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# Hedge Fund Report—Summary of Key Developments—Spring 2014

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 and issue guidance to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and the Jumpstart Our Business Startups Act (the "JOBS Act"). There have also been a number of significant developments in the hedge fund tax area, and the SEC and private plaintiffs have continued to bring enforcement actions and litigation involving hedge funds and other types of private investment funds and fund managers.

This Report provides an update since our last Hedge Fund Report in Fall 2013, and highlights recent regulatory and tax developments, as well as recent civil litigation and enforcement actions as they relate to the hedge fund industry. Paul Hastings attorneys are available to answer your questions on these and any other developments affecting hedge funds and their investors and advisers.

# I. SECURITIES-RELATED LEGISLATION AND REGULATION

## *A. Dodd-Frank Updates*

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

### *1. Agencies Adopt Final Rule Implementing the Volcker Rule*

On December 10, 2013, the Treasury, the Federal Reserve, the Federal Deposit Insurance Corporation ("FDIC"), the SEC and, separately, the CFTC (collectively, the "Agencies"), issued final regulations implementing the Volcker Rule (Section 619 of the Dodd-Frank Act) (the "Final Rule"). The Final Rule generally prohibits any "banking entity" from engaging in proprietary trading, or owning or sponsoring a hedge fund or private equity fund (a "covered fund"), subject to certain exemptions. Key considerations in determining applicability of the covered fund provisions include: (i) whether an investing or sponsoring entity is a "banking entity;" (ii) whether a target investment vehicle is a "covered fund;" and (iii) whether a particular activity involves an "ownership interest" in or "sponsorship" of the covered fund. Beyond these threshold questions, certain conditions apply, including the application of various exclusions and exemptions to covered fund treatment, as well as other requirements arising from covered fund treatment.

Under the Final Rule, a "banking entity" generally includes any insured depository institution or foreign bank operating a branch or agency in the U.S., as well as any of their affiliates and subsidiaries. However, insured depository institutions that function solely as a fiduciary or in a trust capacity are not deemed "banking entities," provided that substantially all of their deposits are in bona fide trust funds and certain other requirements are satisfied.

Generally, an issuer may be a "covered fund" under one of three circumstances, provided the fund is not otherwise eligible for any of the 13 express definitional exclusions in the Final Rule, or not otherwise granted an exclusion that the Agencies may jointly determine is appropriate. An issuer will be deemed a covered fund if it: (i) *would be* an investment company, *but for* section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended (the "Investment Company Act"), or a "similar fund" as the agencies designate by rule; (ii) is a foreign fund not subject to the Investment Company Act (and, thus, not reliant on an exclusion to avoid registration as an investment company), but such a fund will still be a "covered fund" to a sponsoring/owning U.S. banking entity under certain circumstances; and (iii) is a "commodity pool" under Section 1a(10) of the Commodity Exchange Act of 1934, as amended (the "CE Act"), and meets one of two alternative tests. Importantly, the Final Rule excludes foreign public funds from the definition of "covered fund." These are funds organized outside the U.S. that are authorized to sell via a public offering to retail investors in their home jurisdiction, where at least 85% of the fund is held by non-U.S. persons.

A "sponsor" of a covered fund includes: (i) a general partner, managing member or trustee (not acting in a fiduciary capacity) of, or a commodity pool operator of, a covered fund; (ii) an entity that in any manner selects or controls a majority of the directors, trustees or management of a covered fund; or (iii) an entity that shares the same name (or a variation of the same name) as a covered fund, for corporate, marketing, promotional or other purposes. A trustee of a covered fund is not deemed to be a "sponsor" where the trustee does not exercise investment discretion with respect to the fund; this includes where the trustee is acting at the direction of another trustee who is deemed a sponsor of the covered fund. However, a trustee arrangement cannot be structured to hide trustee sponsorship of a covered fund.

An "ownership interest" under the Final Rule includes any equity or partnership interest in a covered fund, as well as any "other similar interest" in a covered fund. An "other similar interest" includes the right to participate in the selection or removal of a fund's general partner, managing member, investment manager, investment adviser and certain other parties of the fund, as well as the right to share in income, gains and profits, but *not* "carried interest." Finally, it is important to note that a banking entity's ownership of an interest in a covered fund is restricted only where the banking entity holds the interest in the fund ''as principal.''

The Final Rule also includes numerous exemptions for permitted covered fund activities. The most prominent, the asset management exemption, permits investment in or sponsorship of a covered fund "organized and offered" by a banking entity where the banking entity provides *bona fide* trust, fiduciary, investment advisory or commodity trading advisory services to the fund. The exemption is subject to various conditions, including that the fund may only provide asset management services to customers of the bank or an affiliate, may not guarantee the obligations or performance of the fund, and name-sharing restrictions apply. In addition, the banking entity cannot own more than 3% of the total number or value of the outstanding ownership interests of the covered fund; and the total value of all ownership interests of the banking entity and its affiliates in all covered funds cannot exceed 3% of the tier 1 capital of the banking entity after the initial one-year "seeding period" for the covered fund. During the seeding period, there is no percentage ownership limitation.

Other activity exemptions include: (i) the asset-backed security ("ABS") issuer exemption, available to a banking entity organizing and offering a covered fund that is an ABS issuer; (ii) an exemption for underwriting and market-making activities subject to certain conditions; and (iii) an exemption permitting an investment in a covered fund designed as a risk-mitigating hedge related to employee compensation arrangements.

The Final Rule also prohibits certain affiliate transactions between a banking entity and its affiliates that serve, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor ("CTA") or sponsor to a covered fund with the covered fund, or with any other covered fund that is controlled by such covered fund. And the covered fund provisions of the Final Rule include a "backstop prohibition" that bars certain transactions that otherwise satisfy applicable compliance criteria if a transaction would involve or result in a material conflict of interest, result in a material exposure to high-risk assets or high-risk trading strategies, or pose safety and soundness risks to a banking entity or to U.S. financial stability.

The Federal Reserve has announced that banking organizations covered by the Volcker Rule will be required to fully conform their activities and investments by July 21, 2015. The Final Rule is available here (SEC, Treasury, Federal Reserve and FDIC) and here (CFTC).

*2. SEC Reviewing Accredited Investor Standards*

The SEC is currently reviewing the definition of "accredited investor" in Regulation D of the Securities Act as it applies to natural persons, as required by Section 413(b) of the Dodd-Frank Act. In a letter dated November 15, 2013 to Representative Scott Garrett (R-NJ), SEC Chair Mary Jo White stated that the SEC's review will consider adjustments to or replacement of the current net worth and annual income tests.[1] In July 2013 the SEC requested comments on changes to the accredited investor standard, including (i) whether net worth and income thresholds are the appropriate test for determining whether a natural person is an accredited investor and (ii) if so, whether the thresholds should be revised and/or indexed for inflation. A July 2013 Government Accountability Office ("GAO") report found that adjusting the net worth threshold to account for inflation "would decrease the number of households qualifying as accredited from approximately 8.5 million to 3.7 million." The SEC expects to complete its review by July 2014.

The full text of Ms. White's letter is available here, the full text of the SEC's July 10, 2013 release is available here and the full text of the July 2013 GAO report is available here.

### *B. JOBS Act Updates*

The following is a summary of recent guidance regarding the JOBS Act that are most relevant to the hedge fund industry.

*SEC Offers Additional Guidance on General Solicitation Rules and Bad Actor Disqualification*

On December 4, 2013, January 3 and January 23, 2014, the staff of the SEC's Division of Corporation Finance ("Corp Fin") published Compliance and Disclosure Interpretations (the "New CD&Is") addressing issues arising under the new general solicitation regime in Rule 506(c) (the "General Solicitation Rule"), the "bad actor" provisions in Rule 506(d) (the "Bad Actor Disqualification") and the disclosure requirements in Rule 506(e) (the "Bad Actor Disclosure") under the Securities Act. As discussed in our prior Report, private fund advisers relying on the General Solicitation Rule may conduct public advertising campaigns for their funds provided that the issuer takes reasonable steps to verify that all purchasers of the securities are accredited investors at the time of the sale. The Bad Actor Disqualification prohibits an issuer from relying on the Rule 506 safe harbor for private offerings (including offerings pursuant to the General Solicitation Rule) if any of the issuer's "covered persons" are or were subject to certain disqualifying events occurring on or after September 23, 2013 (the "Effective Date"). The Bad Actor Disclosure requires disclosure by the issuer of any disqualifying events involving covered persons that occurred before the Effective Date.

With respect to the Bad Actor Disqualification the New CD&Is clarify that, among others, affiliates of the issuer are covered persons only if they are "issuing securities in the same offering" as the issuer. The New CD&Is also confirm that issuers must determine whether the Bad Actor Disqualification applies any time they "offer[] or sell[] securities in reliance on Rule 506." While issuers may "reasonably rely" on contractual covenants or undertakings by covered persons to provide notice of disqualifying events, the New CD&Is require that issuers of extended (*i.e.*, "continuous, delayed or long-lived") offerings (*e.g.*, hedge funds) update their "factual inquiry periodically" through bring-down of representations, questionnaires and certifications, negative consent letters, periodic re-checking of public databases, and other steps, depending on the circumstances.

Other topics covered by the New CD&Is include the scope of the "reasonable care" exception to the Bad Actor Disqualification and the Bad Actor Disclosure. The full text of Corp Fin's Compliance and Disclosure Interpretations, including the New CD&Is, are available here.

On March 28, 2014, Keith Higgins, Director of Corp Fin, speaking at the 2014 Angel Capital Association Summit in Washington, D.C., stated that the SEC would not "second guess" good faith status verification decisions made by issuers relying on the General Solicitation Rule and was unlikely to issue guidance on whether specific investor verification methods were reasonable. The full text of Mr. Higgins' speech is available here.

### *C. Other Securities-Related Updates*

*1. SEC Addresses Cybersecurity Issues Facing Investment Advisers*

On March 26, 2014, the SEC hosted a Cybersecurity Roundtable (the "Roundtable") to discuss cyber threats in the securities markets and the financial services industry. Among other topics, the Roundtable discussed cybersecurity concerns for investment advisers, including private fund advisers. Among the key cybersecurity risks affecting investment advisers were account takeovers, identity theft and "hacktivisim," as well as a lack of expertise in the field of cybersecurity. The panelists recommended that investment advisers (i) take a proactive approach to cybersecurity, understanding that cybersecurity protections must continuously evolve in response to developing risks, (ii) understand and address their firm's points of vulnerability, (iii) where possible, "wall-off" information to prevent intrusions from spreading across systems and (iv) view cybersecurity as an "enterprise-wide" risk. The panelists noted that the SEC's proposed (but never adopted) 2008 amendments to Regulation S-P continue to provide good guidance on creating, implementing, testing and revising security programs.

Following the Roundtable, on April 15, 2014 the SEC's Office of Compliance Inspections and Examinations ("OCIE") published a risk alert on the "OCIE Cybersecurity Initiative" (the "Cybersecurity Risk Alert") to provide additional information concerning OCIE's initiative to assess cybersecurity preparedness in the securities industry (the "Cybersecurity Initiative"). The Cybersecurity Initiative will involve OCIE examinations of more than 50 registered broker-dealers and investment advisers with a focus on (i) cybersecurity governance; (ii) identification and assessment of cybersecurity risks; (iii) protection of networks and information; (iv) risks associated with remote customer access and funds transfer requests; (v) risks associated with vendors and third parties; (vi) detection of unauthorized activity; and (vii) experiences with cybersecurity threats. As part of the OCIE Cybersecurity Initiative the SEC may request information and documents from investment advisers, including but not limited to copies of relevant policies regarding information technology, security, and data protection, and descriptions of practices to detect unauthorized activity on firm networks and devices.

A full webcast of the Roundtable is available here and the SEC's proposed amendments to Regulation S-P are available here. The Cybersecurity Risk Alert is available here.

*2. National Examination Program Risk Alert on Investment Adviser Due Diligence of Alternative Investments*

On January 28, 2014, OCIE published its risk alert on "Investment Adviser Due Diligence Processes for Selecting Alternative Investments and Their Respective Managers" (the "Diligence Risk Alert"). The Diligence Risk Alert describes widespread trends in investment advisers' due diligence of the alternative investments that the advisers recommend to their clients. Among others, the Diligence

Risk Alert reports that investment advisers are (i) seeking more and broader information and data (*e.g.*, position-level transparency) directly from alternative investment managers, (ii) utilizing third parties (*e.g.*, risk aggregators, administrators, custodians and auditors, and online tools such as FINRA BrokerCheck) to supplement analyses and validate information regarding alternative investments, (iii) performing additional quantitative analyses and risk measures on alternative investments and their managers and (iv) expanding their due diligence focus areas to include, among others, non-investment risks, legal document reviews, liquidity issues, audited financial statements and onsite visits.

The Diligence Risk Alert also highlights certain risk indicators identified during adviser's diligence reviews which generally trigger additional review or other actions. These risk indicators include, but are not limited to, the following:

- *Investment Risk Indicators*: (i) an alternative investment manager's unwillingness to provide transparency on portfolio holdings; (ii) poor correlation between performance returns and known factors associated with the alternative investment manager's strategy; (iii) opaque research and investment processes; and (iv) an inadequate control environment.

- *Risk Management Risk Indicators*: (i) highly concentrated portfolio holdings in a purportedly diversified investment; (ii) insufficiently knowledgeable personnel; (iii) style drift; and (iv) overly complex or opaque investments.

- *Operational Risk Indicators*: (i) an inexperienced or unqualified administrator or auditor; (ii) multiple changes in key service providers; (iii) unfavorable results in background checks of key personnel; (iv) undisclosed potential conflicts of interest; (v) insufficient operational infrastructure, including compliance programs; and (vi) deficient fair valuation processes.

The full text of the Diligence Risk Alert is available here.

### *3. SEC No-Action Letter Clarifies Scope of "Knowledgeable Employee" Definition*

On February 6, 2014, the SEC's Division of Investment Management (the "IM Division") issued a no-action letter (the "IM Division Letter") providing updated guidance on the definition of "knowledgeable employee" under Rule 3c-5 of the Investment Company Act. A private fund's "knowledgeable employees" include, among others: (i) "Executive Officers" of the private fund or any of its affiliated investment managers (each, an "Affiliated Manager" and collectively with the private fund, the "Covered Entities"); and (ii) certain employees of the Covered Entities who, in connection with their regular functions or duties, participate in the investment activities of the private fund, other private funds, or investment companies the investment activities of which are managed by the Affiliated Manager ("Participating Employees").

The IM Division Letter emphasizes that the determination of whether certain Covered Entity employees are "Executive Officers" or "Participating Employees" under Rule 3c-5 depends on an analysis of all relevant facts and circumstances and does not depend on the employee's title. The IM Division Letter also states that the IM Division would not recommend enforcement action to the SEC if a private fund treated as a Participating Employee employees of the Affiliated Manager who participate in the investment activities of separate accounts (rather than the Covered Fund or investment companies); provided, that (i) the clients of the separate accounts are "qualified clients" and are otherwise eligible to invest in the private funds advised by the Affiliated Manager and (ii) the separate accounts "pursue investment objectives and strategies that are substantially similar to those pursued by one or more of those private funds."

The IM Division Letter emphasizes that other employees may qualify as knowledgeable employees and that the ultimate responsibility for determining who qualifies as "knowledgeable employees" rests on the investment manager. To that end, the IM Division recommends that investment managers "maintain in their books and records a written record of employees the investment manager has permitted to invest in a Covered Fund as knowledgeable employees" and be able to explain "the basis in the rule pursuant to which the employee qualifies as a knowledgeable employee."

The full text of the IM Division Letter is available here.

4. *SEC No-Action Letter Indicates Some Flexibility in Broker-Dealer Determination*

On February 4, 2014, the SEC's Division of Trading and Markets issued a no-action letter (the "Trading Division Letter") indicating that in certain circumstances it would not recommend enforcement action to the SEC under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), for certain persons who receive transaction-based compensation without registering as a broker-dealer. The Trading Division Letter is limited to "M&A Brokers" that facilitate "M&A Transactions" (each as defined in the Trading Division Letter) between sellers and buyers of privately-held companies, provided that certain conditions are met. Although the Trading Division Letter is not directly applicable to a private fund's marketing activities, the Trading Division Letter suggests that in certain circumstances the SEC may not require persons receiving transaction-based compensation to register with the SEC as broker-dealers. The full text of the Trading Division Letter is available here.

5. *CFTC Issues Guidance on CTA Rules*

On December 23, 2013, the CFTC Division of Swap Dealer and Intermediary Oversight issued a Staff Advisory Concerning Commodity Trading Advisors and Swaps (the "Advisory") to provide guidance on advisory obligations of CTAs subject to registration under the CE Act, as amended by the Dodd-Frank Act. The Advisory provides an overview of the regulatory framework for new and previously exempt CTAs and addresses, among others, the general regulatory requirements applicable to registered and unregistered CTAs, disclosure obligations for CTAs engaged in swap transactions and special requirements for CTAs that advise "Special Entities" (as defined in CFTC Rule 401) on swaps. The full text of the Advisory is available here.

6. *SEC Further Extends Exemptions for Security-Based Swap Agreements*

On February 5, 2014, the SEC extended for three years (until February 11, 2017), the interim final rules (the "Interim Final Rules") providing exemptions under the Securities Act, the Exchange Act, and the Trust Indenture Act of 1939, as amended (the "TIA"), for certain security-based swap agreements ("exempt swaps"). As discussed in our Spring 2013 Report, the Interim Final Rules were previously extended for one year (until February 11, 2014) in January 2013. "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 TIA, provided certain conditions are met. The full text of the SEC's adopting release extending the exemptions for security-based swap agreements is available here.

*7. SEC Officials Discuss Hedge Fund Compliance, Examination and Enforcement Priorities*

On January 30, 2014, the SEC hosted its Compliance Outreach Program National Seminar (the "National Seminar") for Chief Compliance Officers ("CCOs") and other senior officers of registered investment advisers and investment companies. The Compliance Outreach Program (the "Outreach Program") is co-sponsored by OCIE, the IM Division, and the SEC Enforcement Division's Asset Management Unit (the "AMU"). The National Seminar covered, among others, SEC-wide and program-specific examination and enforcement priorities for 2014 and topics related to private fund advisers, valuation, and the role of the CCO. Opening remarks by the SEC Chair and senior officials from the Enforcement Division, the IM Division and OCIE emphasized the importance of collaboration between private fund advisers and SEC enforcement officials, the importance of a registrant's "tone at the top," and the SEC's continued willingness to pursue enforcement actions for minor violations of SEC rules, including but not limited to violations of the Custody Rule, Rule 206(4)-2 under the Investment Advisers Act of 1940, as amended (the "Advisers Act").

Panelists noted that valuation issues remained a key concern for the OCIE National Examination Program (the "NEP") "presence exam" initiative, with a focus on a fund's valuation process and internal controls, including sufficiency of written valuation policies and procedures, the experience and background of valuation personnel and the extent to which actual valuations are conducted consistently and in accordance with the fund's policies and procedures. The National Seminar also discussed potential supervisory liability of CCOs, noting that the SEC is focused on firms that (i) ignore or insufficiently focus on previously identified deficiencies; (ii) lack effective or sufficiently customized compliance programs; or (iii) fail to conduct annual compliance reviews. Marshall Sprung, Co-Chief of the AMU, identified common hedge fund manager compliance issues discovered in the course of examinations, including but not limited to (i) missing or insufficient compliance programs; (ii) policies and procedures insufficiently tailored to the firm's business or that fail to address the firm's risks or obligations; (iii) lack of code of ethics; and (iv) recidivism.

Additional information about the National Seminar, including a full agenda and webcast, are available here.

*8. SEC Publishes 2014 Priorities for National Examination Program*

On January 9, 2014, OCIE published its 2014 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 2014 include (i) fraud detection and prevention (including the continued use of "quantitative and qualitative tools and techniques" to identify fraudulent or unethical behavior); (ii) corporate governance, conflicts of interest and enterprise risk management (under which NEP staff will continue to meet with senior management and boards of SEC-registered entities); (iii) governance and supervision of information technology systems; (iv) conflicts arising with dual-registered investment advisers/broker-dealers; (v) compliance with the General Solicitation Rule, particularly with respect to due diligence conducted in connection with such offerings; and (vi) sales practices by investment advisers in connection with retirement vehicles and rollovers.

The Priorities List also identifies "core" risks (*i.e.*, common risks selected because of their significance in recently conducted examinations) and new and emerging risks and initiatives with respect to investment advisers. Core risks include (i) the safety of client assets and compliance with the Custody Rule (focusing on instances where advisers fail to realize they have custody of client assets);

(ii) conflicts of interest inherent in investment adviser business models (*i.e.*, undisclosed compensation arrangements, allocation of investment opportunities, side-by-side management of performance-based and asset-based accounts, risk controls and disclosure for illiquid investments and leveraged investment products/strategies, and higher risk products/strategies targeted to retail investors); and (iii) the accuracy and completeness of advisers' claims about their investment objectives and performance.

New and emerging risks and initiatives include the NEP's ongoing presence exam initiative for newly registered (*i.e.*, since July 21, 2011) investment advisers, which focuses on marketing, portfolio management, conflicts of interest, safety of client assets and valuation. As in past years, SEC staff is prioritizing examinations of private fund advisers "where the staff's analytics indicate higher risks to investors, or where there are indicia of fraud . . . or other serious wrongdoing." Separate from the presence exam initiative, the SEC staff will also review (i) wrap fee programs; (ii) compliance policies and procedures that substantially rely on quantitative portfolio management and trading strategies; and (iii) payments made by investment advisers and funds to distributors and intermediaries (to determine whether such payments are "in fact, payments for distribution and preferential treatment").

The Priorities List is not exhaustive and the NEP will conduct additional examinations in 2014 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.

On January 27, 2014, SEC Chair Mary Jo White, speaking at the 41st Annual Securities Regulation Institute, announced that the NEP has developed a new analytical tool to search for evidence of insider trading, front running, window dressing, improper allocations of investment opportunities and other misconduct. The tool, called "NEAT" for "National Exam Analytics Tool" allows OCIE examiners to access and analyze "massive amounts of trading data . . . in a fraction of the time it has taken in years past." OCIE Director Andrew J. Bowden acknowledged the NEAT roll-out in a March 6, 2014 speech at the Investment Adviser Association Compliance Conference, noting that NEAT "will enable [OCIE] examiners to quickly subject years' worth of [a firm's] trading data to a battery of more than 50 tests." The full text of Ms. White's speech is available here. The full text of Mr. Bowden's speech is available here.

*9. IM Division Issues Guidance Update on the Testimonial Rule and Social Media*

In March 2014 the IM Division staff released a Guidance Update on the Testimonial Rule and Social Media (the "Guidance"). The Testimonial Rule, Rule 206(4)-1(a)(1) under the Advisers Act, prohibits an investment adviser from publishing "testimonials" about itself or its services. The Guidance addresses, among other topics, the inclusion of (i) third-party commentary from independent social media sites ("Independent Sites") on an investment adviser's social media site (the "Adviser's Site"); and (ii) investment adviser advertisements on Independent Sites.

Under the Guidance, an investment adviser may publish commentary from Independent Sites on the Adviser's Site if (i) the Independent Site and its content are independent of the investment adviser, and there is no material connection between the Independent Site and the investment adviser that would call into question the independence of the Independent Site or its content; and (ii) the investment adviser publishes *all* unedited comments on the Independent Site regarding the investment adviser in a content-neutral manner (*i.e.*, no "cherry picking"). Commentary would not be considered "independent" if the investment adviser authored, compensated a social media user for authoring, or prioritized, removed or edited the commentary. An investment adviser may provide social media users a way to sort commentary by any criteria (including ranking), as long as the adviser does not itself sort the commentary on the Adviser's Site. Investment advisers may also advertise on Independent Sites; provided, that (i) the advertisement is clearly distinguishable from the social media commentary on the Independent Site; and (ii) the receipt of advertising revenue by the Independent Site does not influence the inclusion or presentation of commentary on the Independent Site.

Investment advisers should review the Guidance before including third-party social media commentary on their own social media sites to ensure compliance with the Testimonial Rule. The full text of the Guidance is available here.

*10. Bitcoin Developments*

In March 2014, the CFTC announced that it was conducting an internal study on whether the CFTC should regulate crypto-currencies such as Bitcoin and/or derivatives contracts based on Bitcoin or other crypto-currencies. If Bitcoin and other crypto-currencies are to be regulated as "commodities" by the CFTC rather than as "currencies", there will likely be significant limitations on the ability of hedge funds and other investors to trade futures or options on Bitcoin. CFTC regulations are not expected, however, to impact the "spot" market for Bitcoin or other crypto-currencies.

*11. CFTC Substituted Compliance Determinations*

On December 20, 2013, the CFTC approved a series of substituted compliance determinations, which allow CFTC-registered non-U.S. swap dealers and foreign branches of U.S. swap dealers to comply with local requirements rather than the corresponding CFTC rules in cases where substituted compliance is available under the CFTC's July 12, 2013 Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations. The CFTC made substituted compliance determinations for certain swap dealer entity-level requirements for Australia, Canada, the European Union (the "EU"), Hong Kong, Japan and Switzerland[2] and a limited number of transaction-level requirements for the EU and Japan[3]. Further information on the substituted compliance determinations and the covered requirements is available here.

*12. CFTC Issues No-Action Relief from Outward-Facing Swaps Condition in the Inter-Affiliate Exemption*

On March 6, 2014, the CFTC issued a no-action letter ("CFTC Letter No. 14-25"), extending the time-limited exemption contained in the alternative compliance frameworks available to certain affiliated counterparties pursuant to CFTC Rule 50.52(b)(4)(ii)-(iii) from March 11, 2014 to December 31, 2014. On April 11, 2013, the CFTC published a final rule providing an exemption from required clearing for swaps between certain affiliated entities, subject to specific requirements and conditions (the "Inter-Affiliate Exemption"). One of those conditions, the treatment of Outward-Facing Swaps Condition, requires the clearing of swaps between affiliated counterparties claiming the Inter-Affiliate Exemption ("Eligible Affiliate Counterparties") and unaffiliated counterparties. Other conditions include that (i) both counterparties elect not to clear the swap; (ii) the terms of the swap are documented in a swap trading relationship document; and (iii) the swap is subject to a centralized risk management program. The CFTC provided two temporary, alternative compliance frameworks to satisfy the Outward-Facing Swaps Condition to assist counterparties to transition to full compliance with CFTC Rule 50.52(b)(4)(i), both of which expired on March 11, 2014. The Eligible Affiliate Counterparties electing to rely on the relief provided by CFTC Letter No. 14-25 will be required to promptly provide to the CFTC Division of Clearing and Risk, upon request, documentation regarding their compliance with any aspect of CFTC Letter No. 14-25 and CFTC Rule 50.52. A copy of CFTC Letter No. 14-25 is available here.

On March 6, 2014, the CFTC issued another no-action letter ("CFTC Letter No. 14-26"), providing time-limited no-action relief from the requirements of the trade execution requirement in Section 2(h)(8) of the CE Act ("Commission Review of Swaps for Clearing") to Eligible Affiliate Counterparties, as defined in CFTC Rule 50.52(a), that engage in swap transactions with one another that involve a swap subject to the trade execution requirement. The no-action letter stated that the CFTC will continue to evaluate, based on ongoing observations of inter-affiliate market activity occurring both on and off of swap execution facilities and designated contract markets, whether such swap transactions should be subject to the trade execution requirement. The relief expires on December 31, 2014. A copy of CFTC Letter No. 14-26 is available here.

*13. Department of Labor Issues Proposed Amendment to Section 408(b)(2) Regulations*

In March 2014, the Department of Labor (the "DOL") issued a proposed amendment (the "Proposed Amendment") to the final regulation under Section 408(b)(2) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), requiring that certain service providers to pension plans disclose information about the service provider's compensation and potential conflicts of interest (the "Final Regulation"). The Proposed Amendment, if adopted, would require covered service providers, including investment advisers to private funds that manage plan assets (*i.e.*, funds that are "plan asset" pools), to furnish a guide to assist plan fiduciaries in reviewing the initial disclosures required by the Final Regulation, if such initial disclosures are contained in multiple or lengthy documents. The guide would specifically require the service provider to identify the document and page, or other sufficiently specific locator, such as a section, that would enable the plan fiduciary to find quickly and easily the required information disclosed pursuant to the Final Regulation. In addition, the Proposed Amendment would require that the guide be in a separate document and identify personnel that the plan fiduciary may contact regarding the disclosures as well as provide any changes to the guide on an annual basis. Our recent Client Alert discussing the Proposed Amendment is available here.

*14. Changes to Law Governing California Limited Liability Companies*

Effective as of January 1, 2014 (the "Effective Date"), the Beverly-Killea Limited Liability Company Act (the "Beverly-Killea Act"), which previously governed California limited liability companies ("LLCs"), was repealed and superseded by the Revised Uniform Limited Liability Company Act (the "RULLCA"). The RULLCA governs operating agreements entered into after the Effective Date, as well as contracts, votes or consents by members or managers of an LLC made after the Effective Date. Among other changes, the RULLCA expands the number of "default rules" which will apply to all LLCs after the Effective Date if not explicitly overridden in the LLC's operating agreement. These new default rules include but are not limited to:

- limitations on management authority (requiring consent of all LLC members to take certain actions such as the sale, lease or exchange of all or substantially all of the LLC's property, approval of a merger or conversion, or other activities outside the ordinary course of the LLC's activities);
- allowing amendments to operating agreements made after a person has become a transferee to be effective against that transferee;

- addition of events triggering "dissociation" of members (e.g., distribution of a transferrable interest by an estate or trust and dissolution or termination of a legal entity acting as a member);
- mandatory indemnification of members/managers in certain situations; and
- mandatory reimbursement to certain managers/members of payments made by them while acting on behalf of the LLC.

The RULLCA applies to all LLCs that are registered with the California Secretary of State (including foreign LLCs) on the Effective Date. Although the RULLCA does not require existing LLCs to file any new documents with the California Secretary of State or to revise their operating agreements, California-registered LLCs should consider reviewing their existing operating agreements in light of the new default rules. The full text of the RULLCA is available here.

*15. California Department of Business Oversight Issues New Rules Affecting Investment Advisers and Broker Dealers*

On January 9, 2014, the California Commissioner of Business Oversight (the "Commissioner") adopted amendments to the state's custody rule, Section 260.237 of Title 10 of the California Code of Regulations (as amended, the "CA Custody Rule"). The CA Custody Rule incorporates provisions from the SEC's Custody Rule and the North American Securities Administrators Association Model Rule. The CA Custody Rule applies to investment advisers who are licensed or required to be licensed in California, but not to SEC-registered investment advisers (who are instead subject to the SEC's Custody Rule). The CA Custody Rule became effective on April 1, 2014. The text of the amendments is available here.

In an order issued on November 22, 2013 (the "Order"), the Commissioner set forth new electronic communications requirements for licensees of the California Department of Business Oversight (the "DBO"), formerly the California Department of Corporations. The Order applies to financial services providers licensed or required to be licensed in California, including, among others, investment advisers and broker-dealers. The Order requires a licensee to (i) establish a generic dedicated email address (*e.g.*, dbo@abcadvisers.com) within its corporate email system for receiving communications (including email attachments) from the DBO; and (ii) provide for daily monitoring of that email address by the licensee's executive staff. The DBO set a compliance date of January 4, 2014. The full text of the Order is available here. Our recent Client Alert discussing the Order in more detail is available here.

Investment advisers licensed in California should review the CA Custody Rule and the Order and ensure that they are in compliance with the new requirements.

*16. Update on AIFMD – latest developments in Europe*

In Europe, regulators are publishing guidance and taking other steps in connection with the national implementation of the European Union (the "EU") Alternative Investment Fund Managers Directive[4] (the "AIFMD" or the "Directive"). Set out below is a brief overview of the current status of AIFMD implementation in the EU, and its implications for alternative investment fund managers ("AIFMs") marketing or considering marketing alternative investment funds ("AIFs") to EU-based investors.

Where are we now?

The Directive came into force in the EU on July 22, 2013 and has not, as yet, been implemented by all EU Member States; notably only partly implemented by Italy and not implemented at all by Spain, Belgium or Norway.[5] A number of transitional provisions within the Directive are subject to the interpretation of the local regulators of each EU Member State and, consequently, AIFMs will (in some cases) only have to comply with the Directive upon the expiration of the relevant transitional period (which is typically July 22, 2014).

Marketing funds in the EU through private placement regimes

Until July 22, 2015, non-EU AIFMs without the benefit of the relevant transitional period will only be able to market AIFs in the EU via the private placement regime (the “PPR”) of the EU Member State in which their prospective investors are domiciled. There are three pre-conditions to using PPRs to market AIFs under the Directive:

- a co-operation agreement must be in place between the local regulator of the relevant EU Member State and each of the AIF’s and the AIFM’s domicile authority;
- the domicile of each of the AIF and the AIFM must not be listed as a ‘Non-Cooperative Country and Territory’ by the Financial Action Task Force; and
- the AIFM domicile and the relevant EU Member State must enter into a tax information exchange agreement (“TIEA”) [6]

AIFMs marketing AIFs to EU investors may also be subject to the following ‘transparency’ requirements, which vary depending on the AIF’s assets under management (“AUM”):

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

Finally, in most of the key markets (including the United Kingdom and Germany), a notification to or registration with the local financial regulator will be required prior to any marketing taking place, and this process can take several months.

Some jurisdictions impose additional requirements on AIFMs beyond the AIFMD, including, for example requiring AIFMs to appoint a depositary (known as the “depo-lite” regime).

- In Germany and Italy, non-EU AIFMs must appoint one or more persons to perform the depositary functions pursuant to the Directive.

- In Denmark, non-EU AIFMs which have obtained a marketing authorization in Denmark will be required to appoint one or more entities separate from the AIFM to undertake certain activities similar to the activities usually performed by a depository.

- In Switzerland, where a non-EU AIF is exclusively distributed in Switzerland to "qualified investors" the non-EU AIFM will have to appoint a regulated Swiss representative (pursuant to a distribution agreement subject to Swiss law) as well as a paying agent by February 1, 2015.

EU Passport

By July 2015, subject to the anticipated extension of the passport regime by the European Securities and Markets Authority ("ESMA"), non-EU AIFMs may be able to apply for a passport for cross-border marketing of their AIFs in the EU. In addition to the satisfaction of the three preconditions discussed above, AIFMs will need to select a 'Member State of reference' and apply for authorization and supervision from the local regulator in that EU Member State.

Beginning in July 2018, if the passport regime is extended on a mandatory basis to non-EU AIFMs, the national PPRs will be gradually phased out and AIFMs will have to apply for an EU passport to market the AIFs. If the EU passport mechanism is not extended to non-EU AIFMs by ESMA, the PPR will continue indefinitely.

Reverse Solicitation

The Directive defines "marketing" as a direct or indirect offering or placement to EU investors, at the initiative of the AIFM or on its behalf, of units or shares of an AIF that it manages. Based on this definition, non-EU based AIFMs may engage in reverse solicitation or accept subscriptions from EU-based investors that initiate the offering or placement without being engaged in "marketing".

The interpretation of what constitutes "reverse solicitation" varies between Member States and can be narrowly construed. AIFMs should adopt a cautious approach to reverse solicitation, and should seek advice from local counsel on a jurisdiction by jurisdiction basis where certain conflicts may exist with national law.[7]

Exemptions

The Directive does not generally apply to:

- hedge funds with AUM of €100 million or less;
- private equity funds with AUM of €500 million or less;
- certain qualifying securitization special purpose companies;
- single investor funds (this allows managers to run managed accounts for single investors based in the EU outside of the scope of the Directive);
- funds whose only investors are the manager or the manager's group companies (provided that none of those investors is itself a fund); and

- non-EU funds sold in the EU by a non-EU manager solely on a reverse solicitation basis (noting the warning above).

Parallel fund structures

AIFMs that desire to access a wider suite of potential EU investors may consider establishing an AIFMD-compliant EU structure in parallel to an existing non-EU fund. Having a non-EU fund marketing to non-EU investors and an EU fund marketing to EU investors allows for a manager’s obligations under the Directive to be isolated from its non-EU marketing and investment activities. We can provide specific advice in this area.

*17. Cayman Islands Update*

Fund Governance

On January 13, 2014, the Cayman Islands Monetary Authority (“CIMA”) released a statement of guidance on matters of investment fund governance (the “SOG”). The SOG establishes key principles of good governance which must be observed by CIMA-regulated funds (each, a “Regulated Mutual Fund”). These principles include a requirement that the board of directors or other governing body of a Regulated Mutual Fund:

- properly oversee the activities of its service providers, including the investment manager, and requires regular reporting;
- suitably identify, disclose, monitor, manage and document conflicts of interest; and
- meet at least twice a year, or more frequently depending on the size, nature and complexity of the fund.

The SOG further sets out a non-exhaustive list of duties which are applicable to any individual director or other ‘operator’ of a fund, including duties which echo the common law fiduciary duties of corporate directors, as well as responsibility for considering the adequacy of the fund’s documentation (both internal and public) and ensuring adequate risk management.

Rights of Third Parties

The Contracts (Rights of Third Parties) Law, 2014 (the “Contracts Law”) has been approved by the Cayman Islands Government and, following its imminent implementation, will introduce a statutory regime to enable certain third parties to enforce terms in contracts governed by Cayman Islands law. The Contracts Law is based on the English Contracts (Rights of Third Parties) Act 1999 (the “English Contracts Act”) but with a number of enhancements, as discussed below.

Cayman law does not currently recognize any enforcement rights of third party beneficiaries to a contract, and the Contracts Law will bring Cayman law in line with the United States, the United Kingdom and other leading financial jurisdictions in enabling parties to reflect better their commercial intentions in contracts. This will be of particular relevance to fund subscription agreements, which usually seek to confer indemnification and other rights on the investment manager, its affiliates and other third parties. This invariably raises questions as to what should be the governing law for these purposes. The Contracts Law will provide for the right of a third party to enforce a contractual term, provided that the contract specifically provides that such third party may do so. Unlike the English Contracts Act, the intention of the Contracts Law is to provide rights for third parties only where the contractual parties agree that the third party may specifically enforce such rights. The Contracts Law will therefore provide something akin to an "opt in" system which is intended to establish, inter alia, greater certainty as to circumstances in which third parties can enforce contractual provisions.

Registration of Directors

In March 2014, the Cayman Islands Government circulated the Directors Registration and Licensing Bill, 2014 (the "Director Bill") for industry review and comment. If enacted, the Director Bill will provide for the registration and licensing of individuals or companies appointed as directors of:

- corporate mutual funds regulated by CIMA; and
- companies registered as 'excluded persons' under the Securities Investment Business Law (as amended) ("SIBL") of the Cayman Islands (each, a "Covered Entity").

The scope of the Director Bill covers directors of Covered Entities wherever those directors are resident or incorporated. It does not cover directors of general partners of CIMA-regulated partnerships, or to trustees of CIMA-regulated unit trusts. The Director Bill distinguishes between professional directors (i.e., a natural person appointed as a director of 20 or more Covered Entities), corporate directors (i.e., a corporate body appointed as a director of a Covered Entity), and natural persons who are not 'professional directors' ("non-professional directors").

Non-professional directors will be required to be registered with CIMA. Non-professional directors who are directors of existing Covered Entities will have three months from the commencement date of the enacted law to register with CIMA.

Professional directors will be required to be licensed by CIMA. Certain categories of natural person who might otherwise fall within the definition of professional director will be excused from the licensing requirement but will instead be required to register with CIMA. Such persons are, in general, managers or stakeholders of (i) an entity holding a Cayman Islands companies management license or a mutual funds administrators license; or (ii) fund managers of a CIMA-regulated mutual fund that is registered or licensed by one of the prescribed overseas regulatory authorities, so long as the natural person is acting as a director of the relevant fund(s) by virtue of his or her relationship to that fund manager.

Corporate directors will be required to be registered as a Cayman Islands ordinary resident company, an exempted company or as a foreign company in Cayman. Corporate directors which do not fall under one of these three categories will have six months from the commencement date of the law to comply. A corporate director will be required to be licensed by CIMA, though corporates which hold a Cayman Islands companies management license or a mutual fund administrators license and which provide directors to Covered Entities will not be required to be separately licensed under the law. Corporate directors must have at least two natural persons on their board who meet CIMA's fit and proper requirements and proposed new or additional appointees are required to be approved by CIMA. Details of the registration and licensing process and applicable fees have not yet been published.

Changes to the Exempted Limited Partnership Law

A long-awaited overhaul of the Cayman Exempted Limited Partnership Law is expected imminently. An important focus of the new law will be to conform the Cayman statute to some extent to corresponding provisions of Delaware law which will bring the Cayman statutory framework more in line with the expectations of the onshore investment community (both managers and investors) who establish, and invest in, both Delaware and Cayman partnerships. The new law will implement numerous enhancements to the existing regime and key changes will include enabling partners to establish more clearly the scope of a general partner's fiduciary responsibilities; allowing a foreign limited partnership to be registered under the Exempted Limited Partnership Law in order to act as the general partner of a Cayman exempted limited partnership; making provisions of a partnership agreement regulating boards and committees binding on members of those boards and committees notwithstanding that they are not party to the partnership agreement itself; and further extending the safe harbour provisions to members of such boards and committees. Other important changes will include recognition of default provisions of the kind usually found in private fund limited partnership agreements; clarification of the statutory claw-back period and simplifying the manner of admitting new partners and transferring partnership interests. It is anticipated that the new Exempted Limited Partnership Law will come into effect in the second quarter of 2014.

## II. TAXATION

Since our last Report, there have not been a material number of tax developments relevant to investment funds. A number of significant developments are pending, as further discussed below. In addition, the Foreign Account Tax Compliance Act ("FATCA") will shortly be in effect, and all investment funds should be ready to meet FATCA's requirements within the next few months.

### *A. Recent Budget Proposals*

On March 4, 2014, President Obama released a $3.9 trillion budget for fiscal year 2015. Among other initiatives, the budget includes new international tax revenue-raising proposals, as well as business tax reform. Portions of the budget align with proposals made by the House Ways and Means Committee Chairman Dave Camp's proposal, which was released in draft form on February 26, 2014. Notably, the budget includes the same proposal as made last year to tax as ordinary income a partner's share of carried interest income with respect to investment partnerships. As a practical matter, it is not expected that most of either the President's budget or Camp's proposal will make significant progress on Capitol Hill. We will continue to monitor the development of the President's budget proposal and any other Congressional developments.

### *B. Recent Foreign Account Tax Compliance Act Developments*

FATCA, which was enacted in March 2010 in the Hiring Incentives to Restore Employment Act, generally requires a foreign financial institution (or "FFI") to enter into an agreement with the IRS and report U.S. accounts to the Internal Revenue Service (the "IRS") or pay a 30% withholding tax on any "withholdable payment" made to the institution or their affiliates.[8] 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*

As part of FATCA, FFIs are generally required to register with the IRS. To that end, the IRS has opened an online FATCA registration portal (the "Portal"), which allows FFIs to submit FATCA registration information to the IRS. The Portal can be accessed here. It is expected that the Portal will remain the main point of contact between FFIs and the IRS with respect to ongoing FATCA compliance issues. The IRS has released a comprehensive user guide with step-by-step instructions on how to use the Portal, which can be found here. Once registered, FFIs will be issued a Global Intermediary

Identification Number (GIIN). FFIs that have not yet reviewed the Portal and user guide are encouraged to do so.

FFIs are generally obligated to enter into an agreement with the IRS (an "FFI Agreement") and adhere to that agreement in order to comply with FATCA. In December 2013, the IRS released the final language of the FFI Agreement as part of Revenue Procedure 2014-13, which tracks the draft FFI Agreement previously released with few modifications. The final FFI Agreement can be found here. Some FFIs may instead be required to comply with intergovernmental agreements ("IGAs"), described below.

*2. Developments Regarding IGAs*

Early in 2012, the Treasury began negotiating and entering into IGAs with foreign governments. As discussed in several of our last Reports, the IGAs are intended to provide an alternative means by which financial institutions located within participating jurisdictions may comply with FATCA. The Treasury maintains a continuously updated list of jurisdictions that have, or are treated as having, an IGA in effect. The list can be found here. FFIs in jurisdictions that have not signed IGAs will generally comply with FATCA by registering with the IRS and executing an FFI Agreement, as described in paragraph II.B.1 above.

*3. Expanded Affiliated Groups*

We have recently dealt with a number of FATCA concerns with respect to expanded affiliated groups ("EAGs"). An EAG is essentially any group made up of a chain of corporations with 50% or greater ownership (by vote and value) that share a common parent corporation, as well as any partnership or trust controlled by any such corporations. All members of an EAG that are FFIs must register with the IRS in order for any FFI in the EAG to be FATCA-compliant, unless they are subject to an exception. Thus, it is important for investment funds to determine which of its entities are FFIs and whether such FFIs are part of an EAG.

These rules may create unexpected headaches for investment funds. For example, in some cases a "fund of one" may create an EAG that includes fund investment entities held by the sole shareholder of the "fund of one" that are unrelated to the "fund of one" in any other manner. If that shareholder is treated as part of an EAG that includes the "fund of one," the fund would have to certify that not only is the sole shareholder FATCA-compliant, but if the investor owns more than 50% of any other funds subject to FATCA, those funds also must be certified as compliant. This outcome could be quite burdensome to all fund entities involved. We encourage investment funds to review their investment structures in light of the EAG rules.

*4. Next Steps*

We do not expect any further delay with respect to FATCA effective dates. As such, investment funds, if not already prepared for the implementation of FATCA, are strongly encouraged to review their internal policies and investment structures for FATCA compliance at this time. Pursuant to recent guidance, the IRS has recommended that FFIs register on the Portal by May 5, 2014. However, the IRS has announced that FFIs subject to so-called Model 1 IGAs should register by December 22, 2014. In each case, such registration deadlines are important to ensure that the relevant FFIs are included on the IRS lists of compliant FFIs that are expected to be released June 2, 2014 and January 1, 2015.

### *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.

*1. Form 114a*

In 2011, the Financial Crimes Enforcement Network (“FinCen”) announced that all FinCen forms must be filed electronically, subject to certain exceptions. Although FinCen granted a general exemption in 2012 from mandatory electronic filing through June 2013, currently all FBARs must be filed electronically. Paper copies will not be accepted. Further, any taxpayer filing a delinquent FBAR must file the delinquent FBAR electronically.

In an effort to assist taxpayers with third party return preparers, in July 2013, FinCen released a new form, Form 114a Record of Authorization to Electronically File FBARs, which permits third party preparers to file FBARs electronically on behalf of their clients. On September 30, 2013, FinCen announced that Form 114a had been revised to permit the filer to select or enter late filing reasons, as well as to add a new section to enter third party preparer information.

Investment funds are encouraged to review the FBAR requirements and, if applicable, complete a Form 114a to authorize their third party preparers to file FBARS on their behalf.

*2. Delays in FBAR Reporting Obligations for Certain Individuals*

On December 17, 2013, FinCen released Notice 2013-1, which generally provides that certain persons who are obligated to file FBARs now have until June 30, 2015 to file the same. This extended deadline applies to certain individuals who have signature authority over, but no financial interest in, one or more foreign financial accounts. The extension also applies to certain employees or officers of investment advisors registered with the SEC who have signature authority over, but no financial interest in, certain foreign financial accounts. The extension applies not only to the reporting of signature authority held by such persons for 2013 but also the reporting deadlines previously extended under FinCen Notices 2011-1, 2011-2, 2012-1, and 2012-2. For all other individuals with an FBAR filing obligation, the filing due date remains unchanged.

### *D. New Guidance on Withholding on Dividend Equivalent Payments*

On December 4, 2013, the IRS released final and proposed Treasury Regulations (the “Final Regulations” and “Proposed Regulations,” respectively) under Code Section 871(m).[9] These regulations provide further guidance and reverse prior guidance to some extent with respect to dividend equivalent payments. The Proposed Regulations represent a significant shift in such guidance and, if finalized, will implement a new approach to dividend equivalent payments.

By way of background, in general, nonresident aliens and foreign corporations are taxed at a gross 30% rate (or lower tax treaty rate) on certain types of U.S. source passive income, including dividends. According to the Treasury, many non-U.S. investors, including foreign investment funds, enter into swaps or other derivative contracts that pay “dividend equivalent amounts” instead of directly holding the dividend-paying equities on which they are based in order to avoid this 30% withholding tax. In recent years, the IRS has increasingly focused on the enforcement of withholding taxes on dividends by examining both financial institutions and foreign persons. The IRS has been specifically targeting transactions such as total return swaps on U.S. equities that it believes have the potential for withholding tax avoidance. To this end, Code Section 871(m) was enacted in March 2010. This section treats a “dividend equivalent” as a dividend from sources within the U.S. for purposes of the 30% withholding tax. Code Section 871(m) generally applies to any dividend equivalent payment made after September 14, 2010.

For this purpose, a “dividend equivalent” includes, among other payments, payments made on a “Specified NPC” that (directly or indirectly) is contingent upon or determined by reference to the payment of a dividend from sources within the U.S. Accordingly, such payments, when made to a non-U.S. person, are generally subject to withholding tax. For purposes of Code Section 871(m), “Specified NPCs” include transactions whereby the referenced security is (i) transferred between the notional principal contract counterparties; (ii) posted as collateral by the short notional principal contract counterparty; or (iii) not readily tradable on an established securities market. Further, the IRS is entitled to identify other contracts as Specified NPCs in its discretion. While these categories are relatively narrow, Code Section 871(m)(3)(B) provides that any payment made after March 18, 2012 on any NPC is a Specified NPC unless the IRS determines the notional principal contract (“NPC”) is of the type that does not have the potential for tax avoidance.

In 2012, the IRS issued temporary Treasury Regulations (the “Temporary 2012 Regulations”) that applied to swap payments and proposed Treasury Regulations (the “Proposed 2012 Regulations”) that would have applied to swap payments. The Temporary 2012 Regulations extended application of the statutory definition of Specified NPC described above through December 31, 2013. For payments made on or after January 1, 2014, the Proposed 2012 Regulations provided that a Specified NPC was an NPC that met one of a broader set of factors. The Proposed 2012 Regulations also applied to payments made pursuant to certain equity linked instruments (“ELIs”) that were calculated by reference to U.S. source dividends if they met a seven-factor test.

Given the factor tests, Specified NPCs and ELIs were relatively easy to identify. However, the IRS has changed its approach to such identification as of December 2013 pursuant to the release of the Final Regulations and the Proposed Regulations. The Final Regulations apply to swap payments made after March 18, 2012 and before January 1, 2016, whereas the Proposed Regulations would apply to swap payments made on or after January 1, 2016. The Final Regulations also withdraw the Temporary 2012 Regulations, and the Proposed Regulations withdraw the Proposed 2012 Regulations.

The Final Regulations are not overly controversial. They adopt with minimal changes the definition of Specified NPC under Code Section 871(m)(3)(B). However, the Proposed Regulations, if implemented, will eliminate the factor-based approach to identifying Specified NPCs and ELIs that would have applied beginning in 2014 and instead take an approach that measures a derivative’s “delta” to determine whether a contract is subject to tax under Code Section 871(m). This would generally apply to payments made on or after January 1, 2016. Effectively, the Proposed Regulations institute a new system whereby any NPC or ELI that has a delta of 0.70 or greater when the long party acquires the transaction will be a Specified NPC or ELI, regardless of any other indicia of tax avoidance. Such delta would be the ratio of the change in the fair market value of the NPC or ELI to the change in the fair market value of the referenced property determined in a commercially reasonable manner.

This represents a fundamental change in the government’s approach to cross-border derivative payments with respect to U.S. equities because the Proposed Regulations replace a regime that would subject to withholding tax only specified transactions under a factor test with a system that treats all cross-border equity derivatives on U.S. equities with sufficiently high delta as abusive tax avoidance transactions that are subject to withholding tax. Investment funds are encouraged to monitor any derivatives they execute before January 1, 2016 and evaluate their existing portfolios of derivatives (to the extent that such instruments are expected to continue into 2016) to determine whether any such instruments would be subject to withholding under the Proposed Regulations.

### *E. Tax Court Denies Trader Status (Again)*

Following a long line of decisions that demonstrate the difficulty of attaining trader status for federal income tax purposes, the Tax Court recently held in Sharon Nelson v. Commissioner, T.C. Memo 2013-259 (11/13/13), that a taxpayer was not in the trade or business of trading in securities and upheld the IRS's disallowance of over $800,000 in expenses purportedly claimed in connection with these activities over two tax years. The Tax Court also held the taxpayer was liable for accuracy-related penalties.

In general, for federal income tax purposes, a person who purchases and sells securities falls into one of three categories: dealer, trader, or investor. "Dealers" are generally individuals or entities that buy securities for resale to customers. "Traders" generally engage in a "trade or business" of buying and selling securities for their own accounts to take advantage of short-term price changes. "Investors" likewise buy and sell for their own accounts, but generally buy securities for long-term appreciation and are not engaged in a trade or business. Whether one is a "trader" or an "investor" is not determined by a specific formula or objective criteria. Instead, it depends on an analysis of all the facts and circumstances involved in one's activities, taken as a whole. This characterization will affect, among other things, the extent to which partners in a partnership may deduct certain items of the partnership's expenses for federal income tax purposes. Specifically, qualifying trade or business expenses are deductible in full under Code Section 162 whereas investment expenses are generally deductible only as itemized deductions under Code Section 212 and subject to a 2% of adjusted gross income floor.

In the case at issue, the taxpayer was the sole stockholder of Clear Concepts, Inc., a corporation engaged in the mortgage broker business ("Concepts"). Concepts employed the taxpayer as a mortgage broker and paid her salary during each of 2005 and 2006.

During 2005 and 2005, the taxpayer executed securities trades on an investment account that she maintained with TD Ameritrade. Her live-in companion also executed trades on that account. The taxpayer had no clients for any of the trades executed on her account during 2005 and 2006.

During 2005, there were a total of 250 available trading days. 535 trades were executed on the taxpayer's account on a total of 121 days (or 48.4% of total available trading days). The purchases for 95 of those trades occurred in the one-week period from September 27 to October 3. The holding period for the securities traded on the account during 2005 ranged from one to 48 days. Over the course of the year, there were eight periods of at least seven days where no purchases or sales occurred on the account. The 2005 trades generated $470,472.90 of net short-term capital gain for that tax year.

During 2006, there were a total of 250 available trading days. 235 trades were executed on the account on a total of 66 days (or 26.4% of the total available trading days). The holding period for the securities traded on the account during 2006 ranged from one to 101 days. During 2006, there were only two trading days on which trades were executed on the account during the period of January 27 to May 4, and there were seven periods of at least seven days where no purchases or sales occurred. The 2006 trades generated $36,852.28 of net short-term capital gain for that tax year.

On the taxpayer's 2005 and 2006 returns, she included Schedule C Profit or Loss from Business. She described the principal business as "Stock Trading/Trader Status" and "Securities Trader/Trader Status," in 2005 and 2006, respectively. The IRS disallowed all of the expenses that the taxpayer claimed on the 2005 and 2006 Schedules C—more than $504,000 in 2005 and nearly $304,000 in 2006—and imposed accuracy-related penalties. The taxpayer challenged the IRS's determination and went to trial on the issue of her disallowed trader status.

The Tax Court initially stated that it was unclear what portion of the trades for each year was in fact executed by the taxpayer. However, the court found that, even if it were to assume that she executed all of them, she still would not carry her burden of establishing that she was a trader for both years. The number of trades was not sufficient to constitute a "substantial" amount for either year. Further, the Tax Court stated that while the amount of money involved each year was "considerable" (purchases and sales ranged from $24.2 to $32.0 million), it was not determinative of whether the activity was substantial. The Tax Court noted that in other cases that upheld trader status, trading occurred on an almost daily basis. Ultimately, the Tax Court concluded that the total number of days spent trading, in addition to extended periods of inactivity, refuted her claim that she was a trader.

As we have stressed in previous Reports, funds may wish to consider whether they qualify for trader status, given the continuing scrutiny by the Tax Court of dealer, trader, and investor status characterizations. This case provides some guidance for such determinations. Key factors to examine include number of trades per year, daily trading frequency and the holding period of the securities involved in the trades. A fund that previously determined that it qualifies as a trader should reexamine its trader status each year in which it has a mark-to-market election in place to ensure that the election will not be challenged.

The full text of the Tax Court opinion can be found here.

## III. CIVIL LITIGATION

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

- The Second Circuit upheld a trial court decision requiring a portfolio manager who had engaged in insider trading to disgorge the amount of the fund's illegal profits, regardless of his personal gain.
- The Southern District of New York used the "faithless servant" doctrine to allow Morgan Stanley to recover compensation paid to a portfolio manager of a Morgan Stanley hedge fund management company following his insider trading conviction.
- The Southern District of New York limited application of the "selective waiver" doctrine to require two hedge fund management companies to produce otherwise attorney-client privileged documents that had formed the basis for voluntary disclosures to the SEC.

### *A. New Developments in Securities Litigation*

*1. Portfolio Manager Can Be Liable for Fund's Profits from Insider Trading Even Without Personal Gain*

On February 18, 2014, the Second Circuit affirmed the decision of the U.S. District Court for the Southern District of New York requiring a portfolio manager who had engaged in insider trading to disgorge the fund's illicit profits, even though he had never had possession of the monies he was required to disgorge.[10] In 2005, Joseph Contorinis ("Contorinis"), Managing Director at the investment bank Jeffries & Company, Inc., had engaged in insider trading on behalf of the Jeffries Paragon Fund (the "Fund"), resulting in more than $7.2 million in profits and $5.3 million in avoided losses for the Fund. Contorinis did not trade on the inside information for his own account, but benefited in that his income was tied to the Fund's performance.

Contorinis was convicted of securities fraud, which was upheld on appeal, and sentenced to six years in prison. Under a criminal forfeiture order, Contorinis was required to forfeit $12.65 million, which was reduced to $427,875 on appeal, equating to the compensation he received from the trades.

The district court also found Contorinis liable in the SEC's civil fraud proceeding and ordered him to disgorge the ill-gotten profit earned by the Fund. The court also permanently enjoined him from violating securities laws in the future, imposed a civil penalty of $1 million, and ordered him to pay $2.5 million in prejudgment interest. Contorinis appealed.

The Second Circuit affirmed the district court's decision, holding that Contorinis could be required to disgorge the Fund's profits despite the fact that he did not benefit personally, because the duty to disgorge may extend to "the benefit that accrues to third parties whose gains can be attributed to the wrongdoer's conduct." The court explained that disgorgement is an equitable remedy designed to deter subsequent fraud, analogizing the situation to an insider trading tipper who can be required to disgorge profits made by a tippee.

The court explained that criminal forfeiture was limited to the amount of Contorinis' pecuniary gain because forfeiture is aimed solely at punishing the wrongdoer. In contrast, disgorgement prevents unjust enrichment even of innocent third parties. While the SEC could have sought disgorgement from the Fund itself, there was no conflict in seeking disgorgement from Contorinis on behalf of the Fund.

Notably, the court was careful to highlight the limitations of its decision: "We do not conclude that district courts must impose disgorgement liability for insider trading upon wrongdoers when the gains accrue to innocent third parties, but rather that the district courts may elect to do so in appropriate circumstances." Future courts will need to decide on a case-by-case basis whether to order those engaging in insider trading to disgorge profits received by others.

*2. Morgan Stanley Recovers Compensation Paid to Portfolio Manager Guilty of Insider Trading*

The U.S. District Court for the Southern District of New York recently held that Morgan Stanley could recover compensation paid to a former portfolio manager who admitted to insider trading, applying New York's "faithless servant" doctrine.[11]

In 2011, Joseph F. "Chip" Skowron III ("Skowron"), a former portfolio manager for FrontPoint Partners, LLC, a Morgan Stanley hedge fund manager, pleaded guilty to insider trading and obstruction of justice charges. Skowron admitted that he had sold company-held stocks based on material nonpublic information, and was sentenced to five years in prison. Morgan Stanley was awarded restitution of 20% of Skowron's compensation during the conspiracy.

In October 2012, Morgan Stanley sued Skowron to recoup the entirety of the compensation paid to him—more than $31 million—alleging causes of action for faithless servant, fraud, breach of fiduciary duty, breach of contract and contribution. Morgan Stanley recently moved for partial summary judgment based on New York's "faithless servant" doctrine, which allows for recovery of compensation where (1) “the misconduct and unfaithfulness . . . substantially violates the contract of service” such that it “permeate[s] [the employee’s] service in its most material and substantial part” or (2) the “misconduct [] rises to the level of a breach of a duty of loyalty or good faith.”

Skowron did not dispute that his misconduct constituted a breach of the duty of loyalty and good faith, but argued that he never violated his employment contract in a way that “permeated his service as an employee.” The court granted partial summary judgment, finding that Skowron was a faithless servant under either standard.

Morgan Stanley’s Code of Conduct expressly prohibited insider trading. The court found that “insider trading is the ultimate abuse of a portfolio manager’s position and privileges because it goes to the heart of his ‘primary area of responsibility,’” which was “to lawfully invest hundreds of millions of dollars and to safeguard the Firm’s reputation.” Because Skowron “knowingly committed insider trading, explicitly lied to the SEC under oath, and failed to disclose his participation to Morgan Stanley over the course of several years,” the court found that “no reasonable jury could conclude that Skowron’s insider trading and subsequent cover-up did not substantially violate the terms of his employment and permeate his service.” Therefore, the court held that Skowron had raised no issue of material fact, and Morgan Stanley was entitled to summary judgment. Skowron was thus ordered to forfeit the entire $31 million in compensation he had received from Morgan Stanley during the relevant time frame.

*3. Court Limits Selective Waiver Doctrine Based on Hedge Fund Manager’s Voluntary Production*

Recently, the U.S. District Court for the Southern District of New York held that a fund manager’s voluntary production of privileged materials to the SEC amounted to a waiver of the privilege, thus limiting the application of the “selective waiver” doctrine.[12]

The case arose after it was discovered in 2006 that two hedge fund management companies controlled by Daniel Zwirn (“Zwirn”), D.B. Zwirn & Co., L.P. and D.B. Zwirn Partners, LLC (the “Zwirn Entities”), had collected management fees from investor funds before they were due and used investor funds to purchase an airplane for Zwirn’s personal use. The law firm of Schulte Roth & Zabel, LLP, conducted an internal investigation, and prepared summaries of the interviews it conducted. Perry Gruss (“Gruss”), Chief Financial Officer of the Zwirn Entities, was found to be responsible and resigned.

The Zwirn Entities next hired the law firm of Gibson, Dunn & Crutcher LLP (“Gibson Dunn”) to conduct another internal investigation and report the findings to the SEC in 2007. The SEC then launched its own investigation. Gibson Dunn’s presentations to the SEC were governed by a confidentiality agreement, which stated that the Zwirn Entities did not intend to waive the attorney-client privilege through disclosure of any protected materials to the SEC.

The Zwirn Entities later disclosed the financial irregularities to investors, blaming Gruss for the misconduct. In 2010, Gruss sued Zwirn and the Zwirn Entities for defamation, breach of contract, and promissory estoppel. During discovery, the defendants produced documents from both internal investigations, including PowerPoint presentations that Gibson Dunn had used in its reports to the SEC, which summarized the attorneys’ notes from witness interviews. Gruss then demanded production of the original attorneys’ notes and interview summaries, which the defendants opposed on the ground that the materials were protected by the attorney-client privilege and work product doctrine. Gruss moved to compel production.

The magistrate judge denied the motion, holding that the materials were privileged. On July 10, 2013, the district court reversed, holding that the defendants had waived the attorney-client privilege and work product protection by disclosing portions of the interview notes and summaries to the SEC.

In reaching its decision, the court reviewed the selective waiver doctrine, which generally provides that voluntary disclosure of documents to a government agency in a nonpublic investigation constitutes only a limited waiver of the attorney-client privilege. The Second Circuit had previously rejected the doctrine, holding in In re Steinhardt Partners, L.P., that voluntary disclosure to the SEC constitutes a waiver of work product protection as to other parties, but had stated that privilege waivers must be determined on a case-by-case basis, leaving open the possibility of selective waiver where the SEC and the party had entered into a confidentiality agreement.[13]

Applying Steinhardt, the court noted that the relationship between the SEC and the defendants was adversarial, and the defendants voluntarily produced information only to escape liability, which would normally waive the attorney-client and work product protections. The defendants argued that their confidentiality agreement with the SEC was sufficient to allow application of the selective waiver doctrine. The court disagreed, noting that the confidentiality agreement included a clause allowing the SEC to disclose the documents at its discretion, which rendered the agreement illusory. Allowing selective waiver in this context would thus, according to the court, "exalt form over substance." Since the defendants produced "presumably favorable witness interview excerpts" to the SEC, while withholding the remainder of the witness summaries and notes, selective waiver would have allowed the defendants to "manipulate[] their evidentiary privileges to serve their interests."

The defendants challenged the portion of the court's order requiring production of attorney notes, arguing that those notes were intended for internal use only. In a November 20, 2013, order, the court disagreed, holding that the notes were "integral to the Zwirn parties' defense" and thus must be produced. The court noted that in camera review of the notes would be sufficient to protect any opinion work product.

## IV. REGULATORY ENFORCEMENT

Enforcement actions against hedge funds are proceeding at a steady pace, with the SEC devoting even more resources to combat suspected misconduct. For example, in April 2014, the SEC established the "private fund unit," which is a group dedicated to the examination of private equity firms and hedge funds. In particular, the private fund unit will focus on how funds "value their assets, disclose their fees, and communicate with investors."[14] The unit will be reportedly co-chaired by Igor Rozenblit and Marc Wyatt, a former partner and senior portfolio manager at Stark Investments in London. Additionally, the SEC announced in its fiscal 2015 budget request that it was seeking to add 316 staff to OCIE, which conducts the SEC's examination programs and is where the new unit is based.[15] The SEC noted in that request the success of the AMU in using risk-based analytics to identify and bring enforcement actions against hedge funds with suspicious performance returns.[16] The SEC's focus, however, is not limited to valuation and performance issues. As discussed in Section I.C of this Report, above, in the January 2014 Outreach Program National Seminar, the SEC noted that conflicts of interest, insider trading, and misrepresentations to investors were areas of particular enforcement interest.[17]

The recent enforcement developments described below reflect all of these areas of scrutiny, highlighting that the SEC intends to keep enforcement pressure on hedge funds in 2014.

### *A. Insider Trading*

There continue to be several insider trading enforcement actions stemming from the S.A.C. Capital Advisors L.P. ("SAC") investigation. As reported in our prior Report, in November 2013 SAC pled guilty to one count of wire fraud and four counts of securities fraud in connection with alleged insider trading by employees as part of a global settlement resolving both civil and criminal charges. The civil portion of that settlement was approved by the U.S. District Court for the Southern District of New York on November 6, 2013. On April 10, 2014, the court accepted SAC's guilty plea in the criminal action and approved the parties' plea agreement. The court "imposed a sentence that included a criminal fine of $900 million . . . a statutory maximum five-year term of probation for each of the SAC Companies[18], the condition that the SAC hedge fund terminate its investment advisory business, effectively closing the hedge fund to outside investors; and a requirement that the defendants, and any successor entities, employ the compliance procedures necessary to identify and prevent insider trading; and that the defendants retain an independent compliance consultant, who will review, revise and report to the government on those compliance procedures."[19] In total, SAC paid roughly $1.8 billion in settling the civil and criminal charges. Below, we provide further updates concerning the SEC enforcement actions involving SAC.

*U.S. v. Martoma*

On February 6, 2014, a jury in the U.S. District Court for the Southern District of New York found Matthew Martoma ("Martoma"), a former portfolio manager at SAC, guilty of two counts of securities fraud and one count of conspiracy to commit securities fraud.[20]

Martoma was charged with insider trading based on material, nonpublic information received from two doctors regarding problems during a clinical trial for an experimental Alzheimer's drug being developed by Elan Corp., Plc and Wyeth LLC (collectively, the "Companies"). SAC had built a $700 million long position in the Companies, and then allegedly liquidated it based largely on Martoma's inside information. Prosecutors alleged that the sales enabled SAC to avoid losses and generate profits totaling $275 million by the time the Companies publicly announced the problems with the clinical trial on July 30, 2008.

Dr. Sidney Gilman, a former University of Michigan medical professor and an expert in treating brain diseases, and another doctor, Dr. Joel Ross, testified at trial that they provided the confidential information to Martoma during paid consultations that were set up through expert networking firms.[21] Both doctors testified pursuant to non-prosecution agreements. Martoma's sentencing is expected to occur sometime this summer.

*SEC v. Dennis*

On March 13, 2014, the SEC charged Ronald Dennis ("Dennis"), a former analyst at an affiliate of SAC, in the U.S. District Court for the Southern District of New York with insider trading in the securities of Dell Inc. ("Dell") and Foundry Networks ("Foundry").[22] The SEC alleged that Dennis netted $3.75 million for SAC in illicit gains and avoided loss from these trades. The charges against Dennis stem from the SEC's broader investigation into expert networks, which connect buy side investors with industry experts for consultations and investment research advice.

According to the complaint, Dennis received material, non-public information from Jess Tortora ("Tortora"), an analyst at Diamondback Capital Management LLC.[23] Specifically, the SEC alleged that Dennis received Dell's financial performance results in advance of at least two Dell quarterly earnings announcements. Among the evidence cited in the complaint is an instant message that Tortora sent to Dennis within minutes of one of the Dell announcements, in which Tortora wrote "your [sic] welcome," and Dennis responded "you da man!!! I owe you."[24] Other text messages had similar communications. The SEC alleged that Tortora received the information from a friend who communicated with a Dell insider. As a result of the alleged insider trading scheme, the SEC claims that Dennis caused hedge funds managed by CR Intrinsic (a SAC affiliate) and SAC to generate approximately $3.2 million in profits and avoided losses.[25]

The SEC separately alleged that Dennis received material, non-public information about an impending acquisition of Foundry from Matthew Teeple, an analyst at a San Francisco-based hedge fund advisory firm.[26] Shortly after receiving the inside information, Dennis allegedly caused a hedge fund managed by CR Intrinsic to purchase Foundry stock, which generated approximately $550,000 in profits.[27]

Dennis agreed to pay $95,351 in disgorgement, $12,632.34 in prejudgment interest and a $95,351 penalty, and agreed to be permanently enjoined from future violations of the federal securities laws.[28]

### *B. Fraudulent Misrepresentation*

Fraudulent misrepresentations continue to be a staple of SEC enforcement actions. Hedge fund managers have been charged with affirmatively misrepresenting fund performance, trading strategies and fee disclosures in order to lure and retain investors in their funds. Below we provide one such example, as well as another case in which a hedge fund and its manager allegedly made a fraudulent offer to acquire the shares of another company. In addition to affirmative misrepresentations, hedge fund and asset managers have also been charged with failing to disclose material information to their clients. In one such example, summarized below, an asset management company was charged with failing to tell its clients about a trading error that caused losses in accounts subject to ERISA.

*SEC v. Sample*

On April 4, 2014, the SEC filed suit in the U.S. District Court for the Northern District of Texas alleging that hedge fund manager Matthew D. Sample ("Sample") fraudulently raised approximately $1 million from five investors between 2009 and 2012.[29] Sample allegedly represented to investors that he would trade options by employing a proprietary trading strategy. When the trading strategy failed, Sample allegedly provided investors with false documents that made it appear as if his trading was successful.[30] Additionally, to satisfy redemption requests, Sample raised money from a new investor by falsely claiming he would use the money to trade securities on the investor's behalf.[31] Finally, Sample diverted at least one-third of the investor monies for his own personal use, including for credit card payments, retail purchases, meals and entertainment, as well as to make payments to other investors. This use of funds was contrary to Sample's representations that he would only take a monthly management fee of 1/12 of 1% of the fund's net asset value, 20% of trading profits and only limited fund-related expenses.[32]

The SEC charged Sample with violating Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), (2) and (4) of the Advisers Act. Sample consented to permanent injunctions against violations of these provisions and from directly or indirectly soliciting or accepting funds for any unregistered offering of securities. Additionally, the SEC moved for an order of disgorgement of ill-gotten gains and/or a civil penalty. Sample did not admit or deny the allegations, and is precluded from arguing that he did not violate the federal securities laws or challenging the allegations of the complaint in connection with any upcoming hearing for disgorgement and civil penalties.[33]

*SEC v. Mascioli*

On March 13, 2014, the SEC settled charges against Alexander Mascioli ("Mascioli") and his hedge fund, North Street Capital, LP ("NSC"), in the U.S. District Court for the District of Connecticut. The SEC had charged Mascioli and NSC with making a fraudulent offer to acquire all of the outstanding shares of common stock of Winnebago Industries, Inc. ("WGO").[34]

According to the SEC, on May 9, 2012, Mascioli sent an offer on NSC letterhead to WGO, offering to acquire the shares for approximately $321 million in cash. NSC advised WGO that it would be prepared to complete the acquisition process within approximately two weeks.[35] The SEC alleged that, at the time, Mascioli and NSC had virtually no assets, no reasonable prospects of securing any financing to fund the acquisition, and they had not even retained any financial or legal advisors to represent them in the transaction.[36] The SEC also alleged that Mascioli created a website for NSC that contained various misrepresentations about NSC's business. For example, the SEC alleged that NSC's website emphasized NSC's specialization in leveraged buyouts ("LBOs"), even though NSC had never participated in an LBO. NSC's website also allegedly included statements that its core markets were automotive, consumer retail and business services even though NSC had not engaged in a single transaction in any of those markets.[37]

The SEC also alleged that Mascioli, acting on behalf of NSC, published the May 9, 2012 letter to WGO by e-mailing a copy of it to Bloomberg in the form of a press release. The press release allegedly contained the same false and misleading statements as the offer letter, and he copied a fictitious NSC employee, Christina Stark, on the e-mail to make it seem legitimate.[38] After Bloomberg posted the press release on its website, WGO's stock price and trading volume increased significantly.[39]

Mascioli and NSC consented to entry of a final judgment permanently enjoining each of them from violating Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and ordering them to pay, jointly and severally, a $100,000 civil penalty. Mascioli also consented to a final judgment that permanently bars him from serving as an officer and/or director of a public company. The proposed settlement is still subject to court approval."[40]

*In re Western Asset Management Company*

On January 27, 2014, the SEC issued an order instituting administrative and cease-and-desist proceedings against investment adviser Western Asset Management ("WAM") for alleged trading errors involving accounts subject to ERISA.[41]

According to the SEC, in early 2007, WAM improperly allocated a restricted private placement to ERISA accounts under its management, as a result of a coding error.[42] At the time of placement, neither the trader at WAM nor the compliance staff recognized that the security was not ERISA eligible, and accordingly placed $90 million par value of the issue in a number of ERISA client accounts over the course of several months.

In October 2008, WAM allegedly became aware of the coding error, and corrected the coding fields from ERISA eligible to ERISA ineligible. However, it did not notify its ERISA clients of the improper allocation. By this time, the value of the security had dropped by more than 25% percent. Subsequently, in May and June 2009, WAM sold the positions held by the ERISA plans at prices which were "materially lower" than the purchase prices.[43] At time of sale, WAM did not notify its ERISA clients of the improper allocation of the security to their accounts. According to the SEC, it was not until more than one year after the sale, when WAM learned of the SEC investigation, that clients were first notified.

The SEC charged WAM with violating Section 206(2) of the Advisers Act for willfully engaging in a transaction, practice or course of business which operates as a fraud or deceit upon a client. The SEC also charged WAM with violating Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder for failing to implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder. The order directs WAM to (i) make a distribution of $9,620,392 to the affected ERISA plans; (ii) hire an independent consultant to conduct a comprehensive review of WAM's supervisory, compliance, and other policies and procedures designed to resolve allocation and coding errors; and (iii) cease and desist from violating or causing violations of various provisions of the federal securities laws. Additionally, WAM agreed to pay disgorgement of $8,111,582 and prejudgment interest of $1,508,810.[44]

This action is significant not only because it illustrates the importance of following internal error correction practices, but also because it illustrates how broadly the SEC staff views the concept of a trade error. Advisers that manage ERISA accounts in the fixed income area should confirm that their pre-trade compliance procedures in this area are well designed to ensure that ineligible fixed income securities are not acquired for ERISA accounts.

### *C. Valuation Issues*

As discussed in prior reports, the SEC has instituted the "Aberrational Performance Inquiry" initiative. The initiative uses proprietary risk analytics to evaluate hedge fund returns. Inconsistent or abnormal returns can subject a fund to closer scrutiny. Below is a case that arose from that initiative involving a London-based hedge fund adviser.

*In re GLG Partners, Inc.*

On December 12, 2013, the SEC charged GLG Partners, L.P., a London-based hedge fund adviser ("GLG"), and GLG Partners Inc., its former U.S.-based holding company ("GPI"), with internal control failures that led to the overvaluation of a fund's assets and inflated fee revenue.[45] GLG is not registered with the SEC but is regulated by the U.K. Financial Conduct Authority. The allegedly deficient internal controls led to a purported overvaluation of an illiquid asset in one of the firms' funds for more than two years, allegedly resulting in the collection of nearly $7.77 million in inflated management fees.[46]

The order states that GLG and GPI caused violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder. The order requires the firms to hire an independent consultant to recommend new policies and procedures for the valuation of assets. The order further directs the firms to cease and desist from violating or causing violations of various provisions of the federal securities laws. Additionally, the firms agreed to pay disgorgement of $7,766,667, prejudgment interest of $437,679 and penalties totaling $750,000.[47]

### *D. Conflicts of Interest*

Undisclosed conflicts of interest are another area that often results in enforcement actions against hedge funds. In particular, the SEC has been interested in identifying conflicts of interest in principal transactions where an adviser acts for its own account while buying or selling a security for a client account. Below are two conflicts of interest cases, one of which involves principal transactions.

*In re Agamas Capital Management, LP*

On November 19, 2013, the SEC issued an Order Instituting Administrative and Cease-and-Desist Proceedings (the "Order") against hedge fund manager and investment adviser Agamas Capital Management, LP ("Agamas").[48] Agamas managed almost $900 million in assets through Agamas Continuum Master Fund, Ltd. (the "Continuum Fund") and a separately managed account that emulated the risk, performance and asset profile of the Continuum Fund. The Order found that Agamas failed to adopt and implement effective written compliance policies and procedures, as required by Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, concerning the following areas of private fund management: (i) the valuation of fund assets; (ii) the accuracy of disclosures to fund investors about the valuation practice; and (iii) cross trades between clients.[49]

Regarding the valuation issues, the SEC alleged that Agamas deviated from its written policy of valuing non-widely quoted securities based on a methodology of "calculating a weighted average of available quotes from independent broker-dealers."[50] Instead, Agamas used its discretion to discard quotes without documenting its rationale or overrode the final price under its disclosed methodology by substituting its own market price.[51] While Agamas's disclosures allowed for the exercise of valuation discretion under certain circumstances, it failed to fully document the basis for exercising such discretion, as required under its policy.[52]

The SEC also alleged that Agamas engaged in 32 impermissible cross trades between the Continuum Fund and the separately managed account. Agamas's disclosures stated that "conflicts of interest may arise if Agamas began advising separate accounts with similar investment strategies," but Agamas never adopted or implemented policies or procedures to address how it would manage those potential conflicts. Additionally, Agamas's trades included trades that caused the separately managed account to breach an exposure limit.[53]

The SEC charged Agamas with violating Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. Agamas agreed to a censure and a $250,000 penalty. Agamas also agreed to (i) deliver a copy of the Order to all investors who owned any interest in the Continuum Fund or its feeder funds in 2007 or 2008; and (ii) certify to the SEC its compliance with that undertaking and provide evidence of that compliance.[54]

*In re Parallax Investments and In re Tri-Star Advisors, Inc.*

On November 26, 2013, the SEC issued orders instituting administrative and cease-and-desist proceedings against hedge fund manager Parallax Investments, LLC ("Parallax"),[55] investment adviser Tri-Star Advisors, Inc. ("TSA")[56] and executives of each firm for allegedly engaging in principal transactions through Tri-Star Financial ("TSF"), an affiliated brokerage firm, co-owned by executives from Parallax and TSA, without notifying or obtaining the requisite consent from clients.[57] The SEC alleged that Parallax's owner, John P. Bott II ("Bott") aided, abetted and caused Parallax's violations, and that TSA's Chief Executive Officer William T. Payne ("Payne") and President Jon C. Vaughan ("Vaughan") caused TSA's violations, for which they collectively were paid more than $2 million in sales credits.

With regard to Parallax, the SEC alleged that Bott initiated and executed at least 2,000 undisclosed principal transactions from 2009 to 2011 without the consent of Parallax's clients.[58] In each transaction, TSF used its inventory account to purchase mortgage-backed bonds for Parallax clients, and then transferred the bonds to the applicable client accounts. Bott, who was a 40% owner of TSF, received 55% of the sales credit generated by each trade. Bott was aware that Parallax did not disclose to or obtain consent from its clients before executing these principal transactions.[59] The SEC charged both Bott and Parallax with violating Section 206(3) of the Advisers Act. The SEC also charged Parallax with violating Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder for failing to undertake an annual surprise exam or distribute annual audited financial statements to its investors, and Sections 204A and 206(4) of the Advisers Act and Rules 204A-1 and 206(4)-7 thereunder for failing to adopt and implement proper written compliance policies and a written code of ethics.[60] Bott and Parallax's CCO, F. Robert Falkenberg, was charged with aiding and abetting Parallax's violations of Sections 206(4) and 204A of the Advisers Act and Rules 204A-1, 206(4)-2 and 206(4)-7 thereunder.[61]

Concerning TSA, the SEC alleged that Payne and Vaughan executed more than 2,000 principal transactions with its advisory clients without providing prior written disclosure to clients or obtaining consent.[62] TSA allegedly executed the trades through TSF. Payne and Vaughan, who owned 40% and 20% of TSF, received approximately 55% of the sales credit generated by each trade respectively.[63] The SEC charged TSA with violating Section 206(3) of the Advisers Act. The SEC also charged TSA with violating Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder for failing to implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder. Payne and Vaughn were charged with having caused TSA's violations of Sections 206(3) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.[64]

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

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[1] Rule 501 under Regulation of the Securities Act defines an "accredited investor" to include natural persons who have (i) individual net worth, or joint net worth with their spouse, that exceeds $1 million at the time of the purchase, excluding the value of their primary residence; or (ii) income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year.

[2] 78 Fed. Reg. 78864 (Australia), 78 Fed. Reg. 78839 (Canada), 78 Fed. Reg. 78923 (the EU), 78 Fed. Reg. 78852 (Hong Kong), 78 Fed. Reg. 78910 (Japan) and 78 Fed. Reg. 78899 (Switzerland).

[3] 78 Fed. Reg. 78878 (the EU); 78 Fed. Reg. 78890 (Japan).

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

[5] Switzerland has amended its national law in order to take account of the AIFMD provisions even though it is not a Member State.

[6] The Cayman Islands has currently entered into approximately 30 TIEAs with EU Member States.

[7] For example, under French law non-EU AIFMs must pay careful attention not to engage in "marketing" as defined under French law (which, for example, excludes the sale of financial instruments in response to an investor's unsolicited request to purchase such financial instruments). In some jurisdictions (for example, Belgium) the concept is not covered at all under the local law/implementing law and is therefore thought to be permitted. In Germany placement of AIF interests is not subject to the implementing law when not made at the "initiative" of the AIFM. "Reverse solicitation" applies to both (i) an approach by a potential investor on its own initiative and (ii) a fund manager approaching a potential investor when there is a pre-existing relationship with the potential investor. A relationship is deemed to pre-exist when there has been certain intensity in past contact and where a connection with the relevant product category can be made. The difference of interpretation can be seen again under Swedish law where, in a situation of reverse solicitation the information provided must specifically relate to the AIF on which the investor has requested information about and the AIFM is not allowed to provide the investor with information on a continuous basis. Further guidance is awaited to clarify whether if the AIF it marketed before it has been established, there is a risk that the marketing activities carried out at that time will be considered to constitute marketing at the later date when the AIF has been established and the investors (on their own initiative) invest in the AIF. Following guidance from the Financial Conduct Authority in the United Kingdom it has been set out that in order to be able to take advantage of a reverse solicitation and for the AIFM to provide information with regards to a specific AIF, the solicitor must first name the specific AIF in its solicitation.

[8] 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.

[9] References to the "Code" are to the Internal Revenue Code of 1986, as amended.

[10] *SEC v. Contorinis*, 2014 U.S. App. LEXIS 2927, Case No. 12-1723 (2d Cir. Feb. 18, 2014).

[11] *Morgan Stanley v. Skowron*, Case No. 1:12-cv-08016 (S.D.N.Y. Dec. 19, 2013).

[12] *Gruss v. Zwirn*, Case No. 1:09-cv-06441 (S.D.N.Y. July 10, 2013; subsequent decision, Nov. 20, 2013).

[13] *In re Steinhardt Partners*, L.P., 9 F.3d 230 (2d Cir. 1993).

[14] Greg Roumeliotis and Sarah N. Lynch, *Exclusive: U.S. SEC Forms Squad to Examine Private Funds*, Reuters (Apr. 7, 2014), *available at* http://www.reuters.com/article/2014/04/07/us-sec-privatefunds-idUSBREA360M420140407.

[15] SEC FY 2015 Budget Request by Program at p. 55, *available at* http://www.sec.gov/about/reports/sec-fy2015-budget-request-by-program.pdf ("SEC FY2015 Budget Request").

[16] SEC FY 2015 Budget Request at p. 51.

[17] *See* Section I.C.8 of this Report for additional discussion of the SEC Compliance Outreach Program National Seminar. *See also* presentation at http://www.sec.gov/info/cco/ccons2014-presentation.pdf.

[18] The "SAC Companies" include SAC, S.A.C. Capital Advisors, LLC, CR Intrinsic Investors, LLC ("CR Intrinsic"), and Sigma Capital Management, LLC.

[19] Press Release, *SAC Capital Management Companies Sentenced in Manhattan Federal Court for Insider Trading*, S.D.N.Y. U.S. Attorney's Office (Apr. 10, 2014), *available at* http://www.justice.gov/usao/nys/pressreleases/April14/SACSentencingPR.php.

[20] Ex-SAC Trader Convicted of Securities Fraud, The New York Times Dealbook (Feb. 6, 2014), *available at* http://dealbook.nytimes.com/2014/02/06/former-sac-trader-found-guilty-of-insider-trading/?_php=true&_type=blogs&_r=0..

[21] SAC Capital's Martoma found guilty of insider trading, Reuters (Feb. 6, 2014), *available at* http://www.reuters.com/article/2014/02/06/us-sac-martoma-idUSBREA131TL20140206.

[22] SEC Litig. Release No 22942 (March 13, 2014), *available at* http://www.sec.gov/litigation/litreleases/2014/lr22942.htm.

[23] SEC v. Ronald Dennis, 14-CV-1746, S.D.N.Y (March 19, 2014), *available at* http://www.sec.gov/litigation/complaints/2014/comp-pr2014-53.pdf.

[24] *Id*. at ¶ 44.

[25] *Id*. at ¶ 38.

[26] The SEC charged Teeple and two others last year for insider trading in Foundry stock.

[27] *Id*. at ¶¶ 26-30.

[28] EC Litig. Release No. 22942 (Mar. 13, 2014), *available at* http://www.sec.gov/litigation/litreleases/2014/lr22942.htm

[29] SEC v. Matthew D. Sample, 3:14-cv-01218-B, N.D. Tex. (Apr. 4, 2014), *available at* https://www.sec.gov/litigation/complaints/2014/comp22967.pdf.

[30] *Id*. at ¶ 1.

[31] *Id*. at ¶¶ 1, 15.

[32] *Id*. at ¶¶ 10-11.

[33] SEC Litig. Release No. 22967 (Apr. 7, 2014), *available at* http://www.sec.gov/litigation/litreleases/2014/lr22967.htm.

[34] SEC Litig. Release No. 22941 (March 13, 2014), *available at* http://www.sec.gov/litigation/litreleases/2014/lr22941.htm ("Mascioli Release).

[35] SEC v. Alexander H. Mascioli, 3:14-cv-00325, D. Conn. (March 13, 2014), *available at* http://www.sec.gov/litigation/complaints/2014/comp22941.pdf.

[36] *Id*. at ¶ 3.

[37] *Id*. at ¶ 12.

[38] *Id*. at ¶ 31.

[39] *Id*. at ¶¶ 32-34.

[40] Mascioli Release, *supra* note 34.

[41] SEC Release No. 2014-13 (Jan. 27, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540675955.

[42] *In re Western Asset Management Company*, Administrative Proceeding, File No. 3-15689 (Jan. 27, 2014), *available at* http://www.sec.gov/litigation/admin/2014/ia-3763.pdf, at p. 3-4.

[43] *Id.* at p. 6.

[44] *Id.* at pp.7-11.

[45] SEC Release No. 2013-259 (Dec. 12, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540491613.

[46] *In re GLG Partners, Inc.*, Administrative Proceeding, File No. 3-15641 (Dec. 12, 2013), *available at* http://www.sec.gov/litigation/admin/2013/34-71050.pdf.

[47] SEC Release No. 2013-259 (Dec. 12, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540491613.

[48] *In re Agamas Capital Management, LP*, Administrative Proceeding, File No. 3-15616 (Nov. 19, 2013), *available at* http://www.sec.gov/litigation/admin/2013/ia-3719.pdf.

[49] *Id.* at ¶ 2.

[50] *Id.* at p. 4.

[51] *Id.* at p. 5.

[52] *Id.* at p. 4.

[53] *Id.* at p. 5-7.

[54] *Id.* at pp. 8-9.

[55] *In re Parallax Investments, LLC*, Administrative Proceeding, File No. 3-15626 (Nov. 26, 2013), *available at* http://www.sec.gov/litigation/admin/2013/34-70944.pdf ("Parallax Order").

[56] *In re Tri-Star Advisors, Inc.*, Administrative Proceeding, File No. 3-15627 (Nov. 26, 2013), *available at* http://www.sec.gov/litigation/admin/2013/ia-3727.pdf ("Tri-Star Order").

[57] SEC Release No. 2013-250 (Nov. 26, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540414827.

[58] Parallax Order, *supra* note 55, at ¶ 11.

[59] *Id.* ¶¶ at 4, 8, 13.

[60] *Id.* ¶¶ at 14-19.

[61] *Id.* ¶¶ at 21-26.

[62] Tri-Star Order, *supra* note 56, at ¶ 10.

[63] *Id.* ¶ at 8.

[64] *Id.* ¶¶ at 14-17.