclusive safe harbors for verification following investor self-certification and many individuals commented that the proposed rule does not sufficiently protect against fraud. The SEC has not indicated when it expects to finalize the rule. On April 16, 2013, SEC commissioner Luis A. Aguilar said that he considered the SEC's proposed rule "fatally flawed" and that he thought it should be re-proposed. The full text of Mr. Aguilar's speech is available **here**. Our September 2012 Client Alert discussing the SEC's proposed rule eliminating the prohibition against advertising in certain offerings is available **here**.

9. Update on Key AIFMD Implementation Dates

Private fund advisers marketing funds in any European Union ("EU") Member State (a "Member State") should be aware of the upcoming implementation dates for the July 2011 Alternative Investment Fund Managers Directive (the "AIFMD"). The AIFMD creates a comprehensive and harmonized regulatory regime covering, among others, private fund advisers either based in the EU or marketing private funds to EU customers. The AIFMD ultimately requires private fund advisers that wish to operate in the EU to become authorized as alternative investment fund managers ("AIFMs") with a Member State, meet ongoing operating conditions and comply with transparency and reporting requirements. The following implementation dates apply primarily to non-EU private fund advisers ("non-EU advisers") marketing non-EU alternative investment funds ("non-EU funds") in one or more Member States.

- **July 22, 2013:** Deadline for Member States to implement the AIFMD into their national law. After this date, non-EU advisers offering non-EU funds in one or more Member States must comply both with certain AIFMD requirements around disclosure and domicile[2] and with each Member State's private placement rules (on a Member State by Member State basis).
- **July 22, 2015:** Start date for Non-EU advisers marketing non-EU funds to begin seeking authorization under the AIFMD. Authorization would require the non-EU adviser to become subject to all AIFMD requirements, but would also enable the non-EU adviser to receive an EU "passport" for marketing non-EUs fund to professional investors in Member States without having to rely on a Member State's private placement regimes.
- **Late 2018:** The EU has the option of eliminating the private placement option and requiring non-EU advisers marketing in Member States to become authorized under the AIFMD.

Our recent Client Alert discussing in greater detail the implications of the AIFMD for non-EU based AIFMs is available **here**.

II. TAXATION

Since our last Report, Congress has resolved the so-called fiscal cliff by, among other things, implementing various tax changes as formally adopted in early 2013. These developments, and other notable tax developments, are summarized below.

A. The American Taxpayer Relief Act of 2012

The American Taxpayer Relief Act of 2012 (the "Act") was signed into law by President Obama on January 2, 2013. The Act is a sweeping compromise measure that includes, among other items, a permanent extension of the Bush-era tax cuts for most taxpayers, permanent relief from the alternative minimum tax ("AMT") for individual taxpayers and a number of retroactive and extended tax breaks for individuals and companies. The Act also increases income tax rates for high-income individual taxpayers and reinstates certain deduction limitations. The Act additionally provides permanent estate, gift and generation-skipping transfer tax relief, which such aspects are not discussed herein.

Specifically, the Act provides that the Bush-era tax cut brackets for individual taxpayers ranging from 10% to 35% will remain in place and are permanent with respect to taxable years beginning in 2013. However, the Act adds a new 39.6% rate that applies to taxable income thresholds beginning at $400,000 for single filers, $425,000 for head of household filers, $450,000 for joint filers and qualified widow(er)s, and $225,000 for married persons filing separately. Such amounts will be adjusted for inflation in future taxable years.

The Act retains the 0% rate on long-term capital gains and qualified dividends but increases the 15% rate to a 20% rate for taxable years beginning in 2013. In addition, the Act phases out certain personal exemptions. Specifically, for taxable years beginning in 2013, personal exemptions are reduced for taxpayers whose adjusted gross income exceeds $250,000 for single filers, $275,000 for head of household filers and $300,000 for joint filers. Such amounts will be adjusted for inflation in future taxable years. Many itemized deductions for such taxpayers are also limited under the Act with respect to taxable years beginning in 2013.

The Act provides permanent AMT relief. Prior to the Act, individual AMT exemption amounts for 2012 would have been $33,750 for single filers, $45,000 for joint filers, and $22,500 for married persons filing separately. Retroactively to taxable years beginning after 2011, the Act permanently increases these exemption amounts to $50,600 for single filers, $78,750 for joint filers, and $39,375 for married persons filing separately. Further, for tax years beginning after 2012, the Act allows the exemption amounts to be indexed for inflation. For 2013, the AMT exemption amounts are $51,900 for single filers, $80,800 for joint filers, and $40,400 for married persons filing separately.

B. Recent Foreign Account Tax Compliance Act Developments

The Foreign Account Tax Compliance Act ("FATCA"), which was enacted in March 2010 in the Hiring Incentives to Restore Employment Act, requires a foreign financial institution (or "FFI") to enter into an agreement with the Internal Revenue Service (the "IRS") and report U.S. accounts to the IRS or pay a thirty percent (30%) withholding tax on any "withholdable payment" made to the institution or their affiliates.[3] 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 FATCA Guidance*

On January 17, 2013, the Treasury issued final Treasury Regulations under FATCA. The final Treasury Regulations update and modify the proposed Treasury Regulations issued on February 8, 2012 and provide significant detail regarding the practical aspects of effecting FATCA compliance. The more notable aspects of the final Treasury Regulations are discussed in our recent Client Alert, which may be found **here**.

2. *IRS Released Draft FATCA Registration Form*

On April 5, 2013, the IRS released a draft version of Form 8957, "Foreign Account Tax Compliance Act Registration" ("Form 8957"). Once finalized, the form is intended to be used by FFIs to register with the IRS.

As a general matter, Form 8957 requires an FFI to provide certain identifying information as well as answer, among other questions, whether the FFI has a withholding agreement in place with the IRS to be treated as a qualified intermediary, withholding foreign partnership or withholding foreign trust.

Once finalized, both paper and electronic versions of Form 8957 will be accepted by the IRS. However, the IRS has stated that it expects that FATCA registration will be accomplished most efficiently and effectively through an electronic online process that will avoid the need to print, complete and mail Form 8957. The online registration portal will be available in July 2013. The IRS stated that FFIs registering through the online process will receive notice of registration acceptance and obtain the Global Intermediary Identification Number ("GIIN") needed to demonstrate FATCA compliance on an expedited basis. Clients are strongly recommended to register FFIs online once the portal becomes available this summer.

The IRS stressed that Form 8957 is a draft only and is not intended for use at this time. The draft Form 8957 may be found **here**. We will continue to monitor the development of Form 8957.

3. *IRS Released Draft Form 1042-S*

The IRS recently released a new draft version of Form 1042-S, "Foreign Person's U.S. Source Income Subject to Withholding," which is a long-standing form used to report U.S.-source income subject to withholding and paid to foreign persons ("Form 1042-S"). Form 1042-S has been adapted to incorporate the new withholding requirements under FATCA. Changes to Form 1042-S include not only changes to the face of the form (such as new boxes and reporting requirements) but also changes in the form's codes.

The IRS is accepting comments to Form 1042-S. The draft may be found **here**. Draft instructions to the form have not yet been released.

4. *Developments Regarding Intergovernmental Agreements*

Early in 2012, the Treasury began negotiating and entering into intergovernmental agreements ("IGAs") with foreign governments. As discussed in our last Report, the IGAs are intended to provide an alternate means by which financial institutions located within participating jurisdictions may comply with FATCA. The Treasury reported in November 2012 that it is engaging with over 50 countries and jurisdictions with respect to IGAs and other compliance aspects of FATCA in an attempt to efficiently and effectively implement FATCA. To date, the Treasury has entered into IGAs with the following jurisdictions: Switzerland, Ireland, Mexico, Denmark, Norway and the United Kingdom. IGAs are also expected to be entered into with, among other jurisdictions, the Cayman Islands, Spain, Japan, France, Germany and Italy.

5. Next Steps

Draft instructions for Form 8957 and Form 1042-S should be released soon. The IRS stated that because it is trying to accelerate the finalization of the draft forms and instructions thereto, taxpayers and practitioners should relay any concerns about the drafts to the IRS as soon as possible.

On April 9, 2013, the IRS released a brief preview of its so-called "December list" of FFIs. The list will be a published list of FFIs that have registered with the IRS by October 25, 2012, and their corresponding GIINs. Form 8957 (when finalized) will enable FFIs to obtain a GIIN and be included on the list. We will continue to monitor such developments.

C. Recent FBAR Developments

As discussed in previous issues of our Report, U.S. persons who have an interest in, or signatory authority over, a foreign account with a value over $10,000 are required to file a Foreign Bank Account Report ("FBAR"). The IRS has been actively calling for FBAR compliance and has instituted significant civil and criminal penalties for those who fail to file FBARs. The IRS has not provided significant new FBAR guidance since our last Report.

The Financial Crimes Enforcement Network ("FinCen") announced in Notice 2012-2 on December 26, 2012 that it is further extending the filing deadline for FBARs for certain individuals with signature authority over, but no financial interest in, one or more foreign financial accounts to June 30, 2014. Such deadline had previously been extended by FinCen in Notice 2011-1, Notice 2011-2 and Notice 2012-1. This extension applies to the reporting of signature authority held during the 2012 calendar year, as well as reporting deadlines extended by previous Notices 2011-1 and 2011-2.

Specifically, Notice 2012-2 provides filing relief in the form of exceptions for certain officers and employees with signature or other authority over, but no financial interest in, a foreign financial account owned or maintained by a regulated entity or its controlled subsidiaries (as specified in the final FBAR regulations), as described in the following two categories: (i) employees or officers of a regulated entity who have signature or other authority over, and no financial interest in, a foreign financial account of another entity more than 50% owned, directly or indirectly, by the regulated entity (referred to as a "controlled person"); and (ii) employees or officers of a controlled person of a regulated entity who have signature or other authority over, and no financial interest in, a foreign financial account of the regulated entity, the controlled person, or another controlled person of the regulated entity.

Notice 2012-2 and the prior Notices described above also provide administrative relief in the case of officers and employees of investment advisers registered with the SEC with signature or other authority over, but no financial interest in, foreign financial accounts of persons that are not registered investment companies.

All other taxpayers required to file an FBAR this year are required to meet the June 30, 2013 filing date. Unlike federal income tax returns, extensions of time to file FBARs are generally not available.

D. Clarification Regarding Electronic IRS Forms W-8

To date, the IRS has provided little guidance regarding the acceptability of electronic submissions of Form W-8 to withholding agents. The Treasury Regulations promulgated under Section 1441 of the Internal Revenue Code of 1986, as amended (the "Code"), generally require that a U.S. withholding agent's electronic system must ensure that the information received from a payee on a Form W-8 is the information sent. The withholding agent must document all occasions of user access that result in the submission, renewal or modification of the form. In addition, the system's design and operation, including access procedures, must make it reasonably certain that the person furnishing the form is

the person named on the form. However, other than these general guidelines, withholding agents have had very limited guidance as to when electronic Forms W-8 are acceptable.

The IRS recently posted on its website a legal advice memorandum, AM 2012-008, elaborating on the circumstances under which a withholding agent may rely on a Form W-8 that is signed with a handwritten signature and electronically transmitted to the withholding agent as a PDF or fax. Specifically, a withholding agent may accept an electronic Form W-8 if it is signed with a handwritten signature, scanned into an electronic system and then transmitted directly to the agent through that electronic system, for example, as a PDF or facsimile. The form must be complete and legible.

The legal advice memorandum also addresses signature requirements. It states that, "when an individual signs the form with a handwritten signature and scans that form into an electronic device for purposes of transmission, those actions constitute a process associated with the form that reflects that the form is executed or adopted by a person with the intent to sign the record." The IRS further stated that the electronically transmitted form may be stored electronically, or otherwise, in a format that would enable the withholding agent to produce a hard copy of the form upon examination.

The guidance in the legal advice memorandum is the most specific that the IRS has released to date. However, IRS personnel who are responsible for advising agents as to how to conduct audits have stated publicly that they have not yet made a decision as to whether they will follow the legal advice memorandum. Instead, at this stage, they will continue to require original, ink-to-paper Forms W-8 on audit. Thus, while the legal advice memorandum is helpful non-binding guidance that may be cited if necessary, we urge clients to obtain paper copies of Forms W-8 for the time being.

The legal advice memorandum may be found **here**.

E. IRS Extends Reporting Deadline for Certain Entities with Financial Interests in Specified Foreign Financial Assets

As reported in our Spring 2012 Report, Code Section 6038D was enacted in 2010 to compel individuals who are U.S. taxpayers with offshore financial accounts to disclose interests in certain "specified foreign financial assets" with an aggregate value exceeding $50,000 for tax years beginning after March 18, 2010. Higher thresholds apply to U.S. taxpayers who file a joint return or who reside abroad (see below). The new disclosure obligation generally became effective for calendar year 2011. Disclosure is accomplished by submitting a statement with a taxpayer's annual federal income tax return containing certain identifying information.

As an anti-abuse measure, the IRS is authorized to provide that Code Section 6038D applies in the same manner to any domestic entity formed or availed of for the purpose of holding specified foreign financial assets as it applies to individuals. The IRS addressed such domestic entities in proposed Treasury Regulations released December 19, 2011. Such specified domestic entities include corporations, partnerships and trusts formed or availed of for purposes of holding specified foreign financial assets. If adopted, the proposed Treasury Regulations would apply the Code Section 6038D reporting requirements to such domestic entities as well as specified individuals. Until then, no domestic entity would be required to meet the reporting obligations imposed under Code Section 6038D.

In the recently released Notice 2013-10, the IRS announced that domestic entities will not be subject to Code Section 6038D for tax years beginning on or earlier than December 31, 2012. Notice 2013-10 states that the IRS intends that the final Treasury Regulations under Code Section 6038D, once released, will modify the effective date discussed in the proposed regulations to state that domestic entities will not be required to report ownership in specified foreign financial assets before the date specified in the final regulations, which will be no earlier than taxable years beginning after December 31, 2012.

Such notice should come as a welcome development to those in the hedge fund industry, given the broad number of domestic entities which are expected to be impacted by Code Section 6038D. For example, it is expected that a U.S. feeder fund investing in a foreign master fund will be subject to the Code Section 6038D reporting requirement once effective.

Notice 2013-10 may be found **here**.

F. De Minimis Partner Rule No Longer Applicable

On December 26, 2012, the IRS released final Treasury Regulations eliminating the so-called *de minimis* partner rule with respect to all allocations that become part of a partnership agreement on or after December 28, 2012 and for all partnership taxable years beginning after that date.

By way of background, Code Section 704(b) provides that allocations of income, gain, loss, deduction and other tax items must be made in accordance with each partner's interest in the partnership, unless such allocations have "substantial economic effect." In order for an allocation to have "substantial economic effect," the allocation must both have economic effect within the meaning of the Treasury Regulations promulgated under Code Section 704(b) and be substantial within the meaning of such Treasury Regulations. As a general matter, an allocation will have economic effect if it is consistent with the partners' economic business deal and will be substantial if there is a reasonable possibility that the allocation will substantially affect the dollar amounts received by the partners independent of tax consequences.

The IRS previously included the *de minimis* partner rule under the Code Section 704(b) regulations to provide that the tax attributes of *de minimis* partners (or those with a less than 10% interest in partnership capital and profits, and allocated less than 10% of the partnership's net income, gain, loss, deduction and other tax items) were disregarded in determining whether an allocation was substantial under the substantial economic effect rules.

Wary of abuse of the rule, the IRS proposed Treasury Regulations in October 2011 to remove the *de minimis* partner rule. Pursuant to the final Treasury Regulations issued in December 2012, the rule has been removed. Specifically, the final regulations provide that the rule does not apply to allocations that become part of the partnership agreement on or after December 28, 2012. With respect to preexisting allocations, the *de minimis* partner rule is no longer applicable, for all partnership tax years beginning on or after December 28, 2012, regardless of when the allocation became part of the partnership agreement. This is true even though substantial economic effect is generally tested when an allocation becomes part of a partnership agreement.

Clients should be aware that the substantiality of all partnership allocations, regardless of when they became part of a partnership agreement, should be retested without the benefit of the *de minimis* partner rule. For allocations in existing partnership agreements, the retest has to be as of the first day of the first partnership tax year beginning on or after December 28, 2012. Such retest will be particularly applicable to partnership agreements that do not have *pro rata* allocations.

The IRS has not provided any alternative relief to reduce the burden of testing the substantiality of allocations to all *de minimis* partners. The IRS stated that it will consider alternative relief and may address the same in future guidance. We will continue to monitor any such developments.

III. CIVIL LITIGATION

Recently, in litigation matters involving hedge funds, courts have addressed such important issues as banks' liability to private plaintiffs for allegedly manipulating LIBOR and the fiduciary duties of hedge fund managers. Significant recent case rulings include the following:

- The Southern District of New York dismissed most of the claims brought by hedge funds and other plaintiffs against more than a dozen banks accused of colluding to manipulate LIBOR.
- A U.K. appellate court affirmed a trial court's ruling that a hedge fund manager's director and senior executive could be held liable for negligent misconduct despite their reliance on the hedge fund principal's representations.
- A pension plan's ERISA claims for breach of fiduciary duty against a hedge fund manager for losses relating to Madoff's schemes survived a motion to dismiss.

A. Update on Previously Reported Cases

Southern District of New York Dismisses Majority of Claims in Consolidated Actions Accusing Banks of Colluding To Manipulate LIBOR

In the Fall 2011 issue of our 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 twelve 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.

Since the complaint was filed, the litigation has become significantly more complex. As we reported in the Spring 2012 issue of our Report, the Judicial Panel on Multi-District Litigation ("MDL") transferred twenty-two other cases involving LIBOR to the Southern District of New York, and on November 29, 2011, the court consolidated the actions and appointed interim class counsel for two putative classes of plaintiffs, one group that engaged in over-the-counter transactions and another group that purchased financial instruments on an exchange.

As we reported in the Fall 2012 issue of our Report, since the consolidation, still more actions have been filed and consolidated into the MDL proceedings. In April of 2012, several amended complaints were filed, and in June and July, the defendants filed multiple motions to dismiss. The court stayed the action pending resolution of the motions to dismiss. Oral argument was held March 5, 2013.

On March 29, 2013, the court granted in part and denied in part the defendant banks' motions to dismiss. The court's order applied to four categories of cases: cases brought by (1) over-the-counter plaintiffs, (2) exchange-based plaintiffs, (3) bondholder plaintiffs, and (4) Charles Schwab plaintiffs. The lead action for the exchange-based plaintiffs was FTC Capital GmbH v. Credit Suisse Group.

The court dismissed all plaintiffs' federal antitrust claims and the Schwab plaintiffs' Cartwright Act claim for lack of antitrust standing. The court also dismissed the Schwab plaintiffs' RICO claims on the grounds they were barred by the Private Securities Litigation Reform Act of 1995 and rested on an impermissible extraterritorial application of RICO. The court dismissed the exchange-based plaintiffs' common law unjust enrichment claim with prejudice and declined to exercise supplemental jurisdiction over the remaining state law claims. Finally, the court dismissed certain of the exchange-based plaintiffs' commodities manipulation claims as time-barred. The remaining commodity manipulation claims, which are the only claims remaining in the action, can now proceed to trial.

In its ruling, the court noted that while "it might be unexpected that we are dismissing a substantial portion of plaintiffs' claims," federal regulators are already addressing the "broad public interests" invoked by the plaintiffs in their complaints.

B. New Developments in Securities Litigation

1. U.K. Appellate Court Holds Hedge Fund Manager Employees Personally Liable for Negligently Relying on Representations of Principal

On February 15, 2013, the Civil Division of the U.K. Court of Appeal upheld a judgment from the England and Wales High Court of Justice, Chancery Division, finding a director and a senior executive of hedge fund manager Weavering Capital (UK) Limited ("WCUK") liable for breaching fiduciary, contractual, and other duties.

WCUK was a hedge fund manager operated by Magnus Peterson ("Peterson"), who, with his wife, was a director of WCUK. Charanpreet Dabhia ("Dabhia") and Edward Platt ("Platt") were respectively a director and senior employee of WCUK. In 2003, Peterson formed Weavering Macro Fixed Income Fund Limited ("Macro"), a hedge fund incorporated in the Cayman Islands and managed by WCUK. In its marketing of Macro, WCUK made false and misleading statements to investors, mischaracterizing Macro as a low-risk fund with low volatility and high liquidity.

When Macro started losing money in 2003, Peterson devised a scheme to show fictitious gains on interest rate swaps where the actual counterparty was a separate worthless entity controlled by Peterson. When the swap transactions were uncovered as shams in 2009, liquidation proceedings began. Claims arising from Macro's losses totaled more than $530 million. When WCUK was unable to pay the claims, it sought indemnity from Dabhia, Platt and the Petersons, claiming breach of contractual and fiduciary duties to WCUK. In May 2012, the trial court found the defendants jointly and severally liable for $450 million in damages plus costs. Dabhia and Platt appealed.

Dabhia and Platt argued that they reasonably relied on Peterson's representations and could not be held liable for negligence. The appellate court affirmed the trial court's order, finding that Dabhia and Platt could be held liable to WCUK. The appellate court noted that the trial court had found that Platt was doing his "incompetent best" and was "simply over-promoted" and "swallowed everything that Mr. Peterson told him." This conduct was deemed "plainly negligent" and violated the defendants' duty to WCUK to act with proper care.

The appellate court's judgment shows that a fund manager's directors and employees can be held liable in the U.K. for negligent misconduct and that ignorance, inexperience and incompetence do not excuse failure to meet contractual and legal duties.

2. Pension Plan's ERISA Claims For Breach of Fiduciary Duty Against Hedge Fund Manager Survive Motion to Dismiss

On January 7, 2013, the Southern District of New York granted in part and denied in part a motion to dismiss claims brought pursuant to ERISA in connection with a hedge fund's investment in a Madoff feeder fund.

Pension Trust Fund for Operating Engineers (the "Plan"), the lead plaintiff in the purported class action, had invested in Meridian Diversified ERISA Fund, Ltd. ("ERISA Fund"). ERISA Fund invested a portion of its assets in a Madoff "feeder" fund, Rye Select Broad Market XL Portfolio Ltd. (the "Feeder Fund"), which invested all its assets with Bernard L. Madoff Investment Securities LLC. Following the collapse of Madoff's scheme, ERISA Fund's investment in the Feeder Fund was lost.

The Plan brought suit against the manager of ERISA Fund and various related entities and individuals on behalf of itself and all those who purchased shares in ERISA Fund. The Plan alleged that the defendants missed "red flags" about Madoff's operations, making them liable for the Plan's losses. The Plan brought claims for federal securities fraud, breach of fiduciary duty under ERISA, engaging in a "prohibited transaction" under ERISA, co-fiduciary liability under ERISA, disgorgement of profits under ERISA and common law claims. The defendants moved to dismiss for failure to state a claim.

The court dismissed the common law claims because the Plan had no standing to assert them and dismissed the federal securities fraud claims, which did not allege that the defendants had acted with the requisite intent.

As to the ERISA claims, because the assets of ERISA Fund constituted "plan assets," the defendants were subject to ERISA and its heightened fiduciary duties of loyalty and prudence. The court found the allegations sufficient at the pleading stage to show that most of the investment advisers and their principals were fiduciaries under ERISA.

In considering the complaint's causes of action based on the defendants' alleged breaches of the fiduciary duties of loyalty and prudence under ERISA, the court noted that the ERISA duty of prudence is "one of the highest duties known to the law." To defeat the motion to dismiss as to those claims, the Plan's allegations had to "support an inference that the ERISA fiduciaries made investment decisions under circumstances that gave rise to an imprudent level of risk." The court's opinion was instructive on the application of the ERISA prudence standard in managing hedge fund investments. In the context of a hedge fund investment, the court said, "the proper question to focus on is whether a prudent, sophisticated investment professional with experience in controlling large hedge funds and faced with the same facts, would have acted in a similar fashion as defendants."

The court held that the complaint withstood the defendants' motion to dismiss based on the fiduciary duty of prudence under ERISA. However, the court dismissed the claim for disgorgement of fees and profits because, while disgorgement is a remedy for breach of fiduciary duty, it is not a separate cause of action.

IV. REGULATORY ENFORCEMENT

In the last six months, the SEC has seen a number of significant departures from its senior management, including SEC Chair Mary Schapiro,[4] Director of Enforcement Robert Khuzami, the SEC's General Counsel Mark Cahn, Director of Corporation Finance Meredith Cross and Director of Trading and Markets Robert Cook. While these departures may lead to some changes in the agency's priorities, the SEC remains committed to sustained enforcement efforts involving hedge funds and their advisers.

In a recent speech, Bruce Karpati, Chief of the SEC's Asset Management Unit discussed his view of the SEC's current enforcement priorities (see also Section I.B.4 of this Report). Citing the "tremendous growth in the number of funds operating" since the 1990s, Mr. Karpati indicated his "firm[]" belief that the hedge fund "industry needs vigilant enforcement oversight."[5]

Mr. Karpati's view is not a new one. Hedge funds have been a focus of the SEC for the last several years. Since 2010, the SEC has brought over 100 cases against hedge fund managers, typically alleging conflicts of interest, improper valuation, inflated performance, and inadequate compliance and controls.[6] Through the continued use of aggressive and innovative investigative tools, the SEC intends to bring significantly more cases involving hedge fund misconduct in 2013.

One of the tools that the SEC will use to bring these cases is the expertise generated by the AMU. The AMU is one of five specialized units within the Division of Enforcement. It is comprised of 75 staff members across 11 SEC offices, and focuses exclusively on investigating and bringing enforcement

actions against investment advisers, investment companies, hedge funds, mutual funds and private equity funds.[7] It also employs the services of hedge fund managers, private equity analysts and due diligence professionals to assist it with issues relating to policy, investigations and exams. Through the establishment of this unit, the SEC is able to identify misconduct more readily, conduct investigations more efficiently and effectively, and generate a wide number of cases.

Another enforcement tool the SEC will continue to use in 2013 is its risk-based, analytic initiatives to flag matters for examination and investigation. As mentioned in a prior Report, one of those analytics is the Aberrational Performance Inquiry. To date, the Inquiry has resulted in seven public enforcement actions against hedge fund advisory firms and managers, one of which also involved criminal charges.[8]

We expect that these tools – along with the SEC's whistleblower program – will continue to generate enforcement cases for the agency, with a particular emphasis on cases involving (a) valuation of portfolio holdings; (b) insider trading; (c) conflicts of interest and preferential treatment of certain investors; and (d) broker-dealer registration issues concerning private investment funds.

We discuss recent developments in each of these areas below.

A. Valuation Manipulation

Enforcement actions involving the fraudulent valuation of assets remain a priority for the SEC. According to Mr. Karpati, "the temptation to overvalue assets to boost compensation has emerged repeatedly in [hedge fund] enforcement cases" because "hedge fund managers are compensated by both management fees and performance fees" giving managers "incentives to over-prioritize compensation."[9] Moreover, inflated valuations can be used as a fraudulent marketing tool to induce new investors to invest in a fund. As a result of this perceived risk to hedge fund investors, the SEC has used the Inquiry to analyze hedge fund performance data and to alert the SEC to funds that consistently outpace the market.[10]

Two representative enforcement actions which focus on matters relating to asset valuation are highlighted below.

1. In re John Thomas Capital Management Group LLC

In *In re John Thomas Capital Management Group LLC,*[11] the SEC instituted administrative cease-and-desist proceedings against a hedge fund manager and his firm for allegedly defrauding investors and steering inflated fees to a brokerage CEO. The CEO was also charged.

According to the SEC, George R. Jarkesy Jr. ("Jarkesy"), a hedge fund manager, and Thomas Belesis ("Belesis"), a brokerage firm CEO, launched two funds in 2007 and 2009 with $30 million in investor money. The SEC alleges that Jarkesy mispriced assets in those funds and inflated valuations in order to increase the management and incentive fees that Jarkesy collected for himself. The SEC also alleges that Jarkesy (a) lied about the identity of the funds' auditors; (b) used fund assets to hire multiple stock promoters in order to create an artificial spike in the price of two stocks in which the funds were heavily invested; and (c) provided excessive compensation to Belesis and his firm.

The SEC's order charges that Jarkesy and his firm violated and aided and abetted violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and violated Sections 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. The SEC's order further charges that Belesis aided and abetted and caused the violations of Sections 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.[12]

2. In re Oppenheimer Asset Management Inc.

On March 11, 2013, the SEC filed an order instituting settled administrative proceedings against Oppenheimer Asset Management and Oppenheimer Alternative Investment Management (collectively "Oppenheimer") for misleading investors as to the valuation of portfolio holdings in and performance of one of its equity funds, Oppenheimer Global Resource Private Equity Fund (the "Fund").[13]

According to the SEC, Oppenheimer distributed misleading quarterly reports and marketing materials that said that the Fund's holdings of other private equity funds were valued "based on the underlying managers' estimated values," when in fact, the Oppenheimer portfolio manager of the Fund actually valued the Fund's largest asset – Cartesian Investors A LLC ("Cartesian") – at a significant markup to the underlying manager's estimated value. The SEC claimed that this change in value caused the Fund's performance to appear significantly better as measured by its internal rate of return.[14] Specifically, the SEC said that, for the quarter ended June 30, 2009, the inflated valuation raised the fund's internal rate of return from 3.8% to 38.3%.[15]

Additionally, the SEC found that Oppenheimer investment results deceived investors by telling them falsely that independent outside auditors had vetted the investment results, and that Cartesian had used a third-party valuation firm to determine its value.[16]

The SEC also found that Oppenheimer's written policies were not reasonably designed to ensure that valuations provided to investors were consistent with the actual valuations themselves.[17]

The SEC alleged that Oppenheimer's conduct violated Sections 17(a)(2) and 17(a)(3) of the Securities Act and Section 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder.[18] Without admitting or denying the SEC's allegations, Oppenheimer agreed to pay a penalty of $617,579 and to return $2,269,098 to investors who invested during the time period when the misrepresentations were made.[19] Oppenheimer also agreed to pay an additional penalty of $132,421 to the Commonwealth of Massachusetts in a related action instituted by the Massachusetts Attorney General, bringing Oppenheimer's total payment to $3,019,098.[20] Finally, Oppenheimer agreed to cease and desist from committing or causing any future violations of the securities laws, and to retain an independent consultant to conduct a review of its valuation policies and procedures.[21]

B. Insider Trading

Since October 2009, the SEC has filed more than 170 insider trading actions, involving charges against more than 410 individuals and entities.[22] In fiscal year 2012 alone, the SEC filed 58 cases against 131 individuals and entities.[23] Given the SEC's perceived success in these actions, and the steep penalties and disgorgements, we anticipate that the SEC will continue its aggressive enforcement of insider trading cases.[24]

1. SEC v. Rajarengan Rajaratnam

On March 21, 2013, the SEC charged Rajarengan "Rengan" Rajaratnam ("Rengan") with trading on inside information supplied by his older brother, Raj Rajaratnam ("Rajaratnam").[25] On the same day, the U.S. Attorney's Office for the Southern District of New York announced parallel criminal insider trading charges against Rengan.[26] The SEC has now charged 33 defendants in its Galleon-related enforcement actions.

The SEC alleges that, from 2006 to 2008, Rengan traded on material nonpublic information for himself and hedge funds that he managed at Galleon Management and Sedna Capital Management ("Sedna"), a hedge fund advisory firm that he co-founded.[27] According to the SEC's complaint, Rengan received material nonpublic information from his brother relating to Polycom, Hilton Hotels, Clearwire Corporation, Akami Technologies and AMD securities.[28] For example, the SEC claims that on

January 21, 2006, Rajaratnam called Rengan and relayed information about Polycom's not yet announced fourth-quarter revenue results, which Rajaratnam had received from a senior executive at Polycom.[29] Over the week that followed, Rengan purchased Polycom shares in his personal brokerage account and caused Sedna to acquire 400,000 shares for the funds it managed.[30] On January 25, 2006, Polycom's shares rose 8% on its quarterly earnings announcement.[31] The next day Rengan sold all of the shares that he had acquired in his personal account and on behalf of Sedna, reaping profits of $66,000 and $890,000 respectively.[32] In total, the SEC alleges that Rengan earned more than $3 million in trading profits based on his use of the inside information.

The SEC action charges Rengan with violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.[33] The complaint seeks a final judgment permanently enjoining Rengan from future violations of these provisions of the federal securities laws, ordering him to disgorge his ill-gotten gains plus prejudgment interest and ordering him to pay financial penalties.[34]

2. <u>SAC Capital</u>

The SEC and the U.S. Attorney's Office for the Southern District of New York have continued a multi-year investigation into potential insider trading at SAC Capital Advisors LP ("SAC").

Since the investigation began, at least nine current or former employees of SAC have faced criminal insider trading charges stemming from their work there, four of whom have pleaded guilty. The pressure on SAC has recently been escalating. In November 2012, prosecutors charged Mathew Martoma ("Martoma"), a former SAC portfolio manager, with trading in certain drug stocks based on nonpublic drug trial data. Steven A. Cohen, SAC's founder, was allegedly involved in those drug stock trades.[35] In March 2013, the SEC and prosecutors charged Michael Steinberg, a senior SAC employee, with insider trading. Later that month, SAC agreed to pay approximately $616 million to settle two civil insider trading actions brought by the SEC.[36] These cases are discussed below.

a. SEC v. CR Intrinsic Investors, LLC

On November 20, 2012, the SEC charged CR Intrinsic Investors, LLC ("CR Intrinsic") – a unit of SAC – its former portfolio manager, Mathew Martoma, and Dr. Sidner Gilman ("Dr. Gilman") for their roles in an insider trading scheme involving pharmaceutical clinical trial data that allegedly resulted in $276 million in ill-gotten gains.[37]

The SEC alleges that Martoma obtained inside information on drugs being developed by Elan Corporation ("Elan") and Wyeth by talking to Dr. Gilman, the chair of the safety monitoring committee overseeing the clinical trial.[38] According to the SEC, Martoma first met Dr. Gilman through paid consultations arranged through an expert network firm.[39] In July 2008, a couple of weeks before any results of the trial were made public, Dr. Gilman allegedly informed Martoma that the drugs were performing poorly.[40] According to the SEC, Martoma then caused several hedge funds managed by CR Intrinsic to sell their Elan and Wyeth holdings and to take substantial short positions, in amounts totaling more than $960 million.[41]

CR Intrinsic's massive trading volume accounted for more than 20% of market-wide sales of Elan and more than 11% of market-wide sales of Wyeth in the seven days prior to the trial results being made public.[42] The SEC alleged that CR Intrinsic and its affiliated advisory firm reaped approximately $82 million in profits and $194 million in avoided losses for a total of more than $276 million in illicit gains.[43] The SEC alleged that a significant portion of the $9.3 million bonus that Martoma received at the end of 2008 was attributable to these allegedly illegal profits.[44] The SEC also alleged that Dr. Gilman was generally paid $1,000 per hour as an expert network consultant and received more than $100,000 for his consultations with Martoma and other hedge fund advisory firms.[45]

The SEC's complaint charged CR Intrinsic, Martoma, and Wyeth with violating Section 17(a) of the Securities Act, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.[46] The SEC is seeking a final judgment ordering them to disgorge their ill-gotten gains and to pay prejudgment interest and financial penalties, and to permanently enjoin them from future violations of the federal securities laws.[47] In a parallel action, the U.S. Attorney's Office for the Southern District of New York charged Martoma with three criminal counts of securities fraud.[48] Each count of securities fraud carries a maximum sentence of 20 years in prison and a fine of $5 million or twice the gross pecuniary gains or losses from the offense.

In November 2012, Dr. Gilman agreed to a permanent injunction against further violations of the federal securities laws and to pay more than $234,000 in disgorgement and prejudgment interest.[49] The proposed settlement is subject to approval by the court, which also will determine at a later date whether any additional financial penalty is appropriate.[50] Dr. Gilman also entered into a non-prosecution agreement with the U.S. Attorney's Office for the Southern District of New York.[51]

On March 15, 2013, the SEC announced that CR Intrinsic agreed to settle the SEC charges for $601,747,463.22, the largest-ever settlement for an insider trading case.[52] Sanjay Wadhwa, the Senior Associate Director of the SEC's New York Regional Office, declared that "[a] robust culture of compliance and zero tolerance toward employee misconduct can help other firms avoid the severe financial consequences that CR Intrinsic is facing for its misconduct."[53] On April 16, 2013, Judge Victor Marrero of the United States District Court for the Southern District of New York approved the settlement "subject to a condition that it would become final upon a definitive determination [by the Second Circuit] that district courts lack authority to reject such settlements on basis of reservations about the 'neither admit nor deny' provision."[54]

b. SEC v. Sigma Capital Management, LLC

On March 28, 2013, the Honorable Harold Baer of the United States District Court for the Southern District of New York approved a $14 million settlement regarding insider trading allegations by Sigma Capital Management, LLC ("Sigma Capital"), Sigma Capital Associates, LLC ("Sigma Capital Fund"), and S.A.C. Select Fund, LLC ("S.A.C. Select Fund").[55] The SEC alleged that Sigma Capital illegally traded in Dell and Nvidia Corporation ("Nvidia") stock based on material, nonpublic information.[56]

The SEC's complaint alleged that Jon Horvath ("Horvath"), a former Sigma Capital analyst who pleaded guilty to charges of insider trading on September 28, 2012, learned information about the not yet released quarterly earnings results of Dell and Nvidia through a group of hedge fund analysts.[57] The SEC alleged that Sigma Capital traded on this information in advance of four quarterly earnings announcements and generated over $6.4 million in profits and avoided losses for Sigma Capital Fund, a hedge fund that Sigma Capital managed, and S.A.C Select Fund, a fund that was managed by S.A.C. Capital Advisors.[58]

The SEC charged Sigma Capital with violations of Section 17(a) of the Securities Act, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.[59] Without admitting or denying the charges, Sigma Capital agreed to disgorge ill-gotten gains of $6.425 million, and to pay prejudgment interest of $1,094,161.92 and a penalty of $6.425 million.[60] Sigma Capital also agreed to be permanently enjoined from future violations of the federal securities laws.[61]

c. U.S. v. Steinberg

On March 29, 2013, FBI agents arrested Michael Steinberg ("Steinberg"), a portfolio manager at Sigma Capital, for trading on inside information in Dell and Nvidia securities, which he was alleged to have received from Horvath.[62] On the same day, the SEC announced that it had charged Steinberg with violating the federal securities laws.[63] The allegations involve the same course of conduct as in

SEC v. Sigma Capital Management, LLC, which is described above. In addition, the SEC alleged that Steinberg illegally tipped information to another portfolio manager at Sigma Capital.[64]

According to the criminal indictment, Horvath called Steinberg on August 18, 2008 to relay inside information regarding Dell's upcoming quarterly earnings announcement.[65] Steinberg allegedly began short selling shares of Dell one minute after his conversation with Horvath.[66] On August 26, 2008, after accumulating a net short position of over 167,000 shares of Dell, Horvath emailed Steinberg and another portfolio manager at Sigma Capital to confirm that his Dell tip had been based on a "2nd hand read from someone at the company."[67] He then added, "[p]lease keep to yourself as obviously not well known."[68] Steinberg responded that, "normally we would never divulge data like this, so please be discreet."[69] After Dell announced its lower than expected quarterly earnings results on August 28, Steinberg's trades netted Sigma Capital an allegedly illegal profit of approximately $1 million.[70]

In the criminal case, Steinberg is charged with one count of conspiracy to commit securities fraud and four counts of securities fraud. The conspiracy count carries a maximum sentence of five years in prison and a fine of the greater of $250,000 or twice the pecuniary gains or losses from the offense. Each count of securities fraud carries a maximum sentence of 20 years in prison and a fine of $5 million or twice the pecuniary gains or losses from the offense.

The SEC complaint charges Steinberg with violating Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. The SEC seeks a final judgment ordering Steinberg to disgorge illegal profits and to pay prejudgment interest and financial penalties, and permanently enjoining him from future violations of the federal securities laws.

3. *SEC v. Teeple*

On March 26, 2013, the SEC charged Matthew Teeple ("Teeple"), David Riley ("Riley") and John Johnson ("Johnson") with an insider trading scheme relating to the merger of two technology companies.[71] The SEC alleges that Riley, the Chief Information Officer at Foundry Networks Inc. ("Foundry") tipped Teeple in advance of an announcement of a merger between Foundry and Brocade Communication Systems Inc.[72] Teeple then allegedly caused the hedge fund advisory firm where he worked to buy large amounts of Foundry securities, a position which increased in value by 32% upon the public announcement of the merger.[73] According to the SEC, Teeple also tipped Johnson, a Denver-based investment professional and business colleague of Teeple, who then traded on the material, nonpublic information.[74]

The SEC's complaint charges Teeple, Riley and Johnson with violating Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.[75] The complaint seeks a final judgment ordering them to disgorge any ill-gotten gains and to pay prejudgment interest and financial penalties, and to permanently enjoin them from future violations of the federal securities laws.[76] The complaint also seeks to prohibit permanently Riley from serving as an officer or director of a public company.[77]

C. Conflicts of Interest and Preferential Treatment of Certain Investors

The SEC is continuing to prioritize conflicts of interest cases, with a particular emphasis on those matters involving preferential treatment, undisclosed fees and certain affiliate relationships.

Since 2010, the SEC has brought over 100 enforcement actions related to "conflicts of interest, questionable performance or inadequate compliance controls."[78] According to Mr. Karpati, the SEC will continue to focus on conflicts of interest for hedge fund managers "[b]ecause some hedge fund managers may . . . have the opportunity and incentive to put [their] personal interests ahead of investors" or "give favored treatment to certain investors through preferential redemptions or side letters."[79]

A summary of recent conflicts of interest and preferential treatment actions is provided below.

1. *SEC v. Aletheia Research and Management, Inc.*

On December 14, 2012, the SEC brought an enforcement action against Peter J. Eichler, Jr. ("Eichler"), and his investment advisory and hedge fund management firm, Aletheia Research and Management, Inc. ("Aletheia"), in which it is alleged that they engaged in a "cherry picking" scheme.[80]

Aletheia managed two hedge funds for investors which consisted mainly of institutional investors, foundations, endowments, pension funds and high net worth individuals. Aletheia also managed "custom accounts" for certain other investors, as well as Eichler's and Aletheia's personal accounts and the accounts of certain of Aletheia's employees and officers.

The complaint alleges that, from 2009 through 2011, Eichler and Aletheia failed to allocate trades in a fair and equitable manner among the various investor accounts. The complaint alleges that trades were not allocated in real time to specific accounts, thereby allowing Eichler to steer winning trades to his own trading accounts and those of favored investors, and to allocate losing trades to other accounts to the detriment of other investors.

The complaint also alleges that the defendants failed to advise Aletheia's investors of the firm's precarious financial situation until shortly before its bankruptcy filing on November 11, 2012. In particular, despite ongoing financial troubles in 2012, Aletheia did not disclose to its clients an unpaid tax lien for $2 million or its suspension of authority to conduct business until November 9, 2012.

The SEC complaint charges Aletheia and Eichler with violating 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 Investment Advisers Act and Rule 206(4)-8 thereunder. The SEC further charges Aletheia with violations of Sections 204, 204A, 206(4) and 207 of the Investment Advisers Act and Rules 204-1(a)(2), 206(4)-7(a) and 204A-1 thereunder. The SEC seeks a permanent injunction, an order directing the defendants to disgorge any ill-gotten gains and the sum of any losses avoided, and civil penalties. Eichler has answered the complaint and a bench trial is currently set for December 17, 2013.

2. *SEC v. New Stream Capital, LLC*

On February 26, 2013, the SEC filed an enforcement action against New Stream Capital, LLC ("New Stream"), a Connecticut-based hedge fund manager, and David Bryson ("Bryson") and Bart Gutekunst ("Gutekunst"), two of the firm's principals, alleging that they defrauded investors by lying about the financial condition of their hedge fund and secretly modifying the capital structure of its feeder fund to give priority to a large investor.[81]

According to the SEC, Bryson and Gutekunst secretly revised the fund's capital structure to give priority in the event of liquidation to their largest investor, Gottex Fund Management Ltd. ("Gottex"), and then continued to market the fund as if all investors were on equal footing.[82] Bryson and Gutekunst allegedly revised the structure to favor Gottex in response to a threat that Gottex would redeem its $300 million investment.[83] According to the SEC, the fund then raised almost $50 million in new investor funds without disclosing Gottex's priority.[84] In addition, the SEC alleges that Richard Pereira ("Pereira"), New Stream's CFO, falsified the hedge fund's financial statements to conceal the revisions to the capital structure.[85]

In March 2011, facing $545 million in redemption requests, New Stream suspended further redemptions, ceased raising new funds, and filed a Chapter 11 bankruptcy petition.[86] The SEC estimates "that the defrauded investors are expected to receive approximately 5 cents on the dollar – substantially less than half the amount that Gottex and other investors in its preferred class are expected to receive."[87]

The SEC's complaint charges Bryson with violating Section 17(a) of the Securities Act, Section 10(b), Section 20(a) and Section 20(e) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2), 206(4), 209(d) and 209(f) of the Advisers Act and Rule 206(4)-8 thereunder.[88] Gutekunst is charged with violating Section 17(a) of the Securities Act, Section 10(b), Section 20(a) and Section 20(e) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2), 206(4), 209(d) and 209(f) of the Advisers Act and Rule 206(4)-8 thereunder.[89] Tara Bryson, New Stream's former head of investor relations, is charged with violating Section 17(a) of the Securities Act, Section 10(b) and Section 20(e) of the Exchange Act and Rule 10b-5 thereunder, and Sections 209(d) and 209(f) of the Advisers Act.[90] Pereira is charged with violating Section 17(a) of the Securities Act, Section 10(b), Section 20(a) and Section 20(e) of the Exchange Act and Rule 10b-5 thereunder, and Sections 209(d) and 209(f) of the Advisers Act.[91] The relief sought includes a permanent injunction against defendants from future violations of the federal securities laws, disgorgement of illegal gains and payment of prejudgment interest and financial penalties.[92]

In a parallel action, the U.S. Attorney for the District of Connecticut announced criminal securities fraud charges against Bryson, Gutekunst and Pereira.

D. Broker-Dealer Registration Issues

The SEC has also turned its attention to the way in which private fund advisers market to investors and raise capital. Recent remarks by the SEC indicate that certain activities of private fund managers may require that they become registered with the SEC as broker-dealers. For instance, in a recent speech given by David W. Blass, SEC Chief Counsel, Division of Trading and Markets, Mr. Blass stated that "absent an available exemption or other relief, a person engaged in the business of effecting transactions in securities for the account of others must generally register under Section 15(a) of the Exchange Act as a broker." [93] Specifically, the types of activities which may require such registration include (a) holding customer funds; (b) marketing fund interests; or (c) soliciting investors in return for transaction-based compensation.

A summary of recent broker-dealer registration actions is provided below.

1. <u>In re Ranieri Partners LLC and Donald W. Phillips & In re William M. Stephens</u>

On March 11, 2013, the SEC announced charges against New York-based private equity firm Ranieri Partners, senior managing partner Donald W. Phillips ("Phillips"), and William M. Stephens ("Stephens"), an unregistered broker who violated securities laws when soliciting more than $500 million for private funds managed by the firm.[94] According to the SEC, Phillips was in charge of raising capital for two private investment funds managed by Ranieri Partners. Phillips, a long-time friend of Stephens, caused an affiliate of Ranieri Partners to hire Stephens as an "independent consultant" to find potential investors for the funds. Phillips allegedly told Stephens that Stephens' work should be limited only to contacting potential investors to arrange meetings with others at Ranieri Partners.[95] However, Stephens actively solicited investors by providing them with private placement memoranda, subscription documents, and due diligence materials. Stephens also provided potential investors with his own analysis of Ranieri Partners' strategy and performance, as well as confidential information that identified other investors and their capital commitments.[96] Phillips allegedly assisted Stephens by providing him with key fund documents and information, thereby failing to limit Stephens' activities to his stated role.[97] In return for his work, Stephens received approximately $2.4 million in transaction-based compensation.[98]

The SEC charged Ranieri Partners, Phillips, and Stephens with violating Section 15(a) of the Exchange Act, which requires persons engaged in the business of effecting transactions in securities to be registered as a broker or dealer or associated with a registered broker or dealer. Each defendant agreed to settle the SEC's charges without admitting or denying the findings. Ranieri Partners agreed

to pay a penalty of $375,000, Phillips agreed to pay a penalty of $75,000, and Stephens agreed to be barred from the securities industry. All were required to cease-and-desist from further violations of the securities laws. The SEC also suspended Phillips from acting in a supervisory capacity at an investment adviser or broker-dealer for nine months.[99]

2. *SEC Charges India-Based Brokerage Firms with Violating U.S. Registration Requirements*

On November 27, 2012, the SEC charged and entered into consent decrees with four financial services firms based in India for providing brokerage services to institutional investors in the United States without being registered with the SEC. The firms – Ambit Capital Private Limited, Edelweiss Financial Services Limited, JM Financial Institutional Securities Private Limited, and Motilal Oswal Securities Limited – agreed to pay more than $1.8 million to settle the charges.

According to the consent decrees, the firms engaged with U.S. investors, despite being unregistered broker-dealers, by sponsoring conferences in the United States, having employees travel regularly to the United States to meet with investors, trading securities of India-based issuers on behalf of U.S. investors and participating in securities offerings from India-based issuers to U.S. investors.

In the settlement agreements, the firms agreed to be censured and to pay disgorgement and prejudgment interest but did not admit or deny the SEC's charges. Because the firms cooperated with the SEC, no civil penalties were imposed.

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[1] Please see our December 2011 client alert for a discussion of the Inquiry. *See* http://www.paulhastings.com/Resources/Upload/Publications/2061.pdf.

[2] The non-EU AIFM will have to comply with a minimum of three conditions:

(1) Comply with reporting and disclosure obligations under the AIFMD for each alternative investment fund ("AIF") which is marketed in the EU. These obligations consist of certain pre-investment and on-going disclosures to investors, an annual report and regular reports to an EU national regulator.

(2) Appropriate cooperation agreements under the AIFMD must exist between the national regulator of each EU member state in which marketing takes place and the supervisory authorities of where the AIF is established and the country where the non-EU AIFM is established.

(3) The countries where the non-EU AIFM or the non-EU AIF are established must not be on the list of non-cooperative countries and territories maintained by the Financial Action Task Force.

If the above conditions are met, the non-EU AIFM may market and raise capital from EU investors under the national private placement regimes of the relevant EU member states. As individual EU member states can impose additional requirements and conditions under their national private placement regimes, country-by-country analysis will remain necessary.

[3] 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 United States; and (ii) 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 United States.

[4] On April 8, 2013, the Senate confirmed Mary Jo White, a former U.S. Attorney for the Southern District of New York, as the next SEC Chair. Mary Jo White was sworn in as SEC Chair on April 10, 2013. She becomes the first former prosecutor to serve as SEC Chair.

[5] Bruce Karpati, Speech at the Regulatory Compliance Association: Enforcement Priorities in the Alternative Space (Dec. 18, 2012), *available at* http://www.sec.gov/news/speech/2012/spch121812bk.htm. Mr. Karpati's speech is discussed further in Section I.B.4 of this Report.

[6] *Id.*

[7] Two other specialized units within the Division of Enforcement – the Market Abuse Unit and the Structured and New Products Unit – focus on the hedge fund industry as well.

[8] Because of the success of the Inquiry, the SEC has instituted additional initiatives to take advantage of data mining, including the "Private Equity Initiative." This initiative seeks to use data sources to identify private equity fund advisers that may be improperly failing to liquidate assets, or improperly misrepresenting the value of their holdings to investors. Bruce Karpati, Speech at the Regulatory Compliance Association: Enforcement Priorities in the Alternative Space (Dec. 18, 2012), *available at* http://www.sec.gov/news/speech/2012/spch121812bk.htm.

[9] *Id.*

[10] Elisse Walter, Speech at American University: Harnessing Tomorrow's Technology for Today's Investors and Markets (Feb. 19, 2013), *available at* http://www.sec.gov/news/speech/2013/spch021913ebw.htm.

[11] Administrative Proceeding, File No. 3-15255 (Mar. 22, 2013), *available at* http://www.sec.gov/litigation/admin/2013/33-9396.pdf.

[12] SEC Press Release No. 2013-46, *SEC Charges Hedge Fund Manager and Brokerage CEO with Fraud* (Mar. 22, 2013), *available at* http://www.sec.gov/news/press/2013/2013-46.htm.

[13] Oppenheimer Order, ¶1.

[14] *Id.*

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[15] *Id.* at ¶21.

[16] SEC Press Release No. 2013-38, *SEC Charges New York-Based Private Equity Advisors with Misleading Investors about Valuation and Performance* (Mar. 11, 2013), *available at* http://www.sec.gov/news/press/2013/2013-38.htm.

[17] *Id.*

[18] Order at ¶¶ 25-28.

[19] SEC Press Release No. 2013-38.

[20] *Id.*

[21] *Id.*

[22] Robert Khuzami, Remarks During News Conference Announcing Charges in a $276 Million Insider Trading Scheme (Nov. 20, 2012), *available at* https://www.sec.gov/news/speech/2012/spch112012rk.htm.

[23] SEC Enforcement Actions: Insider Trading Cases, *available at* http://www.sec.gov/spotlight/insidertrading/cases.shtml.

[24] *See generally* Bruce Karpati, Speech at the Regulatory Compliance Association: Enforcement Priorities in the Alternative Space (Dec. 18, 2012), *available at* http://www.sec.gov/news/speech/2012/spch121812bk.htm.

[25] Complaint at ¶ 1, *SEC v. Rajarengan Rajaratnam*, No. 13-CV-1894 (S.D.N.Y. Mar. 21, 2013).

[26] SEC Litig. Release No. 22658 (Mar. 22, 2013), *available at* http://www.sec.gov/litigation/litreleases/2013/lr22658.htm.

[27] Complaint at ¶ 1, *SEC v. Rajarengan Rajaratnam*, No. 13-CV-1894 (S.D.N.Y. Mar. 21, 2013).

[28] *Id.* at ¶ 1.

[29] *Id.* at ¶¶ 29, 31.

[30] *Id.* at ¶ 31.

[31] *Id.* at ¶ 32.

[32] *Id.* at ¶ 33.

[33] SEC Litig. Release No. 22658.

[34] *Id.*

[35] Mr. Cohen has not been accused of any wrongdoing.

[36] Judge Harold Baer approved the $14 million settlement related to charges that the fund's Sigma Capital unit illegally traded in shares of technology companies after a former analyst there obtained nonpublic information about the companies. Moreover, Judge Victor Marrero approved the larger settlement of $602 million but conditioned the approval on the outcome of a Second Circuit case over the SEC's policy of allowing defendants to neither admit nor deny wrongdoing.

[37] SEC Press Release No. 2012-237, *SEC Charges Hedge Fund Firm CR Intrinsic and Two Others in $276 Million Insider Trading Scheme Involving Alzheimer's Drugs* (Nov. 20, 2012), *available at* http://www.sec.gov/news/press/2012/2012-237.htm.

[38] *Id.*

[39] Complaint at ¶ 29, *SEC v. CR Intrinsic Investors, LLC*, No. 12-CV-8466 (Nov. 20, 2012).

[40] *Id.* at ¶¶ 39-47.

[41] *Id.* at ¶ 4.

[42] *Id.* at ¶¶ 48-49.

[43] SEC Press Release No. 2012-237.

[44] *Id.*

[45] *Id.*

[46] *Id.*

[47] *Id.*

[48] *U.S. v. Martoma*, No. 12-MAG-2985 (S.D.N.Y. Nov. 19, 2012).

[49] SEC Press Release No. 2012-237.

[50] *Id.*

[51] *Id.*

[52] SEC Press Release No. 2013-41, *CR Intrinsic Agrees to Pay More than $600 Million in Largest-Even* Settlement, Mar. 15, 2013, *available at* http://www.sec.gov/news/press/2013/2013-41.htm.

[53] SEC Press Release No. 2012-237.

[54] *SEC v. CR Intrinsic Investors, LLC*, No. 12 Civ. 8466 (VM), at 11 (S.D.N.Y. Apr. 16, 2013).

[55] SEC Litig. Release No. 22662 (Apr. 1, 2013), *available at* http://www.sec.gov/litigation/litreleases/2013/lr22662.htm.

[56] *Id.*

[57] Complaint at ¶ 1, *SEC v. Sigma Capital Mgmt., LLC*, No. 13-CIV-1740 (S.D.N.Y. Mar. 15, 2013).

[58] *Id.*

[59] SEC Litig. Release No. 22662.

[60] *Id.*

[61] *Id.*

[62] SEC Press Release No. 2013-49, *SEC Charges Sigma Capital Portfolio Manager with Insider* Trading (Mar. 29, 2013), *available at* http://www.sec.gov/news/press/2013/2013-49.htm.

[63] *Id.*

[64] *Id.*

[65] Indictment at ¶ 13, *U.S. v. Steinberg*, S4 12 Cr. 121 (RJS) (S.D.N.Y.)

[66] *Id.*

[67] *Id.* at ¶ 14.

[68] *Id.* at ¶ 14.

[69] *Id.* at ¶ 14.

[70] *Id.* at ¶ 17.

[71] SEC Litig. Release No. 22660 (Mar. 26, 2013), *available at* http://www.sec.gov/litigation/litreleases/2013/lr22660.htm.

[72] *Id.*

[73] *Id.*

[74] *Id.*

[75] *Id.*

[76] *Id.*

[77] *Id.*

[78] Hazel Bradford, SEC Makes Strides to Strengthen Oversight, Pensions & Investments (Mar. 18, 2013), *available at* http://www.pionline.com/article/20130318/PRINTSUB/303189974.

[79] Bruce Karpati, Speech at the Regulatory Compliance Association: Enforcement Priorities in the Alternative Space (Dec. 18, 2012), *available at* http://www.sec.gov/news/speech/2012/spch121812bk.htm.

[80] *SEC v. Aletheia Research & Mgmt., Inc.*, No. CV-12-10692 (C.D. Cal. Dec. 14, 2012).

[81] SEC Litig. Release No. 22625 (Feb. 26, 2013), *available at* http://www.sec.gov/litigation/litreleases/2013/lr22625.htm.

[82] Complaint at ¶¶ 46-53, *SEC v. New Stream Capital, LLC*, No. 13-CV-00264 (D. Conn. Feb. 26, 2013).

[83] *Id.* at ¶ 42.

[84] *Id.*

[85] *Id.* at ¶¶ 62-66.

[86] *Id.* at ¶¶ 70-73.

[87] SEC Litig. Release No. 22625.

[88] *Id.*

[89] *Id.*

[90] *Id.*

[91] *Id.*

[92] *Id.*

[93] David W. Blass, Speech at the American Bar Association, Trading and Markets Subcommittee (Apr. 5, 2013), *available at* http://www.sec.gov/news/speech/2013/spch040513dwg.htm#P42_12528.

[94] SEC Press Release No. 2013-36, *SEC Charges Private Equity Firm, Former Executive, and Consultant for Improperly Soliciting Investments* (Mar. 11, 2013), *available at* http://www.sec.gov/news/press/2013/2013-36.htm.

[95] *Id.* at ¶ 7.

[96] *Id.* at Summary.

[97] *Id.* at ¶ 20.

[98] *Id.* at Summary.

[99] SEC Press Release No. 2013-36.