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Hedge Fund Report—Summary of Key Developments—Fall 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 Spring 2014, and highlights recent regulatory and tax developments, as well as recent civil litigation and enforcement actions as they relate to the hedge fund industry. Paul Hastings attorneys are available to answer your questions on these and any other developments affecting hedge funds and their investors and advisers.

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I. SECURITIES-RELATED LEGISLATION AND REGULATION

A. Dodd-Frank Updates

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

1. *SEC Reviewing Accredited Investor Standards*

As discussed in our prior Report, Section 413(b) of the Dodd-Frank Act requires the SEC to undertake a review of the definition of "accredited investor" in Regulation D of the Securities Act of 1933, as amended (the "Securities Act"), as it applies to natural persons, at least once every four years. On October 9, 2014, in connection with the SEC's statutorily mandated review, the SEC's Investment Advisory Committee (the "Advisory Committee") adopted recommendations encouraging the SEC to "consider alternative approaches" to the financial thresholds in the current accredited investor definition. Among others, the Advisory Committee suggested that the SEC (i) enable individuals to qualify as accredited investors based on their financial sophistication (e.g., through professional credentials, professional experience, or investment experience) or (ii) consider the percentage of an investor's income or assets that have been invested in private offerings. The Advisory Committee also urged the SEC to encourage development of alternative methods to verify accredited investor status by reliable third parties (e.g., securities professionals, such as brokers and investment advisers, accountants and attorneys) and to strengthen protections that apply when non-accredited investors qualify to invest in a private offering by virtue of relying on advice from a purchaser representative.

The full text of the Advisory Committee's recommendations is available here.

2. *SEC Proposes Extension to Temporary Rule Regarding Principal Trades with Certain Advisory Clients*

On August 12, 2014 the SEC issued a proposed rule to extend the sunset date for the Principal Trade Rule, temporary Rule 206(3)-3T under the Advisers Act of 1940, as amended (the "Advisers Act"), an additional two years, until December 31, 2016. The Principal Trade Rule provides an alternative means for registered investment advisers that are also SEC-registered broker-dealers ("Dual Registrants") to meet the requirements of Section 206(3) of the Advisers Act ("Section 206(3)") when they act in a principal capacity in transactions with certain of their advisory clients.

Section 206(3) imposes a prior consent requirement on any registered investment adviser that acts as principal in a transaction with a client, or that acts as broker in connection with a transaction for, or on behalf of, a client, on a transaction-by-transaction basis. Under the Principal Trade Rule, Dual Registrants may comply with Section 206(3) with respect to a non-discretionary advisory account by, among others: (i) providing written prospective disclosure regarding the conflicts arising from principal trades; (ii) obtaining written, revocable consent from the client prospectively authorizing the adviser to enter into principal transactions; (iii) making certain disclosures, either orally or in writing, and obtaining the client's consent before each principal transaction; (iv) sending to the client confirmation statements disclosing the capacity in which the adviser has acted and disclosing that the adviser informed the client that it may act in a principal capacity and that the client authorized the transaction; and (v) delivering to the client an annual report itemizing the principal transactions.

The SEC staff noted in its release discussing the proposed rule that it was proposing the extension because it believes that the issues raised by principal trading should be considered as part of the SEC's broader consideration of the regulatory requirements applicable to broker-dealers and investment advisers in connection with the Dodd-Frank Act, and the SEC does not expect to complete its consideration of the regulatory requirements applicable to Dual Registrants prior to the current sunset date for the Principal Trade Rule. Comments were due on the proposed rule on September 17, 2014.

Additional information on the Principal Trade Rule is available here. The full text of the SEC release proposing the extension of the Principal Trade Rule is available here.

3. *SEC Letter to Newly Registered Municipal Advisers Regarding the National Examination Program*

On August 19, 2014, the SEC Office of Compliance Inspections and Examinations ("OCIE") published a letter addressed to senior executives and principals of municipal advisers ("MAs") that are newly registered under the SEC's municipal adviser rules[1] advising them of OCIE's upcoming risk-based examinations of certain newly registered MAs that are registered with the SEC but not with the Financial Industry Regulatory Authority, Inc. (the "MA Examination Initiative"). The MA Examination Initiative is part of OCIE's National Examination Program (the "NEP"). The MA Examination Initiative will take place over the next two years in three phases: engagement, examination and informing policy.

In the engagement phase, NEP staff will engage in nationwide outreach to inform newly registered MAs about their obligations under the Dodd-Frank Act, the MA Examination Initiative, and OCIE's practice of engaging directly with firms' senior management.

In the examination phase, NEP staff will review one or more of the identified risk areas of the business and operations of the MAs selected for examination: (i) compliance with registration rules of the SEC and the Municipal Securities Rulemaking Board ("MSRB"); (ii) compliance with statutory fiduciary duty requirements established under the Dodd-Frank Act and SEC and MSRB rules; (iii) accuracy of disclosures made by the MAs to their client municipalities; (iv) whether the MAs are dealing fairly with any person or entity that may be harmed by an MA; (v) whether the MAs have policies, procedures and controls in place to supervise their MA business; (vi) whether the MAs have created and maintained books and records required under SEC and MSRB rules; and (vii) the knowledge and training of the MAs' staff.

Following the examination phase, in the informing policy phase, the NEP intends to report its observations to the SEC, which report may include (but is not limited to) common practices identified in high-risk focus areas, industry trends and significant issues.

The full text of OCIE's letter to senior executives and principals of newly registered MAs is available here.

4. OCIE Director Discusses Progress of Presence Examinations

As discussed in our prior Reports, on October 2012 OCIE commenced the NEP "presence exam" initiative for newly registered (i.e., since July 21, 2011) investment advisers (the "Initiative"). On May 6, 2014, OCIE director Andrew Bowden, speaking at the Private Equity International Private Fund Compliance Forum 2014 in New York City, discussed observations from the NEP's ongoing examination of more than 150 private equity advisers under the Initiative.

Mr. Bowden stated that the most common observations made by NEP examiners related to an adviser's collection of fees and allocation of expenses, noting that NEP examiners identified what they believed to be violations of law or material weaknesses in more than 50% of exams. Common identified deficiencies relating to fees and expenses included, among others, (i) payments made to "operating partners" directly by portfolio companies or funds without sufficient disclosure to investors, (ii) advisers shifting expenses from themselves to clients during the middle of a fund's life without disclosure to investors, and (iii) advisers charging hidden fees (e.g., accelerated monitoring fees) without sufficient disclosure to investors. Mr. Bowden also highlighted valuation issues identified during the Initiative. Specifically he noted that NEP examiners commonly identified advisers using valuation methodologies different from the ones that had been disclosed to investors. Mr. Bowden emphasized that the NEP's focus with respect to valuation issues is not on second-guessing the adviser's valuations but rather on ensuring that the adviser's actual valuation process "aligns with the process that an adviser has promised to investors."

Although Mr. Bowden's comments focused on private equity fund advisers, many of his observations (particularly with respect to valuation issues) will also be relevant to investment advisers to hedge funds. The full text of Mr. Bowden's remarks is available here.

B. JOBS Act Updates

1. CFTC Lifts Prohibition against General Solicitation and Advertising for Private Funds

As described in our Fall 2013 Report, effective September 23, 2013 (the "Effective Date"), the SEC adopted rules to eliminate, under certain circumstances, the prohibition against general solicitation and advertising in securities offerings made pursuant to Rule 506(c) of Regulation D and Rule 144A under the Securities Act (the "SEC General Solicitation Rules"). The SEC's action was mandated by the JOBS Act.

Because of conflicting requirements in CFTC Rules 4.7(b) and 4.13(a)(3) (the "CFTC Rules"), commodity pool operators ("CPOs") relying on the CFTC Rules were not able to take advantage of the SEC General Solicitation Rules as of the Effective Date. On September 9, 2014, the CFTC Division of Swap Dealer and Intermediary Oversight (the "DSIO") issued a letter ("CFTC Letter No. 14-116") which addressed the inconsistencies between the SEC General Solicitation Rules and the CFTC Rules. CFTC Letter No. 14-116 grants exemptive relief (i) from the requirements in CFTC Rule 4.7(b) that an offering be exempt pursuant to Section 4(a)(2) of the Securities Act and be offered solely to qualified eligible persons (as defined in CFTC Rule 4.7); and (ii) from the requirement in CFTC Rule 4.13(a)(3)(i) that securities be "offered and sold without marketing to the public."

The exemptive relief provided by CFTC Letter No. 14-116 is only available for CPOs who are issuers relying on the exemption provided by Rule 506(c) of Regulation D or CPOs who are using entities reselling securities pursuant to Rule 144A under the Securities Act. Further, CPOs claiming the exemptive relief in CFTC Letter No. 14-116 must file a notice with the CFTC which should include, among others, a description of the CFTC Rules being relied upon by the CPO and a representation that the CPO meets the conditions of the relevant CFTC Rule, with the exception of the conditions exempted by CFTC Letter No. 14-116.

The full text of CFTC Letter No. 14-116 is available here.

2. SEC Offers Additional Guidance on Verification of Accredited Investor Status Under Rule 506(c)

On July 3, 2014, the staff of the SEC Division of Corporation Finance ("Corp Fin") published Compliance and Disclosure Interpretations (the "New CD&Is") addressing issues arising under the accredited investor verification safe harbors in Rule 506(c) under the Securities Act. As discussed in our prior Report, private fund advisers relying on the SEC General Solicitation Rules 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.

Rule 506(c)(2)(ii) sets forth three verification "safe harbors" whereby issuers can verify a purchaser's accredited investor status by reviewing specific documentation described in the safe harbors and obtaining from the purchaser certain representations. An issuer taking advantage of any one of these three safe harbors will be deemed to have taken reasonable steps to verify that a natural person who purchases securities in such offering is an accredited investor; provided, however, that the issuer does not have knowledge that such person is not an accredited investor.

The New CD&Is clarify that the safe harbors are not available if the purchaser cannot provide the documentation specified in Rule 506(c)(2)(ii), including if the purchaser cannot provide documentation for all of the time periods specified by the relevant safe harbor. However, the New CD&Is also provide principles-based verification methods (e.g., reviewing comparable documents and making additional inquiries, if necessary) to satisfy the verification requirement of Rule 506(c) in each of these circumstances.

The New CD&Is also provide guidance on what exchange rate to use when a purchaser's annual income is not reported in U.S. dollars and whether assets in an account or property held jointly with another person who is not the purchaser's spouse can be included in determining whether the purchaser satisfies the accredited investor net worth test.

The New CD&Is are available here.

C. Other Securities-Related Updates

1. SEC Staff Issues Guidance on Investment Adviser Use of Proxy Advisory Firms

On June 30, 2014, the SEC Division of Investment Management (the "IM Division") and Corp Fin published Staff Legal Bulletin No. 20, Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms (the "Proxy Guidance"). The Proxy Guidance provides guidance about investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms, including, but not limited to, (i) steps an investment adviser can take to demonstrate that proxy votes are cast in accordance with clients' best interests and the adviser's proxy voting procedures adopted pursuant to Rule 206(4)-6 under the Advisers Act (the "Proxy Rule"); (ii) whether the Proxy Rule requires an investment adviser to vote every proxy; (iii) considerations for an investment adviser retaining a proxy advisory firm to assist it in its proxy voting duties; (iv) whether an investment adviser has an ongoing duty under the Proxy Rule to oversee a proxy advisory firm that it retains; and (v) an investment adviser's duties with respect to the material accuracy of the facts upon which the proxy advisory firm's voting recommendations are based.

The SEC staff states in the Proxy Guidance that it believes an investment adviser retaining a third party (such as a proxy advisory firm) to assist with proxy voting responsibilities should, in order to comply with the Proxy Rule, adopt and implement policies and procedures reasonably designed to provide sufficient ongoing oversight of the third party in order to ensure that the investment adviser, acting through the third party, continues to vote proxies in the best interests of its clients. Further the Proxy Guidance notes that an investment adviser receiving voting recommendations from a proxy advisory firm should ascertain, among other things, whether the proxy advisory firm has the capacity and the competency to adequately analyze proxy issues, including the ability to make voting recommendations based on materially accurate information. If an investment adviser determines that the proxy advisory firm's recommendation was based on a material factual error that causes the investment adviser to question the process by which the proxy advisory firm develops its recommendations, the Proxy Guidance suggests that the investment adviser should take reasonable steps to investigate the error and seek to determine whether the proxy advisory firm is taking reasonable steps to seek to reduce similar errors in the future.

Investment advisers retaining proxy advisory firms should read the Proxy Guidance to ensure they are in compliance with the Proxy Rules. The full text of the Proxy Guidance is available here.

2. *SEC and CFTC Continue to Address Cybersecurity Issues Facing Investment Advisers*

As discussed in our prior Report, the SEC is actively addressing cybersecurity issues related to the securities markets and the financial services industry, including the OCIE initiative to assess cybersecurity preparedness in the securities industry through examinations of registered broker-dealers and investment advisers ("Cybersecurity Examinations"). Most recently, on May 1, 2014, OCIE director Andrew Bowden, speaking at the Regulatory Compliance Association's Enforcement, Compliance and Operations 2014 Symposium held in New York City, discussed a series of questions that will guide OCIE in the course of its Cybersecurity Examinations. With respect to governance, Mr. Bowden noted that OCIE will focus on whether the examinee (i) takes inventories of software and hardware; (ii) conducts risk assessments; and (iii) has a Chief Information or Security Officer. With respect to protections for networks and information, OCIE would want to know (i) whether the examinee has separate development and testing environments, utilizes encryption, or has controls around removable and mobile media; (ii) whether (and with what functionality) the examinee allows customers to access their accounts remotely; (iii) what protections the examinee has on its network; and (iv) how the examinee monitors and detects unauthorized access on its network. Investment advisers subject to Cybersecurity Examinations should be prepared to address these questions in addition to the items addressed in OCIE's April 2014 National Exam Program Risk Alert on Cybersecurity Examinations (the "Cybersecurity Risk Alert"). The full text of the Cybersecurity Risk Alert (which was discussed in our Prior Report) is available here.

On November 5, 2014, CFTC Chairman Timothy G. Massad, speaking in Chicago at the Futures Industry Association Expo 2014, discussed CFTC activity with respect to cybersecurity. Mr. Massad noted that the CFTC has updated its regulations for clearinghouses, exchanges and other market infrastructure entities to address cybersecurity and information security by requiring these entities to have (i) risk analysis and oversight programs to identify and minimize sources of cyber and operational risk; (ii) reliable and secure automated systems that have adequate scalable capacity; (iii) emergency procedures, backup facilities and business continuity-disaster recovery plans; and (iv) regular, objective, independent testing to verify that system safeguards programs are sufficient to fulfill regulatory responsibilities. Each entity must also have a risk management program that addresses, among others, information security, systems development, quality assurance and governance. Mr. Massad stated that the CFTC conducts examinations to determine compliance with these requirements and that, in conducting these examinations, the CFTC looks for evidence to support management's assertions that they are in compliance with CFTC requirements. Mr. Massad highlighted four key focus areas of CFTC examinations: (i) board oversight and expertise with respect to cybersecurity issues; (ii) resources and capabilities devoted to monitor and control cybersecurity risks across all levels of organization; (iii) whether the regulated entity has adequate plans and policies in place to address critical areas and, if so, whether the plans and policies are actually followed; and (iv) an entity's vigilance and responsiveness in responding to identified weakness and problems. The full text of Mr. Massad's remarks are available here.

3. *IM Division Issues Guidance Update on Private Funds and the Application of the Custody Rule to Special Purpose Vehicles and Escrows*

In June 2014 the IM Division staff released a Guidance Update on Private Funds and the Application of the Custody Rule to Special Purpose Vehicles and Escrows (the "Guidance"). The Guidance addresses, among other topics, how the Custody Rule (Rule 206(4)-2 under the Advisers Act) applies when advisers to pooled investment vehicles, particularly private equity funds, utilize (i) special purpose vehicles when making investments ("Investment SPVs") and (ii) escrow accounts when selling interests in portfolio companies ("Escrows").

The Guidance discusses how the Custody Rule applies to investment advisers to pooled investment vehicles that rely on the audit provision, when the investment adviser utilizes Investment SPVs for legal, tax, regulatory or other similar purposes in four different scenarios: (i) to purchase a single investment on behalf of the pooled investment vehicle client; (ii) to purchase a single investment on behalf of multiple pooled investment vehicle clients; (iii) to purchase multiple investments on behalf of one or more pooled investment vehicle clients; and (iv) to purchase multiple investments on behalf of one or more pooled investment vehicle clients and third parties that are not pooled investment vehicles controlled by the adviser or the adviser's related person(s).

The Guidance also discussed the application of the Custody Rule to Escrows in circumstances involving the sale of a portfolio company owned by one or more pooled investment vehicles advised by a registered investment adviser and other persons that are not clients of the adviser. The Guidance states that the IM Division would not object if an adviser maintains client funds in an Escrow with other client and non-client assets, provided that: (i) the client is a pooled investment vehicle that relies on the audit provision and includes the portion of the Escrow attributable to the pooled investment vehicle in its financial statements; (ii) the Escrow is in connection with the sale or merger of a portfolio company owned by the client (i.e., an indemnification holdback or to adjust the purchase price); (iii) the Escrow contains an amount of money that is agreed upon as part of a bona fide negotiation between the buyer and the sellers; (iv) the Escrow exists for a period of time that is agreed upon as part of a bona fide negotiation between the buyer and the sellers; (v) the Escrow is maintained at a qualified custodian; and (vi) the sellers' representative is contractually obligated to promptly distribute the funds remaining in the Escrow at the end of the escrow period on a predetermined formula to the sellers, including the pooled investment vehicle clients.

The full text of the Guidance is available here.

4. *CFTC Issues Self-Executing No-Action Relief for Delegating CPOs*

On October 15, 2014, the DSIO issued CFTC Letter No. 14-126 (the "CFTC Letter") providing no-action relief from the requirement to register with the CFTC as a CPO to persons who have delegated certain of their responsibilities as a CPO of a commodity pool (each, a "Delegating CPO") to another person who is registered as a CPO (the "Designated CPO"), such that the Designated CPO will serve as the CPO of the pool in place of the Delegating CPO. The CFTC Letter fully replaces the DSIO's previous registration no-action position in CFTC Staff Letter No. 14-69, which was published on May 12, 2014 (the "Prior Letter"). The Prior Letter is available here.

The CFTC Letter restates the criteria for receiving registration relief under the Prior Letter, but clarifies some of the criteria in the Prior Letter and removes the Prior Letter's requirement that Delegating CPOs requesting registration relief submit a request for relief to the CFTC.

The relief granted in the CFTC Letter is self-executing, provided that all of the conditions in the CFTC Letter have been met. The full text of the CFTC Letter is available here.

5. *CFTC Extends Time Limited No-Action Relief for Certain Affiliated Counterparties*

On November 7, 2014, the CFTC issued no-action letters No. 14-135 and 14-136 extending the relief previously provided in CFTC Letters No. 14-25 (Time-Limited No-Action Relief from Certain Provisions of the Treatment of Outward-Facing Swaps Condition in the Inter-Affiliate Exemption) and No. 14-26 (Time-Limited No-Action Relief from the Commodity Exchange Act Section 2(h)(8) for Swaps Executed Between Certain Affiliated Entities Not Electing Commission Regulation § 50.52), respectively, for an additional year, until December 31, 2015. As discussed in our prior Report, CFTC Letters No. 14-25 and 14-26 granted temporary relief to "eligible affiliates" (as defined in CFTC Rule 50.52) from the mandatory swap clearing requirement under Section 2(h)(1) of the Commodity Exchange Act of 1936, as amended (the "CE Act"), and the mandatory swap exchange trading requirement under Section 2(h)(8) of the CE Act, respectively.

A copy of CFTC Letter No. 14-135 is available here. A copy of CFTC Letter No. 14-136 is available here.

6. *SEC Announces Sweep of Liquid Alternative Mutual Funds*

On March 19, 2014, OCIE associate director Jane Jarcho, speaking at the ICI Mutual Funds and Investment Management Conference in Orlando, Florida, announced that the SEC was launching a national sweep exam of retail alternative funds (mutual funds that employ hedge-fund-like strategies) (the "Liquid Alts Sweep"). On June 30, 2014, IM Division director Norm Champ, speaking at the Practising Law Institute Private Equity Forum in New York City, noted that the Liquid Alts Sweep will focus on liquidity, leverage and board oversight of alternative mutual funds. According to Ms. Jarcho and Mr. Champ, among the goals of the sweep are to ensure that the funds are complying with the Investment Company Act of 1940, as amended, and to inform the IM Division and SEC commissioners about areas in which fund managers may need additional guidance. The full text of Mr. Champ's speech is available here.

The Liquid Alts Sweep is looking at approximately 30 fund complexes and is scheduled to be completed by April 1, 2015.

7. Cayman Update

Rights of Third Parties

The Contracts (Rights of Third Parties) Law, 2014 (the "Contracts Law") was enacted in May 2014 to introduce a statutory regime to enable third parties to enforce terms in contracts governed by Cayman Islands law. The law is based on the English Contracts (Rights of Third Parties) Act 1999 although it has a number of enhancements. The introduction of this new legislation has brought the Cayman Islands in line with the United States, the United Kingdom (the "UK") and other leading financial jurisdictions in enabling parties to recognize third party beneficiaries to a contract. This is 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, which invariably raises questions as to what should be the governing law. The Contracts Law provides for the right of the third party to enforce a contractual term, provided that the contract specifically provides that such third party may do so. Unlike the existing English statute, rights for third parties are provided only where the contractual parties agree that the third party may specifically enforce. The English statutory provision whereby a third party may enforce a contractual term where the term "purports to confer a benefit" on a third party has not been adopted. The Contracts Law provides therefore something akin to an "opt in" system which is intended to provide, inter alia, greater certainty as to circumstances in which third parties can enforce contractual provisions.

Registration of Directors

The Directors Registration and Licensing Law, 2014 (the "Director Law") was enacted on June 4, 2014. The Director Law provides for the registration and licensing of individuals or companies appointed as directors of:

- corporate mutual funds regulated by the Cayman Islands Monetary Authority ("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 remit of the Directors Law extends to directors of Covered Entities wherever those directors are resident or incorporated. It does not extend to directors of general partners of CIMA-regulated partnerships, or to trustees of CIMA-regulated unit trusts. The Directors Law distinguishes between professional directors (i.e., being a natural person appointed as a director of 20 or more Covered Entities), corporate directors (i.e., being a body corporate appointed as a director of a Covered Entity), and natural persons who are not 'professional directors' ("non-professional directors").

Non-professional directors are required to be registered with CIMA. Non-professional directors who are directors of existing Covered Entities at the time of enactment of the Directors Law had until September 2014 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 are excused from the licensing requirement but are instead required to register with CIMA. Such persons are, broadly, 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 which fund manager is registered or licensed by one of the prescribed overseas regulatory authorities, so long as such 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 are required to be registered as a Cayman Islands company or as a foreign company in the Cayman Islands. Corporate directors which do not fall under one of these three categories will have six months from June 4, 2014 to comply. A corporate director is 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 are not required to be separately licensed under the Directors 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.

While it appears that the purpose of the Directors Law was to capture corporate directors established to act as such (e.g., for multiple hedge fund entities), caution must be used prior to using a corporate director in Cayman Islands structures in case such a corporate director is inadvertently brought within the licensing requirements of the Directors Law. Details of the registration and licensing process and applicable fees are available here on the CIMA website.

Changes to the Exempted Limited Partnership Law

A long-awaited overhaul of the Exempted Limited Partnership Law was enacted in July 2014 (as amended, the "Partnership Law"). An important focus of the Partnership Law is to conform the Cayman Islands statute to some extent to corresponding Delaware provisions. The Partnership Law has brought the Cayman Islands 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 Islands partnerships. The Partnership Law implements numerous enhancements to the existing regime and key changes include (i) enabling partners to determine more clearly the scope of a general partner's fiduciary responsibilities; (ii) allowing a foreign limited partnership to be registered under the Partnership Law in order to act as the general partner of a Cayman Islands exempted limited partnership; (iii) 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; (iv) further extending the safe harbor provisions to membership of such boards and committees; and (v) for financing purposes, clarifying that floating charges may be granted over the assets of a limited partnership. Other important changes include (i) recognition of default provisions of the kind usually found in limited partnership agreements; (ii) clarification of the statutory claw-back period; and (iii) simplifying the manner of admitting new partners and transferring partnership interests.

8. 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[2] (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")[3] to EEA[4]-based investors.

Where are we now?

The AIFMD came into force on July 22, 2013 (the "AIFMD Effective Date"). The AIFMD contains provisions regulating the management and the marketing of AIFs. For non-EU AIFMs the provisions related to management are limited to the management of EU AIFs and other AIFs which are also marketed to professional investors in the EEA. Some member states (including the UK) opted to implement transitional provisions permitting the continuation of marketing activities that had already commenced prior to the AIFMD Effective Date for one year, until July 22, 2014. However, all new non-EEA AIFs established after the AIFMD Effective Date do have to comply with the AIFMD marketing provisions if marketed in the EEA.

Marketing funds in the EEA through private placement regimes

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

- a co-operation agreement must be in place between the local regulator of the relevant 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").

Marketing

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

Notification to local regulator

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

A few member states are also either yet to fully implement the AIFMD, or have been late in doing so, and the regulatory environment is continuing to develop in most EEA jurisdictions. It is therefore always necessary to seek up-to-date local counsel advice in respect of each jurisdiction into which any form of marketing of non-EEA AIFs (whether actively or passively) is contemplated. Even where the AIFMD has been fully implemented, the regulators of those member states which do not permit marketing of non-EEA AIFs until they have been specifically approved, are facing noticeable delays in granting such permission.

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

Ongoing disclosure and reporting

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

- periodic publication of an annual report and audited financial statements for each AIF marketed in the 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 AIF marketed in the EEA;
- periodic disclosures to investors, including details of any illiquid assets, any changes to the AIF's liquidity or risk profile and, for leveraged funds, the total leverage of each AIF marketed along with any changes to maximum leverage and re-hypothecation rights; and
- periodic reporting to the local EU regulator in the EU Member State in which the AIF is marketed.

EU Passport

By no sooner than 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 EEA. If the passport regime is extended to non-EU AIFMs (and it is not clear it will be at all), these non-EU AIFMs will need to select a 'Member State of reference' and apply for authorization and supervision from the local regulator in that EU Member State.

If the passport regime is extended on a mandatory basis to non-EU AIFMs, it is the EU's intention that the NPPRs will be gradually phased out over a three year period and AIFMs will have to apply for an EU passport to market AIFs in the EEA. If the EU passport mechanism is not extended to non-EU AIFMs by ESMA, the NPPR regime will continue indefinitely.

Reverse Solicitation

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

II. TAXATION

Since our last Report, the Foreign Account Tax Compliance Act ("FATCA") has gone into effect, and all investment funds should be analyzing what is required of them under FATCA as of today. As further discussed below, investment funds subject to FATCA may benefit from a FATCA transition period during calendar years 2014 and 2015 in ensuring FATCA compliance.

There have not been a significant number of legislative tax developments since our last Report that relate to investment funds, although recent U.S. Internal Revenue Service ("IRS") guidance speaks to issues that affect alternative investment vehicles, as further discussed below. We continue to monitor legislative proposals and will update on any new developments in this area.

A. Recent FATCA Developments

FATCA, which was enacted in March 2010 in the Hiring Incentives to Restore Employment Act, generally requires a foreign financial institution ("FFI") to enter into an agreement with the IRS and report U.S. accounts to the IRS or pay a thirty percent (30%) withholding tax on any "withholdable payment" made to the institution or their affiliates.[5] 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. FATCA Transition Period during Calendar Years 2014 and 2015

On May 2, 2014, the IRS released Notice 2014-33, which generally provides that calendar years 2014 and 2015 will be regarded as a transition period for purposes of IRS enforcement and administration with respect to the implementation of FATCA.

During the transition period, the IRS will take into consideration the extent to which an FFI, other entity subject to FATCA or a withholding agent has made "good faith" efforts to comply with the FATCA regulations. The primary reason for the relaxed enforcement period is to facilitate an orderly transition for compliance with FATCA's requirements and to respond to comments regarding certain aspects of the FATCA regulations.

The IRS gave several examples in the notice of how FATCA compliance will be reviewed during the transition period. In one example, the IRS stated that it will take into account whether a withholding agent has made reasonable efforts during the transition period to modify its account opening practices and procedures to document the FATCA status of payees, apply the standards of knowledge provided under FATCA, and, in the absence of reliable documentation, apply the presumption rules under the FATCA regulations. In another example, the IRS stated in the notice that it will consider the good faith efforts of an FFI to identify and facilitate the registration of each other member of its expanded affiliated group as required for purposes of satisfying the expanded affiliated group requirement under FATCA (which was addressed in the last issue of our Report).

An entity that has not made good faith efforts to comply with the new requirements will not be given any relief from IRS enforcement during the transition period. Further, the IRS provided that calendar years 2014 and 2015 would not be considered a transition period with respect to compliance under Chapters 3 and 61 (with respect to withholding obligations on non-U.S. persons) and Section 3406 of the Internal Revenue Code of 1986, as amended (the "Code") (with respect to backup withholding obligations), to the extent those provisions were not modified under the temporary coordination regulations released earlier this year.

The full text of Notice 2014-33 may be found **here**.

2. Developments Regarding FATCA Guidance

To aid U.S. withholding agents in verifying the FATCA status of their payees, the IRS has developed a FATCA FFI List Search and Download Tool. The FFI list contains the names of the financial institutions and other entities (e.g., direct reporting non-financial foreign entities and sponsoring entities) that have completed FATCA registration with the IRS and obtained a global intermediary identification number ("GIIN"). Withholding agents may download the entire list of FFIs or search for a specific one.

We recommend that investment funds that are acting as U.S. withholding agents for FATCA purposes consult a tax adviser if you have any questions concerning the FATCA regulations, the IRS FFI list, or when FATCA withholding is required on a payment. Please keep in mind that the FATCA statute and regulations contain detailed withholding requirements. While many entities are required to register with the IRS and obtain a GIIN in order for payments to them to be free of FATCA withholding, many other entities are not required to register with the IRS and obtain a GIIN under FATCA, and instead must meet different requirements, for payments to them to be free of FATCA withholding.

An FFI list was initially posted by the IRS on July 1, 2014, and thereafter the list has been updated by the IRS each month. The IRS intends to continue to update the list monthly.

The Search and Download Tool may be found **here**.

3. Developments Regarding IGAs

Early in 2012, the U.S. Treasury Department began negotiating and entering into intergovernmental agreements ("IGAs") with foreign governments. The IGAs are intended to provide an alternative means by which financial institutions located within participating jurisdictions may comply with FATCA.

The U.S. Treasury Department initially stated in 2012 that it was engaged with more than 50 countries and jurisdictions to effect IGAs. Since that time many IGAs have been signed and released by the U.S. Treasury Department, as detailed in the last few editions of our Report. The U.S. Treasury Department maintains a continuously updated list of jurisdictions that have, or are treated as having, an IGA in effect. The U.S. Treasury Department announced that it will treat an IGA as "in effect" with a partner jurisdiction if the United States has reached an agreement in substance with such jurisdiction and such jurisdiction consents to disclose this status. Most recently, China, Ukraine and Guyana have been added to the U.S. Treasury Department list of IGAs reached in substance. The list can be found **here**.

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

4. *FATCA Phishing Scams*

On September 24, 2014, the IRS issued a fraud alert for international financial institutions complying with FATCA. The alert reported that scam artists posing as the IRS have fraudulently solicited financial institutions using so-called "phishing" scams seeking account holder identity and financial account information. The IRS has reports of incidents from multiple countries and continents.

As a reminder to taxpayers, the IRS stated in the fraud alert that the IRS does not require financial institutions to provide specific account holder identity information or financial account information over the phone or by fax or email. Further, the IRS does not solicit FATCA registration passwords or similar confidential account access information.

"Tax scams using the IRS name can take many forms and they are not limited by national borders," said IRS Commissioner John Koskinen. "People should always be cautious before sending sensitive information to anyone."

Any financial institutions or their representatives that suspect they are the subject of this type of "phishing" scam are encouraged to report the matter to the Treasury Inspector General for Tax Administration ("TIGTA") at (800) 366-4484, or through TIGTA's secure website. Any suspicious emails that contain attachments or links in the message should not be opened, and the email should be forwarded to phishing@irs.gov.

The full IRS fraud alert may be found **here**.

5. *UK FATCA*

To assist financial institutions ("FIs") tax resident in the UK (or the UK branch of non-residents) ("UK FIs") with their FATCA obligations compliance, the UK, like many other jurisdictions, has entered into an IGA with the U.S. Treasury Department ("U.S. IGA") so that the information required under the U.S. FATCA regime from UK FIs is to be provided first to HM Revenue & Customs ("HMRC", the UK tax authority), who then forward to the U.S. The UK has also entered into agreements similar to the U.S. IGA with Jersey, Guernsey and the Isle of Man (the "Crown Dependencies") and the Overseas Territories of Anguilla, Bermuda, the British Virgin Islands, the Cayman Islands, Gibraltar, Montserrat and the Turks and Caicos Islands (the "Overseas Territories"), so that HMRC can receive, automatically, information about offshore accounts held by UK residents in the Crown Dependencies or Overseas Territories from of 2014 onwards. It is these agreements which are sometimes referred to as "UK FATCA", due to their close alignment to the U.S. FATCA regime.

The package of measures negotiated by the UK with the Overseas Territories closely follows those negotiated with the Crown Dependencies. Broadly, these agreements implementing UK FATCA have the same effect as the U.S. IGA, and certain aspects of FATCA, in that they require certain FIs to report specific information with respect to certain accounts to HMRC or the relevant local tax authority. If applicable, a FI is required to undertake prescribed due diligence with respect to accounts maintained by it on or after June 30, 2014 to determine whether the reporting obligations are triggered. However, the UK generally does not impose any withholding tax for failure to comply with the "UK FATCA" measures. It should be noted that whilst the agreements with the Crown

Dependencies and Gibraltar are reciprocal in nature, meaning that UK FIs will have to provide data on financial accounts held by residents of these territories, the agreements between the UK and the Overseas Territories (other than Gibraltar) are not reciprocal and therefore UK FIs do not have to provide data on financial accounts held by residents of those Overseas Territories.

6. Next Steps

Now that FATCA is in effect, investment funds, if not already in compliance with FATCA, are strongly encouraged to review their internal policies and investment structures for FATCA compliance at this time. Further, given that non-U.S. governments, such as the UK, are adopting regimes similar to FATCA, investment funds should regularly review any new requirements that may be triggered by such new regimes. We will continue to monitor these developments.

B. IRS Advises that Self-Employment Tax Applies to Distributive Shares of Income of Members of an Investment Management Company

On September 5, 2014, the Office of the Chief Counsel, IRS released CCA 201436049, which provides that the members of an investment management company structured as a limited liability company (and treated as a partnership for tax purposes) could not take advantage of the statutory “limited partner” exception to self-employment tax and were therefore subject to self-employment tax with respect to their earnings from the investment management company. Although perhaps not a surprising result given recent increased scrutiny by the IRS with respect to self-employment tax associated with management companies, the analysis in the CCA is contrary to the long-standing common interpretation and market practice of investment managers as eligible for the statutory exception.

Generally, self-employment taxes are imposed on an individual’s distributive share of partnership income and gain (including income and gain from limited liability companies treated as partnerships for tax purposes) from any trade or business carried on by the partnership of which such individual is a partner. Certain exceptions exist to this general rule, including the so-called “limited partner” exception. Under such exception, the distributive share of a “limited partner” is generally not subject to self-employment tax. Neither the Code nor the associated Treasury Regulations define “limited partner” for this purpose. Further, this exception was enacted prior to the widespread use of limited liability companies, which entities do not have “partners” for state law purposes, but instead have “members.”

Many investment managers that are limited liability companies that are treated as partnerships for tax purposes take the position that their members are not subject to self-employment tax pursuant to the “limited partner” exception because such members should be considered “limited partners.” If this exception is no longer available, then all profits of such a management company attributable to such members would be subject to the 3.8 percent “Medicare” portion of the self-employment tax.

In the CCA, an investment management company (the “Manager”) was formed as a state law limited liability company and taxed as a partnership for U.S. federal income tax purposes. The Manager earned management fees from a variety of alternative investment funds in exchange for management services to such funds, including carrying out extensive market research and trading activity of each fund. The Manager took the position that its members were “limited partners” for purposes of the “limited partner” exception to self-employment tax. Therefore, such members did not pay self-employment tax on their distributive shares of the Manager’s fee income.

It should be noted that the members performed a wide range of professional services, including management services, directly for the alternative investment funds on behalf of the Manager or performed operational and support services for the Manager themselves. This fact was highly relevant to the analysis in the CCA. In its analysis, the CCA states that the legislative history for the "limited partner" exception to self-employment tax indicates that Congress did not intend to allow service partners in a service partnership acting in the manner of self-employed persons to avoid paying self-employment tax. Instead, the exception is to exclude for coverage purposes certain earnings which are basically of an investment nature (i.e., passive investment).

The CCA further relied on several recent cases dealing with similar issues, in which the Tax Court ruled that limited partners of a partnership (in this case, lawyers who were partners in a law firm) were not "limited partners" within the meaning of the statutory exclusion. The rationale is such cases was generally that the limited partners' distributive shares of income from the partnerships did not arise as a return on partners' investment, but instead, arose from legal services they performed on behalf of the law firm. Thus, their distributive share of partnership fee income was not exempt under the "limited partner" exception and was instead subject to self-employment tax.

The impact of the CCA is difficult to assess. This type of guidance is not binding on taxpayers and simply conveys an interpretation of current law. In other words, the CCA is not definitive authority on the question of whether members of an investment management company who participate in the company's management business may rely on the "limited partner" exception to self-employment tax. It is further unknown as to whether this issue will become an increasingly common issue on audit. However, the conclusion of the CCA is significant to investment management companies because it indicates, along with recent court guidance, that members of such companies may be challenged on their reliance of the "limited partner" exception to self-employment tax, particularly in circumstances in which such members actively participate in the companies' businesses. Depending on future developments in this area, such members may wish to consider limiting exposure to self-employment tax by structuring management companies through an "S" corporation, which may provide some advantages in this area (although it should be noted that the use of an "S" corporation may also have disadvantages, such as various compliance requirements for "S" corporation status, that should be considered).

We will continue to monitor developments in this area. The full text of the CCA may be found **here**.

C. New Guidance on PFIC Reporting

On September 10, 2014, the U.S. Treasury Department released Notice 2014-51 announcing intent to amend its regulations under Code Section 1298(f) to provide relief for reporting on Form 8621 with respect to investments in a passive foreign investment company ("PFIC") which is marked to market under any provision of the Code. The guidance provides an exception to the Form 8621 reporting obligation for U.S. persons that hold PFIC stock that is marked to market under provisions of Chapter 1 of the Code, other than Code Section 1296. This is a welcome development in particular for dealers and traders employing mark-to-market accounting for PFIC stock under Code Section 475.

By way of background, a foreign corporation is a PFIC if either 75% or more of its gross income is passive income (such as interest, dividends, capital gains and royalties) or 50% or more of the average value of its assets produce passive income. U.S. shareholders of PFIC are subject to certain anti-deferral regimes under the Code under one of three alternate sets rules: the "excess distribution regime," the "qualified electing fund" (or "QEF") regime and the mark-to-market (or "MTM") regime.

The excess distribution regime generally deters the accumulation of passive earnings in a PFIC by a U.S. shareholder by imposing an interest charge on "excess distributions" (i.e., distributions at least 125% greater than the average distributions over a three year period) from the PFIC, which may include actual distributions as well as gain upon disposition of PFIC stock.

A U.S. shareholder may to elect avoid the interest charges and instead accelerate income with respect to its PFIC stock by making a so-called "QEF election". By making a QEF election, the U.S. shareholder is deemed to receive an annual distribution of its pro rata share of the PFIC's earnings and profits. In the case where an investment fund is a PFIC shareholder, if the fund itself is domestic (e.g., a Delaware partnership), then the investment fund makes the QEF election. If the fund is a foreign partnership, then each U.S. partner (including partners who share in carry, if any) in the investment fund that wants to make the QEF election makes the election for itself. A PFIC treated as a QEF must agree to provide sufficient information for the U.S. shareholder to determine its income inclusions in order for such shareholder to make the QEF election.

Lastly, under Code Section 1296, a U.S. shareholder of a PFIC may elect to apply the MTM rules (but only for "marketable" PFIC stock), which treat the investor as having sold its PFIC stock at the end of each year. Under the MTM rules, gains, including gains on disposition, are taxed as ordinary income (not subject to lower capital gains rates), and losses are deductible as ordinary losses but only to the extent of prior inclusions.

Code Section 1291(d) coordinates the application of the excess distribution regime with the QEF and MTM regimes and other relevant Code sections. Specifically, Code Section 1291 will not apply if an MTM election is in effect for a tax year or if PFIC stock is marked to market under any other provision of Chapter 1 of the Code (including Code Section 475)).

In addition to these anti-deferral rules, Code Section 1298(f) imposes a reporting requirement on U.S. shareholders of PFICs. On December 30, 2013, the U.S. Treasury Department released new temporary and proposed regulations (the "Temporary Regulations") under the PFIC rules of Code Sections 1291 through 1298, and withdrew corresponding portions of proposed regulations issued in 1992. The main impact of the Temporary Regulations was to implement the requirements of Code Section 1298(f) that a taxpayer file an annual report on Form 8621 *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund* ("Form 8621") with respect to an investment (whether direct, indirect or by attribution) in a PFIC. The regulations provide only two main exceptions to the reporting obligation: tax-exempt entities and U.S. shareholders with "low value" PFIC stock below specified thresholds.

Notice 2014-51 states that the U.S. Treasury Department and the IRS will amend the regulations previously released under Code Section 1298(f) to provide that U.S. persons that hold PFIC stock that is marked to market under Code Section 475 or another provision of the Code other than Code Section 1296 should not be subject to the Form 8621 reporting obligation. This is a welcome notice because it will allow investment funds that are subject to Code Section 475 accounting to avoid the Form 8621 filing obligation. For example, dealers who mark to market PFIC stock under Code Section 475 and traders who have made a valid and timely election under Code Section 475(f) to mark to market PFIC stock generally would not have to file Form 8621 for such stock.

The notice further states that there will be limits on the reporting exception. First, the exception will not be available for any year in which the excess distribution rules apply pursuant to the coordination rules under Treasury Regulation Section 1.1291-1(c)(4)(ii). This limitation would not affect U.S.

persons who properly mark to market stock under Code Section 475 in the first year and subsequent years they hold PFIC stock, which would not be subject to any provisions of the PFIC regime. Second, the reporting exception would not be available if PFIC stock is not in fact marked to market for any reason; for example, this may result if the PFIC stock is treated as held for investment or as a hedge under Code Section 475.

U.S. shareholders holding PFIC stock may rely on the rules described in Notice 2014-51 for taxable years ending on or after December 31, 2013, which will also be the effective date of the future final regulations incorporating the guidance under the notice. Due to the late release of the notice in the 2013 filing season, the notice effectively serves to eliminate the statute of limitations risk for taxpayers that inadvertently missed the reporting requirement under pre-notice law.

The full text of Notice 2014-51 may be found **here**.

D. IRS Affirms Position that Short Sales Do Not Result in Unrelated Business Taxable Income

The IRS affirmed in a private letter ruling, released on August 22, 2014, its position that short sales undertaken by funds treated as a partnerships for U.S. federal income tax purposes do not cause U.S. tax-exempt limited partners of such funds to earn unrelated business taxable income ("UBTI").

In this case, the short sales were effected by borrowing securities from a broker or other third party and collateralizing the funds' obligation to return such securities by depositing cash and securities of equal value of the securities borrowed. To facilitate the funds' short positions, the funds would direct a broker to sell stock that the funds do not own at the current price to a buyer in the future. At the time that the short sale is settled, the funds would borrow stocks from the broker. The broker would then provide those stocks to the buyer at the agreed price creating an obligation by the funds toward the broker for the amount of securities loaned by the broker. The funds' creating income or loss is based on the difference between the price at the time of the short sale and the price at the time the sale is settled. The broker often also charges a lending fee for this transaction as well.

By way of background, U.S. tax-exempt entities, such as pension plans among others, are generally exempt from federal income tax with respect to investment income. Notwithstanding this general rule, such entities are subject to federal income tax on UBTI. UBTI includes certain income earned from debt-financed property, which generally includes any property that is held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year (or during the 12 months preceding disposition in the case of property disposed of during the taxable year). Acquisition indebtedness is generally defined as the unpaid amount of the indebtedness incurred by the organization in acquiring the property and, in certain cases, indebtedness incurred before or after the acquisition.

A U.S. tax-exempt investor that is a limited partner in an alternative investment fund treated as a partnership for U.S. federal income tax purposes typically does not earn UBTI from the fund if the fund earns investment income, such as interest, dividends and gains from the sale of stocks and bonds, unless such amounts are derived from debt-financed property. A short sale could be deemed to create indebtedness for these purposes because it involves borrowing to obtain property. However, unlike standard borrowing activities, it involves borrowing of property rather than money. The IRS found this distinction important in prior guidance (Rev. Rul. 95-8), stating that a short sale does not create indebtedness for purposes of the UBTI rules because it constitutes the borrowing of property.

In this recent letter ruling, the IRS again stated that it did not believe that short sales should result in acquisition indebtedness and thus income derived from short sales would not constitute debt-financed property (and therefore would not constitute UBTI). This is welcome news for the funds that engage in short sales and that have tax-exempt limited partners that do not wish to earn UBTI. Such tax-exempt limited partners may remain assured that the fund's engagement in short sales in and of itself should not implicate the UBTI rules.

The full text of the letter ruling may 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 Supreme Court grants certiorari in consolidated LIBOR manipulation class actions.
- The Northern District of Texas denies class certification to a group of investors suing defunct hedge fund Parkcentral.

A. Update on Previously Reported Cases

1. Supreme Court Grants Certiorari and Barclays Settles in Consolidated Actions Accusing Banks of Colluding to Manipulate LIBOR

In our Fall 2011 Report, we first noted that European asset manager FTC Capital GmbH ("FTC Capital") and two of its futures funds had filed a putative class action in the Southern District of New York, alleging that during the 2006-2009 period, banks conspired to artificially depress the London Interbank Offered Rate ("LIBOR"). FTC Capital alleged that the defendant banks colluded to suppress LIBOR in order to make the banks appear more financially healthy than they actually were. The Judicial Panel on Multi-District Litigation then transferred and consolidated this and over twenty other LIBOR-related cases in the Southern District of New York.[6] On March 29, 2013, the court dismissed the heart of the litigation, the federal antitrust claims, and allowed certain commodity manipulation claims to proceed. The exchange-based plaintiffs appealed, but the District Court refused to certify its order for appeal with other claims still pending.

Since our most recent update on this case in the Fall 2013 Report, the Second Circuit held in a brief opinion that it had no jurisdiction over any appeal until all claims in the consolidated litigation were resolved.[7] On June 30, 2014, the Supreme Court granted certiorari.[8] The Supreme Court will consider the question of immediate appealability of orders in consolidated litigation, hearing arguments on December 9, 2014.

In addition, the first of the sixteen bank defendants has agreed to a settlement. In early October, counsel for plaintiffs stated in a letter to the court that Barclays had agreed to pay almost $20 million and provide additional documents and information relating to other defendants as part of a settlement agreement. While this amount pales in comparison to the $450 million Barclays paid to U.S. and U.K. regulators in 2012 over LIBOR manipulation, plaintiffs' counsel has indicated a hope that this settlement "is just the beginning."

B. New Developments in Securities Litigation

1. <u>Class Certification Denied for Investors of Collapsed Hedge Fund Parkcentral</u>

On August 25, 2014, the Northern District of Texas denied the motion for class certification filed by plaintiffs Southern Avenue Partners and Levine Capital Ltd. ("Plaintiffs") in a lawsuit against two former managers of the defunct hedge fund Parkcentral Global, L.P. ("Parkcentral").[9] Parkcentral was a hedge fund formed to give outside investors access to Ross Perot's money management team and trading strategies. In 2008, the $2.5 billion fund was heavily invested in commercial mortgage-backed securities, resulting in losses of over $2 billion. Plaintiffs filed suit alleging misrepresentation and non-disclosure, and sought to certify a class of limited partners who had invested in Parkcentral in the year leading up to the loss, incurring an estimated $500 million in damages. The court held that Plaintiffs had failed to show that the class members were numerous enough to maintain their suit as a class action. In addition, the court ruled that the relevant federal class action rules did not provide appropriate avenues for Plaintiffs' claims because of the difficulty of showing common issues.

Plaintiffs contended that the large potential class, totaling between 112 and 130 limited partners, was sufficiently numerous to maintain a class action under Rule 23(a) of the Federal Rules of Civil Procedure. However, the court stressed that the touchstone for numerosity is the practicality of individual joinder of parties, rather than the size of a prospective class alone. Here, almost every one of the limited partners was required to contribute at least $5 million. These were "sophisticated investors of substantial means" who all interacted with Parkcentral individually or through financial advisors. The court reasoned that all of the limited partners could easily be found and individually joined as plaintiffs in the lawsuit. Thus, joinder was not impracticable and Rule 23(a)'s numerosity requirement was unsatisfied.

Plaintiffs also contended the requirements of Rule 23(b)(1)(B) were met, because Defendants' limited assets were the equivalent of a limited fund and preclusion could prejudice future parties if all were not joined into a single class action. The court rejected these arguments because they did not fit within the historical parameters of the rule. While Rule 23(b)(1)(B) does allow for a class action when a limited fund faces claims from multiple parties, and Defendants here had limited assets, the court reasoned that it was still possible for them to earn money and eventually pay any judgments against them, distinguishing them from a true limited fund. Regarding prejudice, the court reasoned that the Supreme Court has taken a restrained approach to non-party preclusion, so the claim that parties not present would be prejudiced was an unfounded worry. In rejecting both of these arguments, the court stressed that Rule 23(b)(1)(B) was not a place for creativity or innovation when crafting potential classes and should be reserved for the historical conception of a class action.

Plaintiffs' alternative argument for class action status fared no better. Plaintiffs argued that common issues predominated and a class action was proper under Rule 23(b)(3), because all of the limited partners were given and relied on the same or very similar financial information in making their decisions. The court disagreed, finding that common questions did not predominate. For instance, only a subset of investors listened to Parkcentral's quarterly calls or made use of Parkcentral's "open door" policy whereby investors asked questions and received individualized responses, and not all information given out to financial advisors by Parkcentral necessarily made it to each individual investor. Thus, the question of what alleged misinformation each investor received was an individualized inquiry. Likewise, the question of reliance was highly individualized.[10] Because each limited partner had a different tolerance for risk, it was unknown how any or all of the limited partners would have changed their behavior or acted differently if they had been provided more accurate information. The court utilized similar logic regarding damages and causation, stating that calling either a common question relied much too heavily on mere speculation.

All in all, the Parkcentral case points up the difficulties faced by investor plaintiffs in attempting to maintain a class action lawsuit against hedge fund managers, given the wide variation in the quantity of information available to investors, the risk tolerance of individual investors, and the causes for any alleged losses that investors may have incurred.

IV. REGULATORY ENFORCEMENT

The SEC recently announced that, for the fiscal year ending September 2014, it filed a record 755 enforcement actions and obtained orders totaling $4.16 billion in disgorgement and penalties.[11] During its fiscal year-end review, the SEC highlighted enforcement actions involving compliance and regulatory violations by investment advisers and those involving the SEC's use of analytical tools to identify potential misconduct.

Many of the SEC's recent enforcement actions reaffirm our belief that the OCIE staff is sharing greater information obtained during the course of its investment adviser examinations with the SEC's Enforcement Division staff. In fact, a number of recent SEC press releases announcing SEC enforcement actions touted the relationship and communication between OCIE and the SEC's Enforcement Division staff.

What is also apparent is that the IM Division, OCIE and the Enforcement Division are increasingly relying on a variety of new tools to identify potential misconduct. For example, OCIE now uses Form PF, a new disclosure form that requires private fund advisers to report assets under management, to detect inconsistencies with an adviser's publicly available documents, the investment strategies disclosed to investors, and other information obtained during an examination.[12] The SEC's Enforcement Division's Asset Management Unit also utilizes information obtained from Form PF when investigating fund advisers, including in connection with the SEC's Aberrational Performance Inquiry initiative, which relies on proprietary risk analytics to identify aberrational hedge fund returns.[13] OCIE officials also have remarked that OCIE has additional trading data at its disposal to investigate a range of additional issues during the course of examinations of hedge funds, including in investigations into improper boosting of fund valuations, misleading marketing and advertising with respect to past fund performance, and non-compliance with rules governing the custody of assets.[14]

The recent enforcement developments described below reflect a focus on the above issues, as well as those involving conflicts of interest, insider trading, beneficial ownership disclosures, spoofing, Regulation M violations and fraudulent misrepresentations. With more data than ever now available to the SEC, along with improvements in staffing, interdepartmental communication, and technology, hedge funds should expect enforcement actions to increase once again in 2015.

A. Whistleblower Awards

The SEC continues to protect whistleblowers and to encourage them to come forward in connection with its whistleblower program, which rewards individuals who provide high-quality, original information that results in enforcement sanctions exceeding $1 million. The whistleblower awards range from 10 to 30 percent of the sanctions collected.

Within the past six months, the SEC announced a number of record and first-ever awards and actions under its whistleblower program. In June 2014, the SEC settled charges against an investment adviser and its owner for retaliating against an employee who reported prohibited principal transactions to the SEC.[15] This was the first time that the SEC brought a case pursuant to its anti-retaliation powers. In August 2014, the SEC announced the first-ever award to an employee with an audit or compliance function after the employee internally escalated wrongdoing that was discovered and the company failed to take action.[16] In September 2014, the SEC announced its largest whistleblower award to date (more than $30 million) to a whistleblower living abroad who provided key original information about an ongoing, difficult to detect fraud.[17]

These recent actions demonstrate that whistleblowers are likely to emerge from a variety of advisory functions and even from abroad.

B. Insider Trading

Although the government's insider trading enforcement efforts were recently dealt a setback with the acquittal of Rengan Rajaratnam, as detailed below, the hedge fund industry will continue to be a prime target area for the SEC and DOJ, as well as for SROs and other investigators. Below we provide an update on two insider trading enforcement actions involving hedge funds.

SEC v. Rajaratnam

In March 2013, the SEC charged Rengan Rajaratnam ("Rengan") with insider trading, alleging that, from 2006 to 2008, Rengan traded on material nonpublic information for his own benefit and that of funds that he managed at Galleon Management and Sedna Capital Management, a hedge fund advisory firm that he co-founded.[18] Rengan allegedly received the material nonpublic information from his brother, Raj Rajaratnam. The United States Attorney's Office for the Southern District of New York subsequently obtained a stay of the SEC civil case pending the outcome of criminal charges filed against Rengan stemming essentially from the same conduct alleged by the SEC.[19]

On July 28, 2014, a jury in the U.S. District Court for the Southern District of New York found Rengan not guilty of the criminal insider trading charges.[20] That verdict represents the only acquittal of an insider trading defendant among the eighty-six defendants who were charged by the United States Attorney's Office with insider trading since October 2009.[21] At trial, Rengan's attorney argued that Rengan did not know that the tippers disclosed material nonpublic information to his brother in exchange for a personal benefit and that Rengan was not part of a conspiracy.

On October 23, 2014, the SEC and Rengan agreed on a proposed judgment against Rengan related to the civil charges filed against him. Without admitting or denying the SEC's claims, Rengan agreed to be enjoined from violating Section 10(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and Rule 10b-5 thereunder and to pay $372,264.42 in disgorgement, $96,714.27 in prejudgment interest, and $372,264.42 in civil penalties. Rengan also consented to being barred for five years from associating with any investment adviser, broker, dealer, municipal securities dealer, or transfer agent, with the right to reenter the industry thereafter.[22] The proposed judgment is subject to U.S. District Court Judge John G. Koeltl's approval.

In re Filip Szymik and In re Jordan Peixoto

On September 30, 2014, the SEC instituted administrative proceedings charging Filip Szymik ("Szymik") and Jordan Peixoto ("Peixoto") with insider trading.[23] This action represents one of the few administrative actions that the SEC has filed alleging insider trading violations. The SEC historically brought insider trading charges as civil actions in federal court. The Dodd-Frank Act, however, enabled the SEC to file administrative proceedings for a wide variety of charges.[24]

According to the SEC, Szymik and Peixoto engaged in insider trading in Herbalife Ltd. securities in advance of hedge fund manager William Ackman's ("Ackman") announcement that his hedge fund, Pershing Square Management, L.P. ("Pershing Square"), had formed a negative view of Herbalife and taken a $1 billion short position in its securities.[25] Szymik, a consultant at a New York consulting firm, allegedly learned from his longtime friend and roommate, an analyst at Pershing Square (the "Analyst"), that Pershing Square planned to announce its negative view of Herbalife on December 20, 2012. The SEC maintains that prior to December 2012, the Analyst cautioned Szymik, and Szymik understood, that all of the Analyst's work at Pershing Square was highly confidential such that Szymik could not disclose any information he learned from the Analyst, and that Szymik could not trade securities using any such information. The SEC alleges that in a series of communications prior to December 19, 2012, Szymik breached his duty of trust to the Analyst by telling Peixoto, Szymik's close friend and a research analyst at Deloitte, of Pershing Square's impending announcement.

According to the SEC, on December 19, 2012, Peixoto purchased Herbalife put options based on the confidential information that Szymik provided to him.[26] Later that same day, CNBC reported that Pershing Square had acquired a significant short position in Herbalife and that Ackman believed Herbalife was operating an illegal pyramid scheme. Following the CNBC report and Ackman's presentation on Herbalife, Herbalife stock decreased by approximately 39% from December 18, 2012, to December 24, 2012. The SEC alleges that Peixoto netted illicit profits of $47,100.[27]

Szymik consented to the entry of an administrative order directing him to cease-and-desist from future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and to pay $47,100 in penalties.[28] Peixoto is contesting the SEC's allegations.[29]

Compliance Violations Relating to Material Non-Public Information

In addition to filing actions for primary violations of insider trading, the SEC has also brought a number of enforcement actions against investment advisers and other financial institutions for failing to maintain adequate compliance procedures to protect against the misuse of material non-public information. Importantly, not all of those SEC actions involved allegations of insider trading. Investment advisers should continue to evaluate the adequacy of and improve their compliance programs to protect confidential information.[30] Necessary compliance measures include, among other things, evaluating the use of material non-public information by and between different business units.[31]

C. Conflicts of Interest

In a September 2014 speech at the Practising Law Institute, Hedge Fund Management Seminar 2014 in New York City, IM Division director Norm Champ emphasized that advisers must be vigilant in identifying, disclosing and managing conflicts of interest, and that OCIE staff would be conducting examinations focused on conflicts of interest inherent in the investment adviser business model. The full text of Mr. Champ's speech is available here.

Below are two conflicts of interest actions, one involving the allocation of fees among funds and the other relating to trade allocation.

In re Lincolnshire Management, Inc.

On September 22, 2014, Lincolnshire Management, Inc. ("Lincolnshire"), a private equity investment adviser, consented to the entry of an SEC administrative order alleging that Lincolnshire misallocated expenses between two portfolio companies that Lincolnshire advised and that were owned by separate Lincolnshire funds.[32]

According to the SEC's administrative order, Lincolnshire integrated the two portfolio companies and managed them as one company.[33] The portfolio companies were Peripheral Computer Support, Inc. ("PCS") and Computer Technology Solutions Corp. ("CTS"). The Lincolnshire funds that owned PCS and CTS had separate limited partnership agreements and distinct sets of limited partner investors.

From at least 2005 to January 2013, PCS and CTS each paid Lincolnshire annual consulting fees, although PCS was unable to pay a portion of its consulting fees for a period of time due to its financial condition. The two companies shared a variety of operational functions, including payroll and 401(k) administration, human resources, marketing, and technology. PCS and CTS were operated by a joint management team, entered into a joint line of credit, and had a joint logo.

PCS and CTS developed an expense allocation policy that required each company to pay a percentage of certain operating and administrative expenses.[34] That policy allocated expenses that benefitted both companies based on the proportion of each company's revenue to the combined revenue of PCS and CTS. However, according to the SEC, there were no written agreements relating to sharing or allocating expenses, and a portion of the shared expenses was misallocated and undocumented.

As a result, PCS paid more than its share of expenses that benefitted both companies.[35] PCS paid all of the expenses, approximately $25,000 annually, for a third-party to provide payroll services and to administer the 401(k) programs for both PCS and CTS employees. A PCS subsidiary in Singapore sold performed services, and supplied parts to, CTS at cost, even though CTS did not contribute to the overhead costs of operating the Singapore subsidiary. PCS also paid for the entire salary of employees who performed work for both companies. Similarly, after the two companies were sold, PCS paid 10% of the transaction bonuses of two CTS executives. As a result, the SEC alleged that Lincolnshire breached its fiduciary duty owed to the two Lincolnshire funds that owned PCS and CTS.

The administrative order, to which Lincolnshire consented, directed Lincolnshire to cease-and-desist from any future violations of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.[36] Lincolnshire agreed to pay $1.5 million in disgorgement, $358,112 in prejudgment interest, and a penalty of $450,000.

In re Structured Portfolio Management, LLC

On August 28, 2014, Structured Portfolio Management, LLC ("SPM"), a hedge fund adviser, and two affiliated investment advisers consented to the entry of an administrative order alleging that SPM failed to implement procedures concerning trade allocation and failed to disclose a change in strategy.[37] Essentially, the SEC alleged that SPM allowed a trader to trade the same securities across three SPM-advised hedge funds, which created a conflict of interest because the trader might have engaged in improper trade allocations between the funds. Although this conflict was apparently disclosed, the SEC alleged that it was inadequately addressed by SPM.

According to the SEC, SPM and its two affiliated investment advisers advised three hedge funds, all of which had different portfolio managers. The trader for the three funds was also the portfolio manager for one of the funds, which maintained a different investment strategy than the other two hedge funds.[38] According to the SEC, the trader was conflicted because his goal when trading for the fund for which he acted as portfolio manager was to make a profit while his goal when trading for the two other funds was to hedge interest rate risk. Because the trader traded treasuries across all three funds, a potential conflict of interest existed as to how the trader should allocate the trades among the three funds.[39]

Although SPM required the trader to identify at the time of the trade execution the fund for which the securities were traded, SPM allegedly did not institute adequate procedures to confirm the trader identified such trades.[40] As a result, the SEC alleged that when the three funds each purchased or sold the same Treasury security on the same day, the fund for which the trader acted as portfolio manager consistently bought the security at a lower price and sold it at a higher price than the other two funds. Although SPM was aware of the possibility for improper trade allocations, SPM and its affiliated advisers allegedly did not amend their policies and procedures to address the potential for conflicts.

In addition, the SEC alleged that SPM failed to disclose to investors that the fund for which the trader acted as portfolio manager changed its trading strategies from trading highly liquid mortgage-backed securities and treasuries to almost exclusively day-trading Treasuries.[41]

The respondents, without admitting or denying the SEC's allegations, consented to the entry of an order that required them to retain an independent compliance consultant, censured them, ordered them to cease and desist from committing and causing any violations and any future violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, and directed them to pay a $300,000 civil penalty.[42]

D. Spoofing

On October 2, 2014, the United States Attorney's Office for the Northern District Illinois announced the first-ever federal criminal charges of "spoofing" against Michael Coscia ("Coscia"), a high frequency trader and the sole owner of Panther Energy Trading LLC ("Panther").[43] The term "spoofing" refers to the act of placing orders in the form of "bids" to buy or "offers" to sell a futures contract with the intent to cancel the bid or offer before execution.[44] The Dodd-Frank Act added an anti-spoofing provision to the Commodity Exchange Act, violations of which may be charged both civilly and criminally. Since the passage of the Dodd-Frank Act there have been few civil enforcement actions charging spoofing. The Coscia indictment marks the first criminal action.

The indictment alleges that Coscia intentionally entered a number of large-volume orders in exchange-traded futures contracts that he intended to immediately cancel before they could be executed.[45] Coscia allegedly did this to create the false impression that there was increased interest and buying and selling activity in the market.

According to the indictment, Coscia instructed a computer program to create the high frequency trading programs needed to allow Coscia to engage in this trading activity. The indictment alleges that ultimately, these trading programs allowed Coscia to spoof the market in more than 20 futures markets.[46]

By engaging in this conduct, Coscia allegedly fooled the market into believing the price of a particular contract was about to increase or decrease, when in actuality, the apparent buying or selling activity was artificial, created by Coscia through algorithmic trading. By fooling the market, Coscia allegedly was able to execute trades for his own benefit in a market that he artificially inflated or depressed, thus enabling him to earn a greater profit from his trades.

Coscia faces six criminal counts of commodity fraud and six criminal counts of spoofing.[47] In 2013, Coscia and Panther consented to the entry of an order by the CFTC, alleging the same conduct contained in the indictment and charging Coscia and Panther with a civil violation of spoofing.[48] As part of that order, Coscia was directed to pay $2.8 million, which included a $1.4 million penalty. Additionally, because Coscia's conduct affected the ICE Futures Europe, the United Kingdom's Financial Conduct Authority also issued an order against Coscia in 2013, imposing a $900,000 penalty.

E. Beneficial Ownership Reporting Delinquencies

In an apparent effort to pursue its "broken windows" policy of pursuing even minor violations as a way of policing the securities markets, the SEC has instituted multiple administrative actions involving delinquent filing of beneficial ownership disclosure forms.[49]

SEC Charges 34 Individuals and Entities for Beneficial Ownership Disclosure Delinquencies and Failures

On September 10, 2014, the SEC announced charges against 13 officers and directors of public companies, five individual beneficial owners of public companies, and 10 investment firms, for violating the beneficial ownership disclosure regulations.[50] Additionally, the SEC charged six public companies for allegedly contributing to filing failures by insiders or for failing to report delinquent filings by company insiders. All but one of the individuals and entities charged settled the charges by the SEC and agreed to pay penalties totaling more than $2.6 million.[51] According to the SEC, the SEC staff used quantitative data sources and ranking algorithms to identify the delinquencies by these insiders.[52]

The administrative proceedings brought by the SEC against these individuals and entities concern either late filing of, or the failure to file, beneficial ownership disclosure forms, Form 4 and Schedules 13D and 13G, in violation of Sections 13(d), 13(g) or 16(a) of the Exchange Act. Based on these enforcement actions, it is clear that the SEC views Section 16(a) as a weapon against the abuse of inside information in that it requires full and prompt disclosure of an insider's holdings. The SEC also believes that these disclosures, including those required under Section 13(a), contain information that investors want to know about because an insider's purchases or sales may indicate the insider's private opinion as to prospects of the company.[53]

These actions also highlight a few key aspects of the beneficial ownership disclosure requirements.[54] First, more than one person may be a beneficial owner of the same securities because the definition of beneficial ownership includes direct and indirect, as well as shared, voting and investment power. Second, a beneficial owner's intent to gain control of a company and a beneficial owner's reasons for engaging in the purchase or sale are immaterial to the obligation requiring disclosure. Third, even an inadvertent failure to file timely a required report constitutes a violation of Section 16(a) and 13(d) and the rules thereunder.

In light of the SEC's recent actions, investment advisers that are subject to Sections 13(d), 13(g) or 16(a) of the Exchange Act (e.g., investment advisers to activist funds) should take steps to ensure continued compliance with the SEC's beneficial ownership disclosure regulations.

In re Gary H. Rabin

On the same day that the SEC announced the actions relating to the above-referenced beneficial ownership disclosure delinquencies, the SEC separately announced that Gary H. Rabin ("Rabin"), the former CEO, CFO, and Chairman of Advanced Cell Technology, Inc. ("Advanced Cell"), a publicly traded company, consented to the entry of an administrative order based on alleged securities fraud violations stemming from his failure to file timely or accurately reports of his beneficial holdings and transactions in Advance Cell securities.[55] Although Rabin was associated with a public company, and not a hedge fund, this action is relevant because it demonstrates the SEC's willingness to pursue a beneficial ownership disclosure violation as a more serious charge if the violation involves a false or misleading statement. Thus, it is imperative that beneficial ownership disclosures contain accurate information.

According to the SEC's order, Rabin failed to file a Form 3, disclosing whether he owned any Advance Cell stock, when he became a director of Advanced Cell in 2007, and he continually failed to file a Form 3 even after he became the interim, and later the permanent, CEO, CFO and Chairman of the company. Additionally, although Rabin filed a Form 4 in connection with 11 transactions that occurred during a 28-month period, the SEC alleged that none of those filings were timely. The SEC also alleged that Rabin completely failed to file a Form 4 in connection with 27 separate sales of Advanced Cell stock, which represented 66% of Rabin's holdings in Advanced Cell stock and yielded approximately $1.5 million in proceeds. The SEC further alleged that Rabin failed to file an annual report on Form 5 for 2011 and 2012.

According to the SEC, some of Advanced Cell's annual reports and proxy statements, which Rabin signed, contained false and misleading statements concerning Rabin's beneficial ownership of Advanced Cell stock. Specifically, the SEC alleged that Advanced Cell's Annual Report on Form 10-K, filed on March 12, 2012, and its proxy statement for 2012 falsely stated that its key officers and directors timely complied with all applicable filing requirements.[56] According to the SEC, Rabin failed to file three Form 4s timely and failed to file Form 4s in connection with 12 transactions during the period covered by the Form 10-K and proxy statement.

The SEC viewed Rabin's failure to disclose timely his sales of Advanced Cell stock and the false statements in the company's Form 10-K and proxy statements as information that investors would find important, and alleged that Rabin was negligent because, among other things, he failed to act reasonably to ensure that he timely file required reports pursuant to Section 16(a) of the Exchange Act.[57]

The order requires Rabin to cease-and-desist from committing or causing any violations and any future violations of Section 17(a)(2) and 17(a)(3) of the Securities Act and Sections 13(a), 14(a) and 16(a) of the Exchange Act and Rules 12b-20, 13a-1, 14a-9 and 16a-3 thereunder and to pay $175,000 in penalties.

F. Regulation M Violations

On September 16, 2014, the SEC announced settled charges against 19 firms and one individual trader in connection with short selling in advance of stock offerings in violation of Regulation M of the Exchange Act ("Reg M").[58] This action was part of the SEC's initiative, announced in 2013, to enhance the enforcement of Rule 105 of Reg M, which generally prohibits short selling of a stock within five business days of participating in an offering of the stock. Such activity, according to the SEC, artificially depresses the market price shortly before the stock is priced in the offering, and it is the SEC's view that such activity could be used to manipulate the pricing of a follow-on or secondary offering. Violations do not depend on the intent of the short seller.

The 19 firms and the one individual each consented to the entry of an administrative order directing them to cease-and-desist from committing or causing any violation of Rule 105 of Reg M.[59] Each firm and the individual traders agreed to pay a combined total of more than $9 million in disgorgement, interest and penalties. The penalty amounts ranged from $65,000 to more than $2.6 million.

G. *Fraudulent Misrepresentations and Conduct*

Fraudulent misrepresentations and related conduct are a mainstay of SEC enforcement actions. Below we discuss cases where hedge fund managers have been charged either with misrepresenting hedge funds' investment profiles and performance results or with misappropriating investor funds for their own personal use.

In re Cooper and WestEnd Capital Management, LLC

On September 17, 2014, the SEC charged Sean C. Cooper ("Cooper"), a former hedge fund manager for investment advisory firm WestEnd Capital Management, LLC ("WestEnd") with fraudulently taking excess management fees for his own use from a fund that WestEnd advised.[60] WestEnd was separately charged for failing to properly supervise Cooper.

According to the SEC, WestEnd was entitled to annual management fees of 1.5% of funds under management to be paid quarterly.[61] However, from March 2010 through February 2012, Cooper withdrew an excessive amount, approximately $320,000, from the fund for his own personal use and falsely characterizing the withdrawals as management fee withdrawals.[62] Cooper, who was primarily responsible for WestEnd's compliance program and had sole authority to transfer money out of the fund, used the money to remodel his home and buy a $187,000 Porsche. Cooper never disclosed the excess fee withdrawals to investors. Instead, Cooper described the withdrawals in the fund's financial statements as prepaid management fees. WestEnd never adopted written policies and procedures to prevent these violations or to restrict Cooper's ability to withdraw money from the Fund.

The charges against Cooper are pending. WestEnd, however, consented to the entry of the order directing that it cease and desist from future violations of Sections 204, 206(4), and 207 of the Advisers Act and Rules 204-2(a)(1), (2), (6), and (7) and 206(4)-7, to retain a compliance consultant, and to pay $150,000 as a penalty.[63]

SEC v. Markusen

On September 9, 2014, the SEC filed suit against a Steven R. Markusen ("Markusen"), a Minneapolis-based hedge fund manager, and Archer Advisors LLC ("Archer Advisors"), his investment advisory firm, and Jay C. Cope ("Cope"), an Archer Advisors' employee, alleging that they cheated two hedge funds they managed out of more than $1 million in false research expenses and fees.[64]

The SEC complaint alleges that, as the funds' performance deteriorated, Markusen and Cope misappropriated and diverted money from the two funds under false pretense.[65] For example, Markusen and Cope allegedly misappropriated $450,000 to Cope as purported research expenses.[66] In addition, Markusen and Cope allegedly diverted fund trade commissions, or "soft dollars," to Cope without disclosing the payments to investors. Cope allegedly shared a portion of the money that he received with Markusen.

The SEC also charged Markusen and Cope in a separate trading scheme to inflate the value of CyberOptics Corp. ("CyberOptics"), which comprised 75 percent of the value in the portfolios of the two funds that they managed. Markusen and Cope allegedly "marked the close" in CyberOptics on the last trading day of the month at least 28 times by placing multiple buy orders often seconds before the market closed to artificially drive up the value of the funds' portfolios.[67] Archer Advisors allegedly reported these monthly returns to investors and used them to calculate Archer Advisor's monthly management fee.

The SEC charged Markusen, Cope, and Archer Advisors with violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Section 206 of the Advisers Act and Rule 206(4)-8 thereunder. Archer Advisors and Markusen were also charged with violations of Section 16(a) of the Exchange Act and Rule 16a-3 thereunder. The SEC seeks a permanent injunction from future violations of the above listed provisions, disgorgement of illicit gains with prejudgment interest, and civil penalties.[68]

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

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1 The SEC's final MA rules (the "MA Rules") went into effect on July 1, 2014. For additional information, *see* Office of Municipal Securities, Registration of Municipal Advisors, Frequently Asked Questions (last updated May 19, 2014), *available at* http://www.sec.gov/info/municipal/mun-advisors-faqs.pdf).

2 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.

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

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

5 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.

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

7 *In re LIBOR-Based Fin. Instruments Antitrust Litig.*, 13-3565-L; 12-3636(Con), 2013 WL 9557843 (2d Cir. Oct. 30, 2013) cert. granted, 134 S. Ct. 2876 (2014).

8 *Gelboim v. Bank of Am. Corp.*, 134 S. Ct. 2876 (2014).

9 *In re Park Cent. Global Litig.*, 3:09-CV-765-M, 2014 WL 4261950 (N.D. Tex. Aug. 25, 2014).

10 A presumption of reliance was not allowed in this case, so each plaintiff would need to prove reliance individually.

11 SEC Press Release No. 2014-230, SEC's FY 2014 Enforcement Actions Span Securities Industry and Include First-Ever Cases (Oct. 16, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543184660#.VFwAJ8lmZ7c.

12 Norm Champ, Speech at the Practising Law Institute, Hedge Fund Management Seminar 2014 (Sep. 11, 2014), *available at* http://www.sec.gov/servlet/Satellite/News/Speech/Detail/Speech/1370542916156.

13 *Id.*

14 Andrew Ackerman and Rob Copeland, *SEC Finds Deficiencies at Hedge Funds*, The Wall Street Journal (Sep. 22, 2014), *available at* http://online.wsj.com/articles/sec-finds-deficiencies-at-hedge-funds-1411403677#printMode.

15 SEC Press Release No. 2014-118, *SEC Charges Hedge Fund Adviser with Conducting Conflicted Transactions and Retaliating against Whistleblower* (Jun. 16, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542096307#.VICfGclmZ7c.

16 SEC Press Release No. 2014-180, *SEC Announces $300,000 Whistleblower Award to Audit and Compliance Professional Who Reported Company's Wrongdoing* (Aug. 29, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542799812#.VGt0Bskqo5s.

17 SEC Press Release No. 2014-206, *SEC Announces Largest-Ever Whistleblower Award* (Sep. 22, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543011290#.VGtwB8kqo5s.

18 SEC v. Rajarengan Rajaratnam, 1:13-CV-01894, S.D.N.Y. (March 21, 2013), *available at* http://www.sec.gov/litigation/complaints/2013/comp-pr2013-45.pdf.

19 Jeff Sistrunk, *Rengan Rajaratnam Settles SEC's Insider Trading Claims*, Law360 (Oct. 23, 2014), *available at* http://www.law360.com/articles/589958/rengan-rajaratnam-settles-sec-s-insider-trading-claims.

[20] *Id*.

[21] *Id*. Most such defendants pled guilty.

[22] SEC Press Release No. 2014-237, *Rengan Rajaratnam Agrees to Settle Insider Trading Charges* (Oct. 23, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543274751#.VFercslmZ7c.

[23] SEC Press Release No. 2014-222, *SEC Charges Two with Insider Trading on Pershing Square's Announcement on Herbalife* (Sep. 30, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543071733#.VFelWslmZ7c.

[24] *In re Marc Sherman*, Administrative Proceeding, File No. 1-15992 (Nov. 14, 2014), *available at* http://www.sec.gov/alj/aljorders/2014/ap-2020.pdf.

[25] *In re Filip Szymik*, Administrative Proceeding, File No. 3-16183 (Sep. 30, 2014), *available at* http://www.sec.gov/litigation/admin/2014/34-73262.pdf.

[26] *Id*. at p. 2.

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

[28] *Id*. at pp. 6-7.

[29] *In re Jordan Peixoto*, Administrative Proceeding, File No. 3-16184 (Sep. 30, 2014), *available at* http://www.sec.gov/litigation/admin/2014/34-73263.pdf.

[30] *In re Wells Fargo Advisors, LLC*, Administrative Proceeding, File No. 3-16153 (Sep. 22, 2014), *available at* http://www.sec.gov/litigation/admin/2014/34-73175.pdf (finding that company failed to maintain adequate controls to prevent one of its employees from insider trading based on a customer's nonpublic information).

[31] *See In re LavaFlow, Inc.*, Administrative Proceeding, File No. 3-15985 (Jul. 25, 2014), *available at* http://www.sec.gov/litigation/admin/2014/34-72673.pdf (finding that a Citigroup business unit operating an alternative trading system failed to protect the confidential trading data of its subscribers by allowing an affiliate operating an application to access confidential information); *In re Liquidnet, Inc.*, Administrative Proceeding, File No. 3-15912 (Jun. 6, 2014), *available at* http://www.sec.gov/litigation/admin/2014/33-9596.pdf (finding that brokerage firm improperly permitted the marketing unit to access confidential trading information from the business unit that operated a dark pool alternative trading system).

[32] *In re Lincolnshire Management*, Administrative Proceeding, File No. 3-16139 (Sep. 22, 2014), *available at* http://www.sec.gov/litigation/admin/2014/ia-3927.pdf.

[33] *Id.* at 2.

[34] *Id.*

[35] Id. at 5-7.

[36] *Id.* at 7.

[37] *In re Structured Portfolio Management, L.L.C., et al.*, Administrative Proceeding, File No. 3-16046 (Aug. 28, 2014), *available at* http://www.sec.gov/litigation/admin/2014/ia-3906.pdf.

[38] *Id*.

[39] *Id*. at 4.

[40] *Id*. at 5.

[41] *Id*. at 6.

[42] *Id*. at 9.

[43] Press Release, United States Attorney's Office for the Northern District of Illinois, *High Frequency Trader Indicted for Manipulating Commodities Futures Markets in First Federal Prosecution for "Spoofing,"* available at http://www.justice.gov/usao/iln/pr/chicago/2014/pr1002_01.html.

[44] *Id*.

[45] Indictment, *United States v. Michael Coscia*, United States District Court, Northern District of Illinois, *available at* http://www.justice.gov/usao/iln/pr/chicago/2014/pr1002_01a.pdf.

[46] *Id*.

[47] *Id*.

[48] CFTC Press Release, *CFTC Orders Panther Energy Trading LLC and its Principal Michael J. Coscia to Pay $2.8 Million and Bans Them from Trading for One Year, for Spoofing in Numerous Commodity Futures Contracts*, available at http://www.cftc.gov/PressRoom/PressReleases/pr6649-13.

[49] Thomas A. Zaccaro and Ryan A. Walsh, *Attempting to Fix the "Broken Windows": Recent SEC Enforcement Action Targets Routine Disclosure Obligations of Public Corporations and Their Insiders*, Paul Hastings LLP Insights (Oct. 10, 2014), *available at* http://www.paulhastings.com/publications-items/details/?id=718be269-2334-6428-811c-ff00004cbded.

[50] SEC Press Release No. 2014-190, *SEC Announces Charges Against Corporate Insiders For Violating Laws Requiring Prompt Reporting of Transactions and Holdings* (Sep. 10, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542904678 ("SEC Release No. 2014-190").

[51] The penalty amounts associated with the settled administrative actions ranged from $60,000 to $120,000 for the entities charged and $25,000 to $100,000 for the individual respondents. In *In the Matter of Ligang Wang*, the one contested proceeding, the SEC alleged that an officer of a public company failed to report eight transactions and filed untimely beneficial disclosure reports in relation to seven other transactions. *See In re Ligang Wang*, Administrative Proceeding, File No. 3-16094 (Sep. 10, 2014) at 2, *available at* http://www.sec.gov/litigation/admin/2014/34-73065.pdf.

[52] SEC Release No. 2014-190.

[53] *See, e.g.*, *In re P.A.W. Capital Partners, L.P.*, Administrative Proceeding, File No. 3-16067 (Sep. 10, 2014) at 2 (internal quotations omitted), *available at* http://www.sec.gov/litigation/admin/2014/34-7308.pdf.

[54] *Id.* at 2-5.

[55] *In re Gary H. Rabin*, Administrative Proceeding, File No. 3-16096 (Sep. 10, 2014) at 2, *available at* http://www.sec.gov/litigation/admin/2014/34-73067.pdf.

[56] *Id*. at 5.

[57] *Id*. at 5-6.

[58] SEC Press Release No. 2014-195, *SEC Sanctions 19 Firms and Individual Trader for Short Selling Violations in Advance of Stock Offerings* (Sept. 16, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542963767#.VIB9JGx0zcs.

[59] *Id*. at 2 (internal quotations omitted).

[60] SEC Press Release No. 2014-200, *Former Hedge Fund Manager in Bay Area Charged With Taking Excess Management Fees to Make Lavish Purchases* (Sep. 17, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542975721#.VFvSpvnF8Qo.

[61] *In re WestEnd Capital Management*, *LLC*, Administrative Proceeding, File No. 3-16129 (Sep. 17, 2014), *available at* http://www.sec.gov/litigation/admin/2014/ia-3919.pdf.

[62] *Id.* at 2.

[63] SEC Press Release No. 2014-200, *Former Hedge Fund Manager in Bay Area Charged With Taking Excess Management Fees to Make Lavish Purchases* (Sep. 17, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542975721#.VFvSpvnF8Qo.

[64] SEC Litig. Release No. 23080 (Sep. 9, 2014), *available at* http://www.sec.gov/litigation/litreleases/2014/lr23080.htm.

[65] *SEC v. Markusen*, 0:14-CV-3395, D. Minn. (September 9, 2014), *available at* www.sec.gov/litigation/complaints/2014/comp-pr2014-187.pdf.

[66] *Id.*

[67] *Id.* at 4-5.

[68] *Id.* at 50-51.