PAUL HASTINGS

PH PERSPECTIVES

December 2015

Follow @Paul_Hastings

Hedge Fund Report: Summary of Key Developments—Fall 2015

By the Investment Management, Securities Litigation & Tax Practices

This continues to be a time of rapid change for the hedge fund industry, as the Securities and Exchange Commission (the "SEC"), the Commodity Futures Trading Commission (the "CFTC"), and various other regulatory agencies, including the Board of Governors of the Federal Reserve System (the "Federal Reserve") and the Department of the Treasury (the "Treasury"), continue to propose and finalize rules and issue guidance to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and the Jumpstart Our Business Startups Act (the "JOBS Act"). There have also been a number of significant developments in the private 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 2015, and highlights recent regulatory and tax developments, as well as recent civil litigation and enforcement actions as they relate to the private fund industry. Paul Hastings attorneys are available to answer your questions on these and any other developments affecting private funds and their investors and advisers.

TABLE OF CONTENTS

I. SECURITIES-RELATED LEGISLATION AND REGULATION

A. Dodd-Frank Act Updates

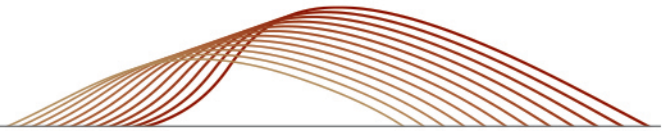
The following items describe the status of various proposed and final rules and regulations implementing the Dodd-Frank Act that are most relevant to the private fund industry.

1. SEC Chair Reflects on the Five-Year Anniversary of Dodd-Frank Act and its Effect on the SEC's Understanding of Private Funds and their Advisers

Speaking at the Managed Funds Association Outlook 2015 Conference on October 16, 2015, SEC Chair Mary Jo White acknowledged the fifth anniversary of the Dodd-Frank Act's passage, which required the SEC to propose and adopt initiatives that, according to Ms. White, have greatly increased reporting and transparency within the private funds industry, as well as the SEC's ability to protect investors from the systemic and specific risks posed by private funds and their advisers. In particular, Ms. White emphasized the importance of Form PF (which is filed confidentially with the SEC by registered advisers that advise private funds with over $150 million in assets), as well as the registration of private fund advisers and the related ability for the SEC to conduct examinations of registered advisers. Since the revamped reporting and registration regime was deployed, the SEC has gleaned information on 30,000 private funds managed by 4,500 registered advisers (1,500 of which are newly registered because of the Dodd-Frank Act's new registration rules).

Through these Dodd-Frank Act initiatives, Ms. White noted that the SEC has become aware of several systemic and firm-specific risks that private fund advisers should consider on a daily basis. For example, Ms. White highlighted three operational risks on which the SEC is currently focusing: (i) risks associated with winding-up and liquidating client accounts or transitioning accounts to a new adviser; (ii) cybersecurity risks; and (iii) risks associated with market stress. For further discussion of the cybersecurity risks, please see Section I.C.2 below.

The crux of Ms. White's prepared remarks was her discussion of firm-specific risks, which focused on an adviser's fiduciary duty owed to its clients. Ms. White called such duty the "cornerstone of [the SEC's] regulatory framework for asset managers," and provided that the SEC staff will continue to zero-in on key areas where deficiencies have been frequently encountered during presence exams. The first is marketing practices, especially where an adviser includes back-tested performance numbers, portable performance numbers, or benchmark comparisons without proper disclosure.



Second, Ms. White noted that some private fund advisers do not make adequate disclosure relating to conflicts of interest. For example, the SEC staff has observed inadequate disclosure of conflicts of interest relating to a hedge fund's proprietary accounts or the personal accounts of its portfolio managers, especially when such accounts are given a priority allocation of profitable trades in violation of established policies and procedures. Finally, Ms. White confirmed that practices and disclosure relating to fees and expenses will continue to be an area of emphasis for the SEC staff. Past deficiencies in this regard have involved misallocation of expenses, shifting of adviser-related expenses to private funds, acceleration of monitoring fees, and hiring of related parties to provide services. For further information regarding recent SEC enforcement activities relating to private fund fees and expenses, see Section IV. D below.

The full text of Ms. White's speech can be accessed on the SEC's website **here**.

2. SEC Publishes Report with Statistics on Private Funds and Their Advisers Based on Data Collected Through Dodd-Frank Act Reporting and Registration Obligations

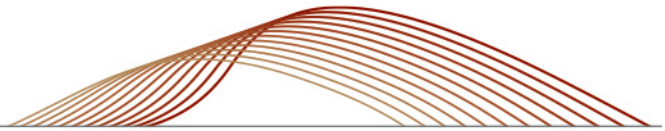
Ms. White's prepared remarks summarized above coincided with the release of a first-of-its-kind SEC report presenting statistics on private funds and their advisers based on data gathered from Form ADV and Form PF filings. The report presents the information on an aggregate basis in dozens of charts and tables. Some broad areas of coverage include funds' use of derivatives, high frequency trading activities, liquidity at the portfolio and investor levels, use of leverage, and beneficial ownership information.

According to Ms. White, the report is meant as both a tool for investors to help evaluate private funds and their advisers, as well as to encourage additional analysis by the SEC and other third parties. In most cases, the report provides quarterly data going back to the first quarter of 2013, which should allow observers to discern trends and other patterns over periods of time. The SEC's press release is available **here**, and the report can be accessed on the SEC's website **here**.

3. SEC Accelerates Focus on Uniform Fiduciary Standard for Broker-Dealers

In November 18, 2015 testimony before the U.S. House of Representatives Committee on Financial Services, SEC Chair White revealed that the SEC is accelerating its development of a rule proposal that would hold broker-dealers to a uniform fiduciary standard. The testimony follows a CNBC interview on November 10, 2015, in which Ms. White indicated that the SEC staff is fully engaged in formulating such a proposal. As discussed in our previous **Report**, the rulemaking would be pursuant to Section 913(f) of the Dodd-Frank Act, which authorizes (but does not require) the SEC to promulgate rules which would hold broker-dealers providing investment advice about securities to retail customers to a similar standard of conduct applicable to investment advisers. Currently, SEC-registered broker-dealers must comply with FINRA's lower "suitability" standard, which requires only that the broker-dealer have a "reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence" of the broker-dealer. According to the recently released SEC agenda for 2016, the agency expects to publish a rule proposal by the fall of 2016.

Earlier this year, the Department of Labor (the "DOL") published its own proposed rules (the "DOL Proposal") that would raise investment-advice standards for brokers handling retirement accounts. Such brokers would be fiduciaries, unless they fall within one of several carve-outs presented in the DOL Proposal.



The DOL Proposal has come under fire from industry participants who argue that it was hurriedly prepared and will prevent retail investors from having access to reasonably priced investment advice and services. Others warn that the DOL should not intrude into what has traditionally been the SEC's regulatory space, as the DOL does not have sufficient understanding or experience to craft effective industry rules. The criticism has gained some traction in the U.S. House of Representatives, where there are a number of bills and initiatives underway to delay or derail the DOL Proposal. Most significantly, the House in late October passed the Retail Investor Protection Act, which would halt the DOL Proposal until after the SEC finalizes its own rules on standards of conduct for broker-dealers. Although the bill is unlikely to be taken up in the Senate, and President Obama has stated his intention to veto the bill, its passage in the House is indicative of the level of political and industry opposition to the DOL Proposal.

Ms. White's testimony and remarks to CNBC appeared to echo some of the concerns expressed by detractors of the DOL Proposal. In both instances, Ms. White emphasized that the task at hand involves incredibly complex issues and will require careful calibration in order to balance the interests of investors with those of other industry participants.

Ms. White's CNBC interview and November 18 testimony can be found **here** and **here**, respectively. A link to the DOL Proposal can be accessed through the DOL's website **here**.

4. SEC Adopts Final Rule for Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants

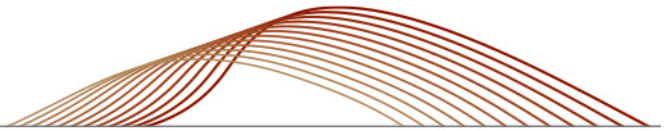
On August 5, 2015, the SEC voted to adopt final rules (including related forms) to govern all aspects of registration for security-based swap dealers and major security-based swap participants (collectively, "SBS Entities").

To register as a SBS Entity, a firm will need to file one of three registration forms (depending on whether the SBS Entity is already registered with the SEC as a broker-dealer or with the CFTC). If any of the information contained in the initial application form becomes inaccurate or out-of-date, it will need to be promptly updated by the SBS Entity.

An application to register as a SBS Entity must be accompanied by certain senior officer certifications that will be required to be made on a separate form. The first required certification must be signed by a senior officer of the applicant and provide that, after due inquiry, the signing officer has reasonably determined that the applicant has developed and implemented policies and procedures reasonably designed to prevent violations of the federal securities laws. In addition, the firm's CCO (or his or her designee) must certify that such person neither knows nor should know that any person associated with the SBS Entity who is involved in effecting security-based swaps on its behalf and is subject to a statutory disqualification, unless otherwise specifically provided by rule, regulation, or order of the SEC. In both cases, the basis behind the certifications must be documented by the individual providing the certification.

Following the applicant's submission of the requisite paperwork, it will automatically become a conditionally registered SBS Entity. The SEC may subsequently determine that more information is required from the registrant or initiate proceedings to deny the applicant's registration.

The SEC's press release and the full text of the final rule can be found **here** and **here**, respectively.



Together with its adopting of the final registration rules, the SEC also proposed new procedures for a SBS Entity to apply to the SEC for permission to permit certain statutorily disqualified persons to be involved in effecting security-based swap transactions under certain circumstances. The full text of the proposed rule can be accessed on the SEC's website **here**.

5. SEC Staff Engaged in Review of "Accredited Investor" Definition

As part of her testimony to the Committee of Financial Services referred to above, SEC Chair White confirmed that the SEC staff remains engaged in a "comprehensive review of the 'accredited investor' definition" in Regulation D of the Securities Act of 1933, as amended (the "Securities Act"), including whether to continue to use net worth and annual income as tests for determining whether a natural person falls within such definition. Ms. White also emphasized that as the staff undertakes this review, it must consider how to balance the "need to facilitate capital formation and the need to protect investors."

As discussed in our **Spring 2014** Report, Section 413(b) of the Dodd-Frank Act requires the SEC to undertake a review of the definition of "accredited investor," as it applies to natural persons, at least once every four years. As previously reported in our **Spring 2015** Report, the SEC's Advisory Committee on Small and Emerging Companies approved recommendations regarding the "accredited investor" definition, including recommendations that applicable thresholds should be tied to the consumer price index, and that any modifications to the definition should expand the pool of accredited investors.

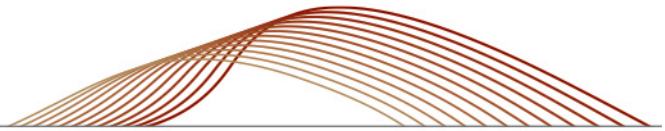
6. Volcker Rule Updates

The Volcker Rule (Section 619 of the Dodd-Frank Act) is now largely in effect. As discussed in our prior **Reports** and **Client Alerts**, the Volcker Rule generally prohibits banking entities from engaging in proprietary trading and from acquiring or retaining ownership interests in, sponsoring, or having certain relationships with a hedge fund or a private equity fund. These prohibitions are subject to a number of statutory exemptions, restrictions, and definitions. Final rules implementing the Volcker Rule were adopted by the Federal Reserve, the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), the SEC, and the CFTC in December 2013, and are available **here** (OCC, Federal Reserve, FDIC, and SEC) and **here** (CFTC).

Given the complexities of the Volcker Rule, the Federal Reserve, OCC, FDIC, SEC, and CFTC (collectively, the "Agencies") continue to issue coordinated guidance on Volcker Rule implementation issues in the form of responses to Frequently Asked Questions ("FAQs"). Substantively identical versions of the FAQs (although formatted differently) and responses are available on each Agency's website, which may be accessed **here** (Federal Reserve), **here** (OCC), **here** (FDIC), **here** (SEC), and **here** (CFTC).

Developments since our Spring 2015 Hedge Fund Report include the Agencies updating the FAQs addressing various issues such as:

- Exempting registered investment companies ("RICs") and foreign public funds ("FPFs") from being treated as banking entities during their seeding periods, provided that there is no evidence that the RIC or FPF is being used to evade the Volcker Rule restrictions;



- Addressing a banking entity's compliance program for market-making related activities including consideration of objective factors on which a trading desk may reasonably rely to determine whether a security is issued by a covered fund;
- Applying the joint venture exclusion from the definition of covered fund; and
- Permitting covered transactions under Section 23A of the Federal Reserve Act and Regulation W of the Federal Reserve System between a banking entity and a fund managed, sponsored, or advised by such banking entity (or affiliate) has taken an ownership interest, subject to the satisfaction of certain conditions, such as delivery of an annual written CEO certification that the banking entity does not guarantee (or otherwise insure) any obligations of the covered fund or of any covered fund in which such covered fund invests.

In addition, the Agencies issued guidance on the methodology banks must use to deduct investments from tier 1 capital under the Volcker Rule and the Basel III regulatory capital regime. Noting that the deduction of investments in certain Volcker-covered funds could overlap with deductions under the Basel III rules, the Agencies clarified the deduction methodology that will avoid double deductions.

B. JOBS Act Updates

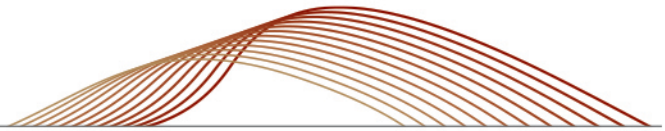
1. SEC Adopts Final Crowdfunding Rules

On October 30, 2015, the SEC adopted final rules, dubbed "Regulation Crowdfunding," which will allow issuers to offer and sell their securities via online crowdfunding portals that are registered with the SEC.

Regulation Crowdfunding allows an issuer, together with its predecessors and other issuers under common control, to raise up to $1 million during any 12-month period through an online funding portal intermediary. In addition to the limitation on capital raised, the rules impose limits on the amount that individual investors may contribute over a 12-month period to all Regulation Crowdfunding offerings. If either of an investor's net worth or annual income is less than $100,000, then that individual may invest the greater of either $2,000 or 5% of the lesser of the investor's annual income or net worth. An investor may invest up to 10% of the lesser of the investor's annual income or net worth if both figures are over $100,000.

All Regulation Crowdfunding capital raises must be made through an intermediary that is registered with the SEC as either a broker-dealer or funding portal (the latter representing a new type of SEC registration). Each offering must be conducted online through the intermediary's public website in a manner such that potential participants may exchange information, ideas, and evaluations concerning the issuance.

Issuers are subject to a variety of disclosure and reporting requirements, some of which phase in depending on the amount of capital that the issuer is trying to raise. For example, in response to comments to the proposed rules, the requirement that an issuer's financial statements be subject to an annual audit is, in the final rules, limited to offerings targeting $500,000 or more. Issuers seeking to raise between $100,000 and $500,000 would need to have an independent public accountant review its financial statements, while issuers seeking less than $100,000 would be required only to have their financial statements reviewed and certified by the issuer's chief financial officer. Issuers are also subject to limitations on advertising relating to the capital raise.



By statute, certain issuers of securities are not eligible to raise capital via crowdfunding, including non-U.S. issuers and private investment funds that rely on exclusions from the definition of "investment company" under Sections 3(b) or 3(c) of the Investment Company Act of 1940, as amended. In addition, the final rules preclude certain "bad actors" and other categories of issuers from participating in a Regulation Crowdfunding offering.

It is worth noting that the adoption of Regulation Crowdfunding marks the final major SEC rulemaking mandated by the JOBS Act.

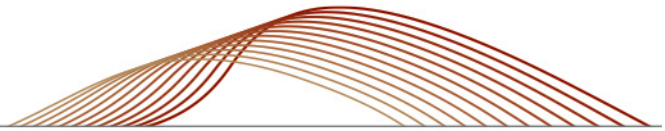
The new rules become effective 180 days following their publication in the Federal Register. The Forms permitting SEC registration of funding portals will become available on January 29, 2016. The SEC's press release and full text of the adopted rule are available **here** and **here**, respectively.

2. SEC Offers Additional Guidance on General Solicitation, Websites, and Online Platforms

On August 6, 2015, the staff of the SEC's Division of Corporation Finance issued a no-action letter (the "No-Action Letter") and published new Compliance and Disclosure Interpretations (the "New C&DIs"), which provide additional interpretive guidance on activities that would or would not constitute "general solicitation" for purposes of Rules 502(c) and 506(b) of Regulation D under the Securities Act. The guidance contained in the New C&DIs and the No-Action Letter deal mostly with what it means for a relationship to be "pre-existing" and "substantive" for purposes of demonstrating absence of general solicitation under Rule 502(c). These new materials also contain useful information for issuers that use websites or online platforms in the course marketing investment advisory services or pooled investment vehicles.

The New C&DIs provide high-level guidance on the kinds of information an issuer can and cannot disseminate broadly (for example, on an unrestricted public website) without giving rise to general solicitation. As an initial matter, the New C&DIs confirm that no general solicitation will have taken place if such broadly disseminated information is limited to "factual business information," meaning information about the issuer, its business, financial condition, products, or services, so long as this information is not presented in a manner as to condition the public mind or arouse public interest in the issuer's securities. The SEC staff also clarified that it would not consider a track record (or other past performance information) of a continuously offered fund to be factual business information.

It is long accepted that no general solicitation will have occurred for purposes of Rule 502(c) if the issuer, or a person acting on the issuer's behalf, has a pre-existing, substantive relationship with each purchaser of the issuer's securities. The New C&DIs and No-Action Letter help to clarify what it means for a relationship to be "pre-existing" and "substantive." As an initial matter, the New C&DIs indicate that an issuer may rely on the pre-existing, substantive relationship between an SEC registered investment adviser and such adviser's clients as a means of establishing that no general solicitation has occurred. The guidance provides that a "pre-existing" relationship is "one that the issuer has formed with an offeree prior to the commencement of the securities offering or, alternatively, that was established through either a registered broker-dealer or investment adviser prior to the registered broker-dealer or investment adviser participation in the offering." Although this definition may appear difficult for private funds engaged in a continuous offering, the staff confirmed that it had, in the past, made accommodations for private funds in view of the fact that such offerings are made on a semi-continuous basis (although the staff did not take the opportunity to expressly expand its previous accommodation beyond bulletin boards and online portals). In addition, the C&DIs confirmed previous guidance that a "substantive" relationship is one in which "the issuer (or a person acting on its behalf)



has sufficient information to evaluate, and does, in fact, evaluate, a prospective offeree's financial circumstances and sophistication, in determining his or her status as an accredited or sophisticated investor."

The No-Action Letter also addressed the issues and interpretations discussed above, especially as they relate to the use of online platforms to offer securities. The No-Action Letter involved Citizen VC, Inc. ("CVC"), which sells interests in special purpose vehicles managed by CVC and its affiliates that aggregate investments from members of CVC's online platform to make venture capital investments in specified portfolio companies. The information relating to CVC's securities offerings is password-protected and made available only to members of the platform who have been approved by CVC following a number of vetting procedures. These procedures include telephone discussions about the investor's qualifications and goals, obtaining third-party credit reports, solicitation of questions, and other procedures designed to ensure that the investor is financially sophisticated and qualified to invest in privately placed securities. Only once an investor is approved is such investor permitted to view information relating to, and invest in, CVC's special purpose vehicles. In the No-Action Letter, the SEC staff agreed that the quality of the relationship between an issuer (or its agent) and an investor is the most important factor in determining whether a "substantive" relationship exists (as opposed to a certain duration of the relationship or other quantitative measure). A short-form accreditation questionnaire is likely not, by itself, sufficient to establish a substantive relationship. The staff also placed emphasis on the fact that no prospective investors are presented with any investment opportunity when being qualified to join the platform, but instead are only presented after the prospective investor becomes a member of the platform. The full text of the No-Action Letter can be accessed through the SEC's website **here**.

Lastly, the New C&DIs also confirm that the existence of a pre-existing, substantive relationship is not the only means of demonstrating the absence of general solicitation in a Regulation D offering. In certain circumstances, an issuer may be able to communicate with members of sophisticated investor groups (such as an established group of "angel investors") that have experience investing in private funds regarding an offering without general solicitation having occurred. In these cases, which the SEC staff admits will be viewed as highly fact-specific determinations, an issuer may be able to rely on a person's informal, personal network to establish a reasonable belief that other offerees in the network have the necessary financial experience and sophistication. The New C&DIs also provide that a presentation by an issuer at a "demo day" or "venture fair" may not involve general solicitation if, for example, the event's audience is limited to persons with whom the issuer or the organizer have pre-existing, substantive relationships, or have been contacted for participation at the event through an informal, personal network as described above.

C. Other Securities-Related Updates

1. FinCEN Proposal Would Require AML Reporting by Investment Advisers

On August 25, 2015, the U.S. Department of Treasury's Financial Crimes Enforcement Network ("FinCEN") proposed a rule that would require SEC-registered investment advisers to establish anti-money laundering ("AML") programs and report suspicious activity to FinCEN pursuant to the Bank Secrecy Act ("BSA"). According to FinCEN, requiring investment advisers to establish AML programs and file reports of suspicious activity would bring advisers under similar regulations as other financial institutions subject to the BSA, such as mutual funds, broker-dealers, banks, and insurance companies.

Generally, the rule proposes three regulatory changes that would impact registered investment advisers:

- First, the proposed rule would require registered investment advisers to establish and maintain an AML program reasonably designed to prevent the investment adviser from being used to facilitate money laundering or the financing of terrorist activities. Specifically, a registered investment adviser would be required to (1) adopt internal policies, procedures, and controls designed to address AML issues, (2) conduct independent testing of its AML program, (3) designate an AML compliance officer, and (4) provide ongoing AML training for firm personnel.

- Second, the proposed rule would require registered investment advisers to report suspicious activity to FinCEN pursuant to the BSA in accordance with specified filing and notification procedures.

- Finally, the proposed rule would expand the general definition of "financial institution" to include registered investment advisers, thus subjecting such investment advisers to the requirements of the BSA. These requirements include the filing of currency transaction reports and complying with record keeping obligations under the BSA.

FinCEN is proposing that registered investment advisers develop and implement an AML program that complies with the requirements of the rule on or before six months from the rule's effective date. The SEC would be delegated authority to examine registered investment advisers to ensure their compliance with the rule.

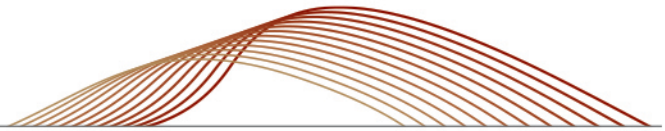
The full text of FinCEN's proposed rule can be found **here**.

2. SEC Continues to Emphasize Cybersecurity Risks as Commodities Regulators Follow Suit

On September 15, 2015, the SEC's Office of Compliance Inspections and Examinations ("OCIE") published a risk alert (the "Cybersecurity Risk Alert") outlining its 2015 cybersecurity examination initiative. The Cybersecurity Risk Alert is a prelude to the second round of cybersecurity sweep examinations to be performed by OCIE in as many years. The initial round of examinations in 2014 culminated with a report summarizing OCIE's findings and suggesting ways to improve firm practices. The prior round of examinations and report of OCIE's findings were discussed in our **Fall 2014 Report** and our prior **Report**, respectively.

Similar to OCIE's 2014 cybersecurity initiative, the SEC staff published OCIE's examination module to give firms notice of the types of information and documentation that firms would be asked to produce if examined. The current initiative's module is similar to its predecessor, though it goes into more detail and places a heavier emphasis on testing than the 2014 version. This aligns with the staff's statement in the Cybersecurity Risk Alert that this round of examinations will involve more testing to assess implementation of a firm's written procedures and controls. The full text of the Cybersecurity Risk Alert, together with the attached examination module, is available **here**.

The CFTC is also ramping up its attention to cybersecurity risks, as it recently approved a National Futures Association ("NFA") interpretive notice (the "Interpretive Notice") titled *Information Systems Security Programs*. The Interpretive Notice, which will become effective for all NFA members on March 1, 2016, sets forth a principles-based approach that provides a firm with flexibility to tailor its policies and procedures based on the firm's size, complexity, customer base, and counterparties. In all



cases, an NFA member firm would need to identify and prioritize risks associated with the firm's technology systems and infrastructure. In addition, the firms will be required to have written policies and procedures that are reviewed on a periodic basis and approved by the firm's CEO, CTO, or other senior executive officer. Employee education regarding the firm's policies and procedures will also be expected to be part of an NFA member firm's cybersecurity program. The full text of the Interpretive Notice can be accessed **here**.

For further information on cybersecurity trends among financial institutions, please see the recent **Client Alert** prepared by the Paul Hastings Global Privacy & Cybersecurity Practice Group.

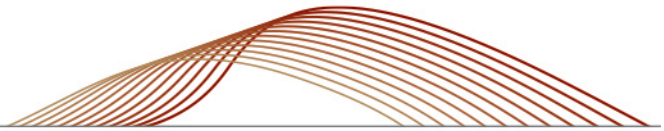
3. SEC Warns on Shortfalls Observed in Examinations Relating to Outsourced Chief Compliance Officers

On November 9, 2015, OCIE published a Risk Alert (the "Risk Alert") noting certain observations following targeted examinations of roughly 20 SEC registered investment advisers and investment companies that use outsourced Chief Compliance Officers ("CCOs"). The Risk Alert begins with a high-level overview of the role of a CCO at a registered adviser or fund, including the role that CCOs typically fulfill during SEC examinations. The Risk Alert then shares OCIE's observations on practices that have led to both successful and unsuccessful implementations of outsourced CCO solutions.

OCIE found that effective outsourced CCOs communicated frequently (and often in-person) with others at their firms, had strong relationships with the registrants, had sufficient support within the registrant to perform their duties effectively, had sufficient access to necessary documents and information, and had sufficient knowledge of the regulatory requirements of the registrant's business.

On the other hand, OCIE made a number of observations regarding firms with outsourced CCOs that had not been particularly effective. It is important to note that the Risk Alert identifies failures by both the registrants and their outsourced CCOs. Some of OCIE's observations regarding ineffective outsourced CCOs include:

- The use of standardized checklists by CCOs to gather pertinent information, which are often generic and may not fully capture the business models, practices, and compliance risks particular to the applicant's business.
- The use of template compliance manuals that have not been sufficiently tailored to the registrant's business needs and compliance risks.
- Non-recognition of critical areas of a registrant's business, resulting in inadequate disclosure and/or failure to implement appropriate policies and procedures, including those to address conflicts of interest.
- Infrequent in-person visits by outsourced CCOs, as well as insufficient follow-up to resolve discrepancies or to ensure compliance policies are being properly followed.
- Limited authority and/or restricted access to information and documents within registrant's organization, leading to inability to improve adherence to compliance policies and procedures and deploy new policies designed to target identified risks.
- Insufficient or infrequent control testing and corresponding lack of documentation to evidence testing.



The Risk Alert concludes with OCIE's recommendation that registered advisers and funds, especially those with outsourced CCOs, review their business practices in light of the observations noted in the Risk Alert. The Risk Alert can be accessed through the SEC's website **here**.

4. SEC Chair Officially Embraces T+2

SEC Chair White, in a letter signed by three other SEC Commissioners, officially endorsed the industry's T+2 initiative to shorten settlement times for stock and bond trades to two days following the trade date. Current rules require a three-day settlement cycle.

In her letter, Ms. White revealed that she had set the relevant rule changes in motion and directed the SEC staff to work toward an implementation date sometime in Q3 2017. She also expressed her agreement with the initiative's supporters, who say that shorter settlement times would reduce counterparty risk and transaction costs associated with trading, as well as improve overall market health and efficiency.

The full text of Ms. White's September 16 letter is available **here**.

5. BEA Form Requires Certain Private Funds and Advisers to Report Transactions with Foreign Persons

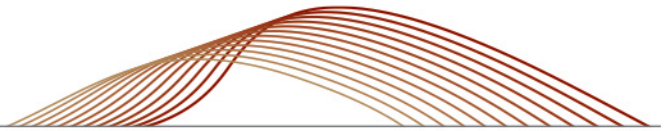
Certain U.S.-domiciled private funds and private fund managers are required to report information relating to financial services transactions entered into with foreign persons on Form BE-180, the Bureau of Economic Analysis (the "BEA") and its *Benchmark Survey of Financial Services Transactions Between U.S. Financial Services Providers and Foreign Persons*. Entities covered by the survey must file Form BE-180 or request a 60-day extension by November 1, 2015 (or December 1, 2015 for certain providers).

U.S. funds, investment advisers, and other pooled investment vehicles are required to complete and submit Form BE-180 if, during fiscal year 2014, they sold more than $3 million of financial services to, or purchased more than $3 million of financial services from, foreign persons. These figures are determined with respect to the reporter's "fully consolidated U.S. domestic business enterprise," which includes the full chain of ownership (greater than 50% owners only) of the U.S. reporting entity, but does not include any greater than 50% owners that are individuals, estates, trusts, or nonprofit organizations. "Sales" and "purchases" of financial services are defined broadly to include management fees, performance fees, and brokerage commissions.

A fillable PDF version of Form BE-180 is available **here**, and additional information relating to the survey is available on the BEA's website **here**.

6. Update on European Derivatives Regulation

The European regulators have continued to push forward with the rules and regulations associated with mandatory clearing, reporting, and the imposition of risk management techniques on European Union ("EU") entities and non-EU entities executing derivative activity with EU entities, all of which emanate from the European Derivatives Regulation: Spotlight on the European Markets and Infrastructure Regulation ("EMIR"). Our Client Alert on developments in European Derivatives Regulation is available **here**.



7. Update on AIFMD—Latest Developments in Europe

In Europe, all of the key jurisdictions have now implemented the EU Alternative Investment Fund Managers Directive[1] (the "AIFMD" or the "Directive") and regulators have been publishing guidance and taking other steps in connection with the national implementation of the Directive. Set out below is a brief overview of the implications for alternative investment fund managers ("AIFMs") marketing or considering marketing alternative investment funds ("AIFs")[2] to EEA[3]-based investors.

Where Are We Now?

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

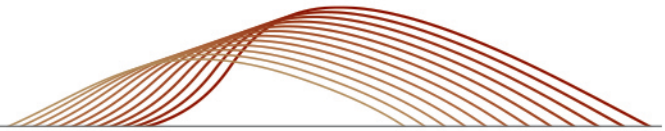
Marketing Funds in the EEA

The Directive provides for a marketing passport, which was initially only made available to EEA AIFMs of EEA funds, permitting a firm (the AIFM) to register in one state to market its EEA funds across the EEA by making application to the regulator of that state and indirectly through that regulator to regulators in other EEA states for permission to market in those other states. However, the Directive also provided for the possible extension of the marketing passport to non-EEA AIFMs, following review by the European regulator ("ESMA") two years following the date of the Directive being required to come into force, should ESMA consider that there are no significant obstacles regarding investor protection, market disruption, competition, and monitoring of systemic risk impeding the such extension.

On July 30, 2015, ESMA published an opinion[4] on the functioning of the marketing passport and the general managing and marketing of EU and non-EU AIFs under the AIFMD regime, and advice[5] on whether or not to extend the AIFMD marketing passport to non-EEA AIFs. Given the late implementation by many member states, ESMA noted that there had been limited time for experience under the Directive to develop.

Ultimately, ESMA only reviewed the possible extension to AIFMs established in six jurisdictions (the Channel Islands, being Guernsey and Jersey, Switzerland, the US, Hong Kong, and Singapore) and only approved, in principle, extending the passport to Guernsey, Jersey, and Switzerland. ESMA required more time and information to make a determination in respect of the other jurisdictions it reviewed, and also cited "competition and regulator concerns" in connection with a possible extension to the U.S.

The European institutions do not yet appear to have made any decisions in connection with the possible extension (or not) of the marketing passport, and are unlikely to do so before receiving further analysis from ESMA.



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

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

Marketing

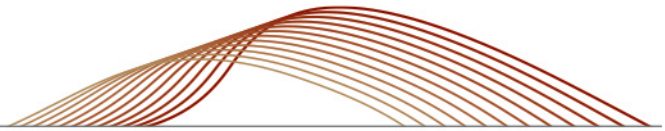
The scope of AIFMD has intentionally been drafted very broadly, yet many key concepts have been left without specific definitions, resulting in different member states implementing, and their regulators interpreting, AIFMD in differing ways. For example, AIFMD defines "marketing" as a direct or indirect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

Notification to Local Regulator

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

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

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



Ongoing Disclosure and Reporting

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

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

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

Future Developments

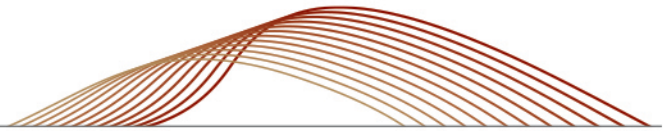
If the passport regime is eventually extended to non-EEA AIFMs (see above), these non-EU AIFMs will need to select a 'Member State of reference' and apply for authorization and supervision from the local regulator in that EU Member State. This would come at the cost of submitting to the full scope of the management requirements of the AIFMD.

If the passport regime is extended to non-EEA AIFMs, then NPPRs may be phased out, though not sooner than 2018, subject to further review by ESMA and decision by the Commission, and all AIFMs would have to apply for an AIFMD passport in order to market any AIF in the EEA. However, given that member states maintain their NPPRs at their own discretion, there is always the possibility that they may amend or remove such regimes before that date. Should the marketing passport eventually be extended to non-EEA AIFMs, then some member states might unilaterally choose to do this.

Reverse Solicitation

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

The approach to reverse solicitation may also differ between member states and it is important to take precautions against the risk of communications later being determined not to have been entered into pursuant to a genuine reverse solicitation. There is also some uncertainty as to how marketing would be viewed, for example, where it occurs in the U.S. offices of an investor who also has registered offices in EEA member states. This is again, ultimately, a question for local counsel to confirm in light of the interpretation adopted in the relevant member state. As a guiding principle however, it may be



helpful to consider the location of the decision maker with respect to that investor, rather than considering the location where the specific act occurs in isolation. There has been significant discussion about the parameters of the reverse solicitation exemption on which Paul Hastings has developed some detailed protocols.

Third Party AIFM

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

8. Cayman Update

Cayman Islands Issues OECD Common Reporting Standard Regulations

Common Reporting Standard ("CRS") is a global reporting standard developed by the Organisation for Economic Co-operation and Development ("OECD") to facilitate the automatic exchange of financial information for tax purposes between countries that have adopted the standard. To date over 90 jurisdictions have committed to the regime, over 60 of which, including the Cayman Islands, have formally adopted the CRS by signing the Multilateral Competent Authority Agreement.

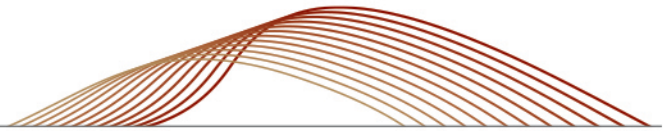
On October 16, 2015 the Cayman Islands introduced The Tax Information Authority (International Tax Compliance) (Common Reporting Standard) Regulations, 2015 (the "Regulations") to implement the CRS. The CRS will require "reporting financial institutions" to conduct due diligence on their accountholders and investors and report certain information to the Cayman Islands Tax Information Authority for automatic exchange with other tax authorities.

Pursuant to the Regulations the due diligence requirements set out in the CRS (in respect of both existing and new clients) will apply from January 1, 2016, with notification and reporting requirements (akin to those already required for FATCA) coming into effect for the first time in 2017. Unlike FATCA, which imposes a 30% withholding tax on U.S. source income and other U.S. related payments of a foreign financial institution, the CRS does not implement a similar penalty for non-compliance and penalties for non-compliance will instead be specified in local legislation which is yet to be published.

Possible Extension of AIFMD Passport to the Cayman Islands

ESMA is to begin assessing whether the Cayman Islands should be included in the "passport" regime under the terms of the AIFMD. The announcement was made by Steven Maijoor, chair of ESMA, at a session of the Economic and Monetary Affairs Committee at the European Parliament on October 13, 2015. The AIFMD applies to alternative investment fund managers actively marketing alternative investment funds to professional investors in the EU, including AIFMs and AIFs, which are domiciled in the Cayman Islands.

The AIFMD was introduced to improve oversight of funds marketed to EU consumers, and a transitional period ended on July 22, 2014. EU managers marketing EU AIFs are required to obtain an EU-wide passport to market their funds to professional investors. Non-EU AIFMs or non-EU AIFs managed by EU AIFMs will be unable to obtain a passport until at least 2016, and have instead



marketed their funds through a NPPR. Currently, Cayman Islands entities are able to operate within the NPPR under the AIFMD but this regime is anticipated to remain in place only until 2018.

An AIFMD passport—currently only available to authorized EU AIFMs and EU AIFs—would allow Cayman AIFMs to manage and/or market AIFs within the EU without being required to set up operations in the EU.

An earlier assessment of other jurisdictions by ESMA resulted in positive advice being given in respect of extending the passport to Guernsey and Jersey, conditional advice in respect of Switzerland (subject to the enactment of pending legislation in Switzerland), and a deferred conclusion in respect of Hong Kong, Singapore, and the United States.

The second assessment group will include the Cayman Islands and also includes Australia, Bahamas, Bermuda, Brazil, British Virgin Islands, Canada, Curacao, Japan, the Isle of Man, Mauritius, Mexico, South Africa, South Korea, Thailand, and the U.S. Virgin Islands.

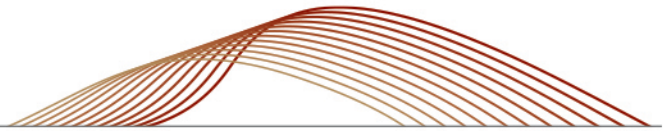
Amendments to the Mutual Funds Law and Securities Investment Business Law will come into force shortly to provide appropriate regulations to enable the Cayman Islands to qualify as an AIFMD regime with the goal of ESMA recommending the extension of the AIFMD passport to Cayman AIFs and AIFMs. CIMA has created a flexible "opt in" regime for a new category of AIF, being an EU Connected Fund that wishes to market in the EU.

Proposed LLC Legislation

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

II. TAXATION

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



Further, over the past few months, the IRS has released guidance on a number of significant issues that affect the alternative investment industry, disguised payments for services, and new audit rules for partnership.

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

A. Disguised Payments for Services / Management Fee Waivers

On July 22, 2015, the Treasury Department released proposed regulations regarding disguised payments from partnerships for services (the "Proposed Regulations"). The Proposed Regulations apply to any arrangement between a partnership and a partner that provides services to the partnership in exchange for a partnership interest, including management fee waiver provisions found in many investment fund agreements. The Proposed Regulations confirm that a partner who receives an interest in a partnership for the performance of services must bear "significant entrepreneurial risk" with respect to the partnership interest if it is to be respected as a profits interest with income recognized through allocations of income from the partnership and not a disguised payment for services taxable as ordinary income for services. A lack of significant entrepreneurial risk will result in such arrangement being re-characterized as a payment for services resulting in ordinary compensation income to the service provider, which income could be recognized on the date of the grant of the interest. It should be recognized that the proposed rules are unclear in many respects, and will likely be modified and/or clarified before they are finalized. For further information on the Proposed Regulations, please see **Client Alert**. We will report updates as additional guidance is released.

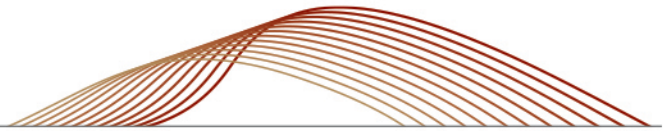
1. Background on Management Fee Waiver Provisions

Under a typical management fee waiver arrangement, a fund sponsor irrevocably waives its rights to receive management fees from the fund before the beginning of the period for which those fees would otherwise be earned. The fund sponsor receives a profits interest in the fund, entitling it to receive distributions equal to the waived amount as and when distributions would have been made with respect to the deemed contribution, plus a share of future fund profits based on the waived amount treated as a deemed contribution. The corresponding allocation of net profits to the fund sponsor is frequently limited to items of long-term capital gain and qualified dividend income, thus resulting in the conversion of ordinary income from management fees taxed at a federal income tax rate of 39.6% to long-term capital gains or qualified dividend income taxed at a federal income tax rate of 20%.

2. Proposed Regulations

a. Facts and Circumstances Analysis. Under the Proposed Regulations, whether an arrangement should be characterized as a payment for services or a profits interest depends on all of the facts and circumstances at the time the parties enter into or modify the arrangement. The Proposed Regulations provide a non-exclusive list of factors that are relevant in this determination.

b. Significant Entrepreneurial Risk. The most significant factor in making this determination is the presence or absence of significant entrepreneurial risk. An arrangement without



significant entrepreneurial risk will be presumed to be a payment for services. Conversely, an arrangement that has significant entrepreneurial risk will generally not constitute a payment for services unless other factors establish otherwise. Whether an arrangement has or lacks significant entrepreneurial risk is determined based on the service provider's entrepreneurial risk relative to the overall entrepreneurial risk of the partnership. The facts and circumstances that create a presumption that significant entrepreneurial risk is lacking are:

- Capped allocations of partnership income if the cap is reasonably expected to apply in most years;
- An allocation for one or more years under which the service provider's share of income is reasonably certain;
- An allocation of gross income to the service provider;
- An allocation that is predominantly fixed in amount, reasonably determinable under all facts and circumstances, or designed to assure sufficient net profits are highly likely to be available to make the allocation; and
- An arrangement in which a service provider waives its right to receive payment for future performance of services in a manner that is non-binding or fails to notify the partnership and its partners of the waiver and its terms in a timely manner.

c. Additional Factors. The Proposed Regulations provide a non-exclusive list of additional factors to consider in determining whether an arrangement is a disguised payment for services, including whether the arrangement provides for different allocations and distributions with respect to related service providers, with significant differences in entrepreneurial risk (e.g., a clawback with respect to carried interest but not with respect to fee waiver interests).

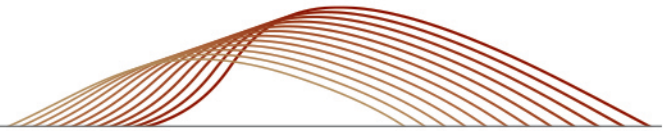
3. Effective Date

The Proposed Regulations will apply only to arrangements entered into or modified on or after the date final regulations are published. For the purposes of determining whether the final regulations apply to an arrangement, if an arrangement permits a service provider to waive all or a portion of its fee at a later date, the arrangement would be considered to be "modified" on any date that the service provider waives its fee. As most fee waivers are made on a quarterly or annual basis rather than at inception of the fund, most existing fee waiver provisions would be subject to the new rules as a modification would occur upon each quarterly or annual election.

B. New IRS Audit Rules for Partnerships

Hedge funds and private equity firms are paying close attention to recent changes in tax audit procedures for partnerships and limited liability companies ("LLCs").

The old "TEFRA" audit rules,[6] in place since the 1980s, allowed the IRS to audit the partnership itself, but required any ultimate tax adjustments to be collected from individual partners. TEFRA arguably made better sense in an era of simpler partnership structures. The IRS has long struggled with audits of partnerships, since it can be extraordinarily difficult to collect tax from layers of indirect partners.



As a result, audits of partnerships have been relatively rare compared to other types of business entities. Even as partnership and LLC structures have proliferated, audits have been rare (less than one percent of partnerships with more than $100 million in assets were audited in 2012, compared to 27 percent of C corporations of equal size).[7] This is expected to change under the new audit rules, which are anticipated to result in nearly $10 billion in additional revenue over 10 years.

The changes came as part of the Bipartisan Budget Act of 2015, signed into law on November 2, 2015.[8] Under the new approach, the IRS will audit at the partnership level just as under TEFRA, but it will be relieved of the burden of collecting tax from individual partners. If the IRS concludes that additional tax is due at the end of an audit, it will now be able to impose tax, interest, and penalties at the entity level. The partnership then has two options: it can pay this tax directly (which causes the current partners to indirectly pay their respective shares of the tax) or it can pass through the tax adjustment to the partners for the audited tax year by issuing amended Schedules K-1. Each partner would then need to file an amended tax return for the audited tax year.

There will be an option for small partnerships (fewer than 100 partners) to opt out of the regime and force the IRS to assess tax against each individual partner, but this option will not be available to any partnership with partners which are also partnerships. Since tiered structures are so common, this opt-out will be largely unavailable to many businesses, including most private investment funds.

The new regime brings an end to the "tax matters partner" role in audit proceedings. As LLCs have multiplied, questions have arisen about who is eligible to serve as tax matters partner under various forms of LLC management structures. The new rules explicitly allow the appointment of any United States person—partner or not—as "partnership representative", with authority to settle actions, pursue litigation, and bind the entity and its partners. Partnership and LLC agreements can be drafted to tailor this authority, giving partners more or fewer participation rights as appropriate.

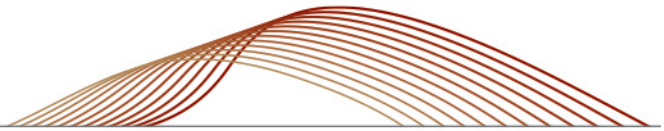
Another significant change relates to the timing of partnership audit adjustments. If the IRS imposes additional tax liability as a result of an audit of a prior year, this adjustment will now apply to the current year rather than the earlier year. This means current partners could find themselves liable for tax adjustments relating to events preceding their entry into the business. As partnership mergers and acquisitions occur going forward, purchase and sale agreements will need to be carefully drafted in conjunction with partnership agreements to allocate responsibility for such adjustments between departing and incoming partners.

The new rules take effect for tax years beginning on or after January 1, 2018. Every existing partnership and LLC agreement should be reviewed and amended over the next two years in light of the new audit rules. Regulations have not yet been issued so many questions remain about how the new approach will be implemented.

C. FATCA Relief

As fund managers are aware, the Foreign Account Tax Compliance Act ("FATCA")[9] was enacted in 2010 to reduce tax evasion by United States citizens and residents with financial assets held abroad, by requiring certain reporting by "foreign financial institutions" ("FFIs") to the IRS. Implementation of FATCA has been a significant challenge.

On September 1, 2015, the Department of the Treasury and IRS extended certain transitional rules.[10] The proposed amendments to the Treasury Regulations provide some relief from impending FATCA



deadlines. Overall these extensions and clarifications to the FATCA rules should ease the ongoing transitional phase-in of FATCA compliance and withholding.

1. Delayed Withholding on Gross Proceeds and Foreign Passthru Payments

FATCA generally subjects withholdable payments, such as U.S. source interest and dividends, made to FFIs to a 30% withholding tax, unless the FFI complies with FATCA or qualifies for an exemption. The FATCA withholding tax also applies to gross proceeds from the sale or other disposition of property that can produce U.S. source interest or dividends, as well as certain "foreign passthru payments" made by a participating FFI (i.e., a FFI that complies with FATCA). The amendments extend the start date of withholding on these payments of gross proceeds by two years to January 1, 2019.

2. Delayed Registration Deadline for Certain Sponsored Entities

In lieu of complying with FATCA directly as a participating FFI, certain FFIs are eligible for deemed compliant FATCA status as a sponsored FFI. In this case, the sponsoring entity is responsible for satisfying the FATCA requirements, including registering the sponsored FFI with the IRS. A sponsoring entity must obtain a Global Intermediary Identification Number ("GIIN") for such sponsored FFIs by registering such FFIs with the IRS. This registration deadline has been extended by one year to January 1, 2017. For payments made prior to the registration deadline, withholding agents may rely on a withholding certificate containing only the sponsor's GIIN.

3. Extended Special Treatment for Limited Branches and Limited FFIs

Existing transitional rules provide that an FFI may qualify as a participating FFI even if one or more FFIs in the expanded affiliated group cannot satisfy the participating FFI requirements. Such FFIs are "limited FFIs" or "limited branches" under the current FATCA regulations. Under the new rules, the availability of limited FFI and limited branch statuses will be extended by one year until December 31, 2016. Beginning January 1, 2017, any limited FFI or limited branch must fully satisfy the participating FFI requirements. To take advantage of the one-year extension, a limited FFI or limited branch must edit and resubmit its registration after December 31, 2015.

4. Extended IGA Deemed Compliant Treatment

Model 1 Intergovernmental Agreements ("IGAs") provide for the exchange of FATCA information between governments. While more than 100 Model 1 IGAs have been signed or agreed to in substance, some have not yet been brought into force. Under the new guidance, the Department of the Treasury will continue to treat FFIs covered by deemed effective IGAs that have not yet entered into force as of September 30, 2015, as complying with FATCA (i.e., not subject to withholding), so long as the relevant jurisdiction continues to demonstrate its "firm resolve" to bring the IGA into force, and any information that was required to be exchanged by September 30, 2015 is exchanged by September 30, 2016.

5. Modified Treatment of Grandfathered Obligations

Generally a payment made under a "grandfathered obligation" is not a withholdable payment under FATCA. A grandfathered obligation includes an agreement requiring a secured party to make payments with respect to posted collateral securing the grandfathered obligation. To the extent collateral secures both grandfathered and non-grandfathered obligations, current rules require a pro rata allocation by value to determine what portion of the collateral secures the grandfathered obligation. In response to comments from the financial industry about the difficulties of this approach, the amendments make the pro rata allocation rule for pooled collateral optional. This will provide

financial institutions the option to treat collateral securing both grandfathered obligations and non-grandfathered obligations as securing only non-grandfathered obligations. Under this alternative, withholding will be required on all payments made with respect to the collateral. Financial institutions may find this less administratively burdensome than the pro rata approach.

III. CIVIL LITIGATION

Litigation matters involving hedge funds continue to involve interesting and novel issues. Significant recent developments include the following:

- Certain plaintiffs in an MDL proceeding—in which hedge funds and others sued banks for artificially depressing LIBOR—seek to join a Second Circuit appeal that the Supreme Court has ruled may proceed.
- Citigroup agrees to settlements in connection with collapse of its hedge funds during the financial crisis.
- Saba Capital Management faces a lawsuit for allegedly improperly valuing illiquid bonds to minimize the payout to a redeeming investor.
- Highland Capital sees an appellate win in Texas, after a court upheld its summary judgment win finding no evidence investors relied on management's statements about the fund.
- Carrington Investment Partners is ordered to pay an investor $1.86 million for contract damages for refusing to allow redemptions during the housing crisis.
- A controversial hedge fund led by Kyle Bass is challenging patents held by pharmaceutical companies.

A. Update on Previously Reported Cases

Claims Trimmed from LIBOR Multi-District Litigation and Parties Seek to Join Second Circuit Appeal

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 20 other LIBOR-related cases in the Southern District of New York.[11] On March 29, 2013, the District Court dismissed the heart of the litigation, the federal antitrust claims, and allowed certain commodity manipulation claims to proceed. The court's refusal to certify its order for appeal with other claims still pending went all the way to the Supreme Court and, as we reported in our **Spring 2015** Report, the Supreme Court remanded the case to the Second Circuit holding that it had jurisdiction to consider the antitrust appeals despite the pending claims.[12] The Supreme Court reasoned that, although the MDL proceedings were consolidated for pretrial purposes, a decision completely resolving one of the individual cases could be appealed while the MDL proceedings continued.

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

court dismissed a number of other remaining antitrust claims, including that of Freddie Mac, and did not allow them to join the appeal to the Second Circuit, stating that Freddie Mac and others should have sought partial judgment along with other plaintiffs. We will continue to monitor and report on the developments in this litigation.

B. New Developments in Securities Litigation

Citigroup Agrees to Settlements in Connection with Collapse of Hedge Funds during the Financial Crisis

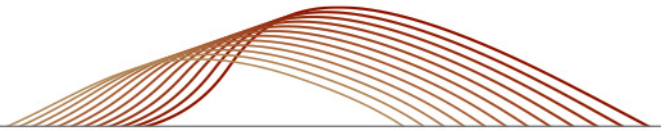
Two Citigroup affiliates, Citigroup Global Markets Inc. and Citigroup Alternative Investments LLC, have agreed to pay $180 million to injured investors in connection with a settlement with the SEC. The investigation and settlement stem from allegations that Citigroup concealed problems at two of its hedge funds, the ASTA/MAT and Falcon Strategies funds, during the financial crisis. Nearly 4,000 investors deposited about $3 billion in the funds, which Citigroup allegedly sold as a safe investment alternative to bonds. Plaintiffs had alleged the funds were actually highly leveraged, complex, and troubled. Citigroup contested primarily on the grounds that all the statements it made in its prospectuses were accurate. On August 17, 2015, the SEC accepted the settlement in which Citigroup did not admit wrongdoing.[13]

Citigroup also agreed to a $13.5 million settlement in civil litigation involving its Corporate Special Opportunities fund. A group of investors brought a class action alleging that Citigroup (1) induced investors to stay with the troubled fund through false assurances that the fund was "fundamentally sound," (2) failed to disclose risky debt, and (3) failed to accurately represent risk controls just weeks before the fund's collapse during the financial crisis. Citigroup responded that they were not in a direct contractual relationship with plaintiffs and that no specific false statements were identified. The fund, which primarily backed European private equity deals, was liquidated in 2008 due to the financial crisis and the fund's leverage. On August 10, 2015 documents reflecting the settlement were filed and the Southern District of New York has preliminarily approved the settlement.[14]

Investor Sues Saba Capital Management for Allegedly Improperly Valuing Bonds to Minimize Redemption Repayment

A recent lawsuit, brought on September 25, 2015, against Saba Capital Management LP ("Saba") highlights the dangers of valuing illiquid securities, especially during stressful periods.[15] The plaintiff, a Canadian pension manager for several Canadian public sector pensions named the Public Sector Pension Investment ("Pension Board"), saw its $500 million investment declining. In January 2015, the Pension Board notified Saba it would redeem its investment. The Pension Board alleged that, in response, Saba improperly manipulated the valuation of certain corporate bond holdings in an attempt to minimize redemption repayment and to discourage other investor redemptions.

Specifically, the dispute centers on bonds of McClatchy, a media company. The Pension Board alleged that fund documents required these bonds to be valued according to external pricing sources, including independent pricing services and dealer quotations from a market maker or financial institution that regularly trades the bonds. However, Saba allegedly deviated from these valuation methods and instead adopted a bids-wanted-in-competition process.[16] This allegedly produced depressed bids valuing the bonds at near $30, while Saba alleges external valuation methods would have yielded values closer to $50. In addition, the Pension Board alleged that soon after Saba returned to using the external valuation methods and abandoned the bids procedure so as to salvage its own value and further discourage other redemptions.



This lawsuit demonstrates that funds must continue to be wary of the procedures used to value illiquid securities when there is no easily ascertainable market value available. Especially when competing motivations are at play, investors may call valuation procedures into question.

Texas Appellate Court Upholds Lower Court's Summary Judgment in Favor of Highland Capital

On August 28, 2015 a Texas appellate court affirmed a lower court's summary judgment favoring Highland Capital Management LP ("Highland").[17] The suit alleged that investors were misled by relying on statements Highland made and failures to disclose information regarding one of its highly leveraged funds. The court found no evidence that investors would have exited the fund sooner had they known the fund faced hundreds of millions in redemptions it could not pay during the recession. The court also found that there was not enough evidence of causation between any deceptive act and injuries plaintiffs suffered. Throughout the case, Highland has maintained that its executives only expressed broad, personal, and vague opinions regarding the outlook of the fund.

Breach of Contract Seen as Acceptable Cost of Doing Business for Fund that Weathered Housing Crisis

On July 21, 2015 a federal court in Connecticut ordered Carrington Investment Partners LP ("Carrington") to pay $1.86 million to an investor, Joseph Umbach, in contract damages.[18] The fund invested in mezzanine and subordinated securities connected to single-family subprime mortgages. In the early days of the housing crisis, Carrington imposed a one-year lockup period rather than allowing investors to withdraw their money. As the subprime market crashed, Carrington faced a growing number of redemptions despite the lock-up period.

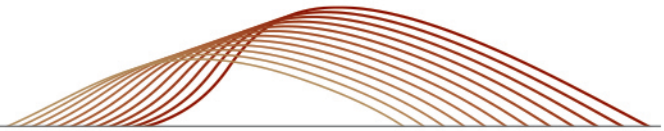
However, while recognizing a breach of contract here, the judge seemed to cast damages in terms of an acceptable loss. Carrington faced the choice of either breaching the agreement and waiting for the market to stabilize, or selling off assets at enormous loss. The judge noted that during the crisis itself, investors did not sue, likely in the hopes that the fund would turn around. The order stated that Carrington's decision "paid off in spades" and that Umbach was the only investor to sue. In awarding damages only on the contract claim, the judge rejected securities fraud and breach of fiduciary duty claims that had survived a dismissal bid in 2009. The judge wrote that, for Carrington, breaching the agreement was "simply a cost of doing business."

C. New Developments in Other Litigation Areas

Controversial Hedge Fund Challenges Patents

Kyle Bass, head of Hayman Capital Management LP, has been using Inter Partes Review ("IPR"), established by the American Invents Act ("AIA"), to challenge patents held by pharmaceutical companies. However, Bass, Hayman, and the entities he is connected to, like the Coalition for Affordable Drugs, are not direct competitors of these pharmaceutical companies. Hayman's strategy to profit from these actions is unclear, but Bass has stated that "[t]his is a short activist strategy and we hold the hammer."[19]

This strategy has received wide criticism. Congress established the IPR process in 2011 to "provid[e] quick and cost effective alternatives to litigation."[20] Commentators argue that Bass' challenges turn IPR on its head by increasing costs through a process designed to serve judicial efficiency. At least two other investment funds, Ferrum Ferro Capital LLC and the Mangrove Partners Master Fund, Ltd., have now also challenged patents.[21]



So far, Bass has not convinced the Patent Trial Appeal Board ("PTAB") that any challenged claims are unpatentable. However, a number of challenges are a long way from resolution. Even if the PTAB allows these challenges to continue, other forces might limit the ability of hedge funds from engaging in this practice. Congress has taken some interest, considering the Support Technology & Research for Our Nation's Growth ("STRONG") Patents Act, which would curtail bringing a petition via IPR unless the petitioner was the subject of a patent infringement charge or suit.[22]

IV. REGULATORY ENFORCEMENT

The SEC recently announced that, for the fiscal year 2015, it filed 807 enforcement actions and obtained orders totaling approximately $4.2 billion in disgorgement and penalties, both new record highs.[23] The SEC's year-end review highlighted a number of first-of-their-kind cases—including those involving an adviser's misallocation of broken-deal expenses, violations arising from the misappropriation of information in the operation of dark pools, the protection of whistleblowers, and the SEC rule prohibiting individuals from impeding whistleblower communication with the SEC—as well as more traditional matters, such as insider trading, conflicts of interest, and valuation issues.[24]

With respect to future investigations, we expect that the SEC will rely on adviser-specific data analysis in investigations of adviser activity. In an October 2015 speech at the Managed Funds Association's Outlook 2015 Conference, SEC Chair Mary Jo White noted that recent registration and reporting requirements for private fund advisers created by the Dodd-Frank Act provide the SEC with considerable data on private fund advisers.[25] This additional data and analytics analysis will likely lead to increased enforcement activity in the hedge fund industry again in 2016, especially in areas involving conflicts of interest, valuation analysis, and expense allocation.

A. SEC's Whistleblower Program

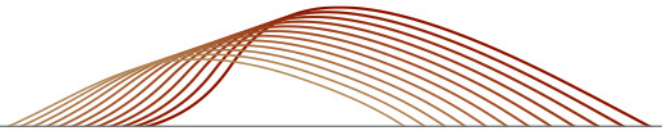
As expected, the SEC continues to rely on and tout its whistleblower program, which under certain circumstances, allows individuals, who provide the SEC with original information that leads to a successful enforcement action, to be eligible for a monetary award. With awards under the program totaling approximately $38 million in fiscal year 2015, the SEC has begun to highlight the factors that it considers when determining the size of a particular monetary award.

In July 2015, the SEC announced a whistleblower award of over $3 million—the third highest award to date under its whistleblower program—to a company insider whose information helped the SEC uncover a complex fraud that would otherwise have been very difficult to detect.[26] The SEC increased the award because the whistleblower's initial tip led to additional, related SEC enforcement actions. Although the SEC found that the whistleblower unreasonably delayed reporting the illegal conduct, it did not apply this factor as heavily as it might have in determining the magnitude of the award because the delay occurred, in part, before the whistleblower award program was established.[27]

In November 2015, the SEC announced a whistleblower award of more than $325,000 to a former investment firm employee whose information, including the identification of specific individuals involved, led the SEC to open an investigation and uncover fraudulent activity.[28] However, the SEC also stated that the award could have been higher had the whistleblower not waited to come forward until after the whistleblower left the firm.

B. Insider Trading

The topic on everyone's mind with respect to insider trading enforcement is how the federal government and courts will interpret the Second Circuit's landmark decision in *United States v.*



Newman, which set a heightened standard for the prosecution of tipper/tippee liability. Now that the Supreme Court has declined the Government's petition for further appellate review, thus ending the government's appellate rights in *Newman*, the issue as to how the *Newman* decision will be viewed by other appellate courts is especially relevant. If a recent decision by the Court of Appeals for the Ninth Circuit in *United States v. Salman* is any indication, it appears that some appellate courts might decline to follow *Newman*, and instead revert back to the tipper/tippee analysis that existed prior to *Newman*.

Insider trading will remain a consistent focus of regulators and prosecutors, even in the post-*Newman* landscape. Below we provide analysis of the *Salman* decision, and summaries of two SEC enforcement actions: one involving the continued enforcement of tippee liability post-*Newman*; and another involving an investment adviser's misuse of material nonpublic information.

United States v. Salman

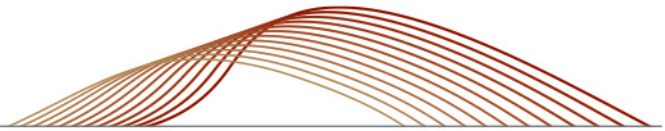
Prior to *Newman*, courts had held that a tippee could be liable for insider trading if he or she traded on material, nonpublic information received from an insider who provided the information in breach of a duty and in exchange for a personal benefit. A gift of confidential information from the insider to a trading relative or friend was considered sufficient to constitute the existence of a personal benefit to the insider. The *Newman* decision, among other things, set a new, heightened standard for what constitutes a sufficient personal benefit, essentially requiring a *quid pro quo* type of arrangement.[29]

The *Newman* decision specifically stated that, to infer that a gift of information provided a personal benefit to the insider, there must exist proof of a meaningfully close personal relationship between the insider and the initial tippee. According to *Newman*, that relationship must be one that "represents at least a potential gain of a pecuniary or similarly valuable nature." Effectively, the *Newman* Court stated that this requires evidence that suggests a *quid pro quo* relationship. Under that standard, the government may not attempt to demonstrate a personal benefit by the "mere fact of a friendship, particularly of a casual or social nature."

It was this analysis by the *Newman* Court that has led many to wonder whether, and to what extent, a personal relationship might be considered sufficient such that a gift of confidential information would convey a personal benefit upon the insider. This analysis is critical to the determination of liability of a tippee because the *Newman* Court further held that all tippees, including all downstream tippees, must have known (or should have known) of the insider's breach of his/her duty and the exchange of a personal benefit to be liable for insider trading.

The *Salman* decision by the Court of Appeals for the Ninth Circuit, which affirmed a defendant's convictions for conspiracy and insider trading, interpreted the gift prong of the liability analysis in a manner consistent with pre-*Newman* court rulings. The Ninth Circuit held that a tippee who received inside information as a gift can be liable for insider trading regardless of whether a pecuniary gain or other *quid pro quo* type benefit was conferred on the insider.[30]

The investment banking insider in *Salman* relayed material, non-public information to his brother, who in turn tipped his future brother-in-law, Salman, who traded on the information. On appeal, Salman argued that the Government failed to carry its burden of proof because there was no evidence that the insider received a tangible benefit in exchange for tipping the inside information. The Ninth Circuit disagreed, finding that the gift prong of the pre-*Newman* personal benefit analysis was satisfied by the mere fact that the insider provided material nonpublic information to a trading family member.



The *Salman* Court specifically declined to follow *Newman* to the extent that it might be read to hold that "evidence of a friendship or familial relationship between tipper and tippee, standing alone, is insufficient to demonstrate that the tipper received a benefit." Instead, the *Salman* Court reverted to pre-*Newman* liability analysis and held that a gift of confidential information to a trading relative or friend is sufficient to confer a personal benefit on the tipper. Notably, the Ninth Circuit's opinion was written by Judge Jed Rakoff, a well-known Senior District Judge for the Southern District of New York, who sat by designation on the appellate panel.

SEC v. Condon, et. al.

On September 23, 2015, the SEC filed a federal civil complaint against Robert G. Condon, a consultant, and his friend Jonathan Ross, for engaging in insider trading in options of P.F. Chang's China Bistro ("P.F. Chang's") based on material, nonpublic information about an impending acquisition offer.[31]

According to the SEC's complaint, Condon, an executive coaching consultant for Panda Restaurant Group ("Panda"), tipped Ross with confidential information about Panda's involvement in the bidding process for P.F. Chang's. The SEC alleged that, even though Panda did not ultimately make a tender offer for P.F. Chang's, Panda's involvement in the process was enough to supply Condon with material, nonpublic information about an impending sale of P.F. Chang's. According to the SEC, after having received the inside information, Ross tipped his friend Ali Sagheb and both men purchased risky, short-term, and out-of-the-money PF Chang's call options with a $45 strike price.[32]

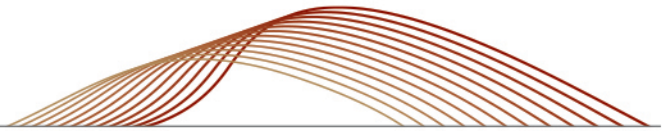
At the time of the purchase of the call options, P.F. Chang's was trading at around $40 per share. When PF Chang's announced publicly that a third party would be making a tender offer at $51.50 per share, its stock price jumped 25%. Following the public announcement, Ross, Sagheb, and a third trader who received the inside information (who is now deceased) sold their options and realized, respectively, $58,281, $17,994, and $231,447 in profits.

The SEC alleged that Condon and Ross violated Sections 10(b) and 14(e) of the Exchange Act, and Rules 10b-5 and 14e-3 thereunder. The SEC also charged Sagheb as a relief defendant and announced that Sagheb had agreed to pay the SEC $19,829, which represented his ill-gotten trading profits plus interest. The matter is pending; however, Ross recently agreed to be enjoined from future violations of the above cited securities laws and to pay disgorgement, prejudgment interest, and a civil penalty in amounts to be determined at a later date.

In re Wolverine Trading, LLC

On October 8, 2015, Wolverine Trading, LLC ("Wolverine Trading"), a registered broker-dealer, and its affiliate Wolverine Asset Management, LLC ("Wolverine Asset Management"), a registered investment adviser, consented to the entry of an administrative order concerning the entities' failure to establish, maintain, and enforce written procedures to prevent the misuse of material, nonpublic information and breaches of information barriers between the two entities that led to the misuse of material, nonpublic information.[33]

On February 21, 2015, the issuer of an exchange-traded fund, TVIX, announced a temporary suspension of any new issuance of TVIX. As a result, TVIX traded at a significant premium until its issuer announced that new issues of TVIX would resume on a limited basis on March 22nd. During the interim and thereafter, Wolverine Trading shared information about TVIX with Wolverine Asset Management, including information relating to its trading positions and strategies. In return,



Wolverine Asset Management shared information with Wolverine Trading about its intent to enter into a swap and to request the creation of TVIX notes that it eventually received. This information sharing allegedly violated existing policies and procedures of the entities. Wolverine Trading and Wolverine Asset Management employees also discussed strategies numerous times and participated in negotiations and conference calls together, all allegedly in breach of the information barriers between the two entities, the entities insider trading policies and procedures, and Wolverine Asset Management's Code of Ethics.[34]

Wolverine Trading and Wolverine Asset Management, without admitting or denying the SEC's findings, consented to an order directing them to cease-and-desist from future violations of Section 15(g) of the Exchange Act and Section 204A of the Advisors Act, respectively. Wolverine Trading agreed to pay a civil monetary penalty of $375,000. Wolverine Asset Management agreed to pay disgorgement of $364,145.80, prejudgment interest of $39,158.47, and a civil monetary penalty of $375,000.

C. Chief Compliance Officers

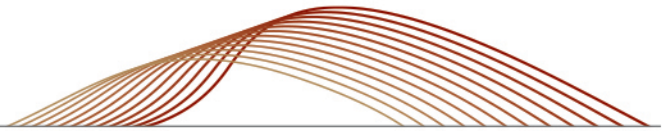
The SEC continues to focus its enforcement efforts on the role and activities of Chief Compliance Officers ("CCOs"). Below we provide analysis of one SEC matter that underscores the need for investment advisers, including their principals, to allocate sufficient resources to the CCO function to allow for an entity's compliance function to operate effectively. This matter illustrates that, under certain circumstances, the SEC will take action against an adviser and its principals, and not necessarily the adviser's CCO, for perceived compliance failures.

In re Pekin Singer Strauss Asset Management Inc.

On June 23, 2015, the SEC instituted a settled administrative action against Pekin Singer Strauss Asset Management Inc. ("Pekin Singer"), its former president Ronald Lee Strauss ("R. Strauss"), its current chairman William Andrew Pekin, and its current co-CEO Joshua Daniel Strauss for failing to conduct timely annual compliance program reviews and for failing to implement and enforce provisions of its policies and procedures and code of ethics during this period. Notably, the SEC alleged that R. Strauss, Pekin Singer's former president, failed to allocate sufficient resources to address compliance issues, which substantially contributed to the advisor's compliance failures. In addition, Pekin Singer and its chairman, Pekin, and J. Struass, its co-CEO, did not obtain best execution for Pekin Singer's clients because they failed to move eligible clients to a cheaper share class for a mutual fund that Pekin Singer managed.[35]

According to the SEC, R. Strauss promoted an employee to CCO, who R. Strauss knew had limited prior experience, training, and knowledge in compliance and who was required to continue his other responsibilities as a portfolio manager and research analyst, among other roles.[36] The SEC also found R. Strauss failed to provide the CCO with sufficient guidance regarding his duties and responsibilities or staffing to assist the CCO with compliance issues, including declining to hire a compliance consultant as requested by the CCO. Furthermore, R. Strauss directed the CCO to prioritize his investment research responsibilities over his compliance responsibilities.

The SEC alleged that, at one point, R. Strauss added the role of Chief Financial Officer to the CCO's responsibilities. As a result, the Chief Compliance Officer only dedicated between 10-20% of his time to his compliance responsibilities. These burdens caused the CCO to fail to complete timely annual compliance reviews.



In May 2011, the SEC conducted an examination and cited several compliance deficiencies, most notably the failure to conduct annual compliance program reviews for two years.[37] In June 2011, a compliance consultant, who Pekin Singer hired in 2010, issued a report that identified additional compliance deficits. Collectively, the SEC and the compliance consultant found that Pekin Singer did not receive all documentation of employee trading, failed to maintain documentation of the best execution reviews, failed to obtain reports and certifications required by the firm's Code of Ethics, and failed to conduct annual compliance meetings for firm personnel. The SEC alleged that the failures to abide by and enforce the firm's Code of Ethics were not disclosed in Pekin Singer's 2011 and 2012 Forms ADV Part 2A, and thus certain statements in the Forms ADV Part 2A were untrue.

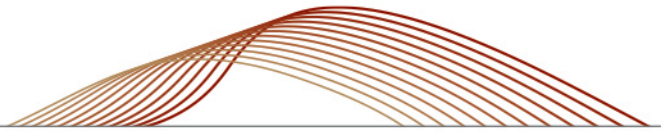
During the SEC's examination, Pekin Singer self-reported its failure to move eligible clients of the Appleseed Fund ("Appleseed"), a mutual fund Pekin Singer formed, from a higher expense fee share class to one with lower expenses. The SEC alleged that, by keeping clients in the higher expense fee share class, Pekin Singer collected additional fees without incurring additional costs. Pekin Singer, W. Pekin and J. Strauss failed to disclose to clients that the clients were eligible for the lower expense fee share class, and as a result, they did not disclose to investors or on Pekin Singer's Form ADV Part 2A that Pekin Singer failed to obtain best execution and that Pekin Singer had a conflict of interest in selecting investor share classes for clients. As a result of the above, from 2011 through June 2014, Pekin Singer earned an additional $307,241.54 in fees.

The SEC also noted the remedial measures Pekin Singer implemented as a result of the SEC's examination findings. Specifically, Pekin Singer voluntarily undertook several steps to improve its compliance programs, including the hiring of a full-time compliance employee to assist Pekin Singer's new CCO, expanding its relationship with the compliance consultant, and engaging outside counsel to advise on regulatory issues.[38] With respect to the failure to transfer clients to appropriate share classes of Appleseed, Pekin Singer retained outside counsel to conduct an investigation of those issues and voluntarily reimbursed all affected clients.[39]

The administrative order, which respondents consented to, alleged Pekin Singer violated Sections 204A, 206(2), 206(4), and 207 of the Investment Advisers Act of 1940 ("Advisers Act") and Rules 204A-1 and 206(7) thereunder. The order also alleged that R. Strauss violated Sections 204A, 206(4) of the Advisers Act and Rules 204(a)-1 and 206(4)-7 thereunder, and that W. Pekin and J. Strauss violated Sections 206(2) and 207 of the Advisers Act. The order directed the respondents to cease-and-desist from future violations of the securities laws that each was alleged to have violated. In addition, R. Strauss agreed to a one-year suspension from association in a compliance or supervisory capacity with any investment advisers, broker-dealers, investment companies, and certain other securities businesses. Pekin Singer agreed to a civil monetary penalty of $150,000 and each of the individual respondents agreed to pay a civil monetary penalty of $45,000. The CCO was not named or disciplined in the action.

D. Conflicts of Interest

In her speech to the Managed Funds Association described above in Section IV, SEC Chair Mary Jo White emphasized that the proper disclosure of conflicts of interest was a focus of examinations by the Office of Compliance Inspections and Examinations. Chair White underscored the importance of these exams to identify practices that would be difficult for investors to discover on their own.[40] Below is a summary of an enforcement action relating to the disclosure of an advisory firm's fees and expenses.



In re Taberna Capital Management, LLC

On September 2, 2015, Taberna Capital Management ("Taberna"), a Philadelphia based investment advisory firm, one of its former Managing Directors, Michael Fralin ("Fralin"), and its former Chief Operating Officer and Chief Legal Officer, Raphael Licht ("Licht"), consented to the entry of an SEC administrative order relating to allegations that Taberna improperly retained fees that should have been passed along to clients in connection with collateralized debt obligations ("CDOs") held by Taberna's clients.[41]

According to the SEC, between 2009 and 2012 Taberna negotiated more than $15 million of fees ("exchange fees") from issuers of certain investments underlying the Taberna CDOs as compensation for Taberna agreeing to restructure the terms of the investments on behalf of the CDOs (i.e., agreeing to "exchange" the existing investments or debt held by Taberna's CDO clients for other investments or debt with different terms). The SEC alleged that, instead of passing the exchange fees along to the CDOs, for the benefit of Taberna's clients, Taberna kept the exchange fees as compensation. Taberna allegedly did not incur any costs relating to these exchange fees.

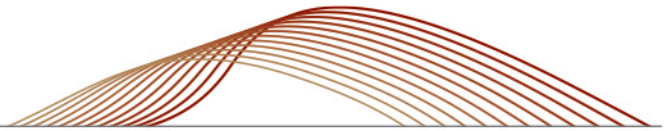
The SEC also alleged that Taberna took steps to make sure that the exchange documents that were created in connection with the restructurings were silent on the exchange fees, and in some instances, falsely described the exchange fees as fees incurred to cover the costs of third parties (e.g., attorney expenses) in connection with the restructurings.

The SEC also alleged that the exchange fees provided an incentive for Taberna to choose a certain type of exchange transaction over other types of restructuring transactions that did not offer Taberna the opportunity to receive exchange fees. As a result, the SEC claimed that the exchange fees created actual and potential conflicts of interest because of Taberna's incentive to select a restructuring that provided for an exchange fee.[42]

In connection with the alleged conduct, the SEC claimed that Taberna made false and misleading statements to clients and in its Form ADV. Specifically, with respect to its Form ADV, the SEC alleged that Taberna failed to disclose the exchange fees as a source of compensation and its conflicts in connection with the exchange fees that it received.

According to the SEC's order, Fralin was responsible for drafting misleading language in the exchange transaction documents. The SEC alleged that Fralin knew or should have known that the language was misleading, and that, on at least one occasion, a senior manager at Taberna noticed that the fee exchange language was "false and misleading" and suggested that the language be altered. According to the SEC, nothing was done in response to the senior manager's comment. With respect to Licht, the SEC alleged, among other things, that Licht personally negotiated some of the exchange fees, was aware that certain exchange language in the exchange transaction documents mischaracterized the exchange fees, and played a role in drafting Taberna's misleading Form ADV.

The SEC's order, to which Taberna consented, directed Taberna to cease-and-desist from future violations of Section 15(a) of the Securities Exchange Act of 1934 and Sections 206(1), 206(2), 206(4), and 207 of the Investment Advisers Act of 1940, as well as Rule 206(4)-8 thereunder. Taberna also agreed to pay disgorgement of $13 million, prejudgment interest of $2 million and a civil penalty of $6.5 million, and not to act as an investment advisor for three years. The order also directed Fralin to cease-and-desist from future violations of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, and Licht to cease-and-desist from future violations of Sections 206(2) and 207 of the Advisers Act. Fralin consented to a $100,000 civil penalty and Licht



consented to pay a $75,000 civil penalty. Fralin and Licht agreed to be barred from the securities industry for a period of five years and two years, respectively.[43]

E. Valuation

Below are summaries of two enforcement actions involving allegations that investment advisors artificially inflated the value of their assets under management in order to collect fees beyond those to which they were entitled.

SEC v. Summit Asset Strategies Investment Management, LLC

On September 4, 2015, Summit Asset Strategies Investment Management ("Summit Asset Strategies"), an investment advisory firm, and its CEO, Chris Yoo, consented to the filing of a civil complaint in federal court, alleging that Summit Asset Strategies and Yoo artificially inflated the value of investments of a fund that it managed—Summit Stable Value Fund ("SSVF")—in order to collect additional management fees.[44]

Yoo allegedly fabricated investments to boost the value of the assets in the SSVF, which had the intended effect of increasing Yoo's fees by $900,000.[45] The SEC also alleged Yoo caused Summit Asset Strategies' affiliate, Summit Asset Strategies Wealth Management, LLC ("Summit Wealth Management"), an investment business for individual clients, to enter into a referral fee agreement with SSVF, but failed to disclose the fees and the resulting conflict of interest to Summit Wealth Management's clients who invested in SSVF.

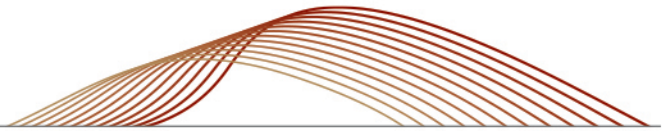
Yoo and Summit Asset Strategies, without admitting or denying the allegations in the complaint, consented to the entry of an injunction enjoining them from violating Section 10(b) of the Exchange Act, Section 17(a) of the Securities Act, and Sections 206(1), 206(2), 206(4)-8, and 207 of the Advisers Act. Yoo and Summit Asset Strategies also consented to pay a total of $889,301 in disgorgement, prejudgment interest of $104,632, and a $150,000 civil penalty.

In a related action, the SEC also instituted administrative proceedings against the two accountants who worked for the auditing firm that performed the audits for SSVF for causing the audit firm to issue an audit report that failed to comply with applicable audit standards.

In re AlphaBridge Capital Management, LLC

On July 1, 2015, AlphaBridge Capital Management, LLC ("AlphaBridge"), Thomas T. Kutzen, AlphaBridge's founder, majority owner, and Chief Executive Officer, and Michael J. Carino, AlphaBridge's minority owner and Chief Compliance Officer, consented to the entry of administrative proceedings, alleging that they inflated the value of securities in hedge fund portfolios managed by the AlphaBridge (the "Funds"), thereby artificially increasing AlphaBridge's management and performance fees.[46]

According to the SEC, AlphaBridge told investors and the Funds' administrator and auditor that for valuation purposes, it obtained independent price quotes for certain mortgage-backed securities from representatives at two reputable broker-dealers, which were independent from AlphaBridge.[47] The SEC alleged that those statements were false. According to the SEC, by 2010, AlphaBridge had been providing its own valuations to the broker-dealers' representatives to present purportedly as the broker-dealers' independent valuations to the Funds' administrator and auditor. The SEC also alleged that, in connection with the Funds' 2011 and 2012 year-end audits, Carino, acting as the CCO, prepared a memorandum for the auditor detailing AlphaBridge's valuation process, which described



the prices quotes from the broker-dealer representatives as "reasonable" because they were corroborated by AlphaBridge's own metrics. In connection with those year-end audits, the Funds' auditor asked to speak to the broker-dealer representatives. Although Carino agreed to make one of the representatives available for a call, Carino, unbeknownst to the auditor, heavily prepared the representative for the call with the auditor. When the auditor posed written follow up questions to the representative, Carino sent the representative draft responses and signed off on any changes the representative made. Additionally, the SEC claimed that both broker-dealer representatives conducted significant business as salespeople for AlphaBridge for a significant period of time.

Without admitting or denying the SEC's findings, AlphaBridge, Kutzen, and Carino consented to an order alleging that AlphaBridge violated Sections 206(1), 206(2), 206(4), 206(4)-7, and 207 of the Advisers Act, and that Carino aided and abetted each of AlphaBridge's violations, and that Kutzen aided and abetted AlphaBridge's violations of Sections 206(2) and 206(4) of the Advisors Act. AlphaBridge, Kutzen, and Carino agreed to cease-and-desist from future violations of the above securities laws. In addition, AlphaBridge and Kutzen were both censured, while Carino was barred from working in the securities industry for at least three years. AlphaBridge, Carino, and Kutzen also agreed to disgorge $4,025,000 in illicit profits and pay civil monetary penalties of $725,000, $200,000, and $50,000, respectively. Kutzen and Carino also agreed to engage an independent monitor to oversee the wind down of the Funds.

In a related action, Richard L. Evans, one of the broker-dealer representatives, consented to the entry of administrative proceedings alleging that he aided and abetted and caused violations by AlphaBridge.

F. Spoofing

As high frequency trading strategies continue to play a significant role in the markets, it is likely that the SEC and other market regulators will continue to investigate instances of possible "spoofing," a strategy by which orders are allegedly placed into the market with the intent of later canceling the orders and artificially affecting the appearance of supply and demand. Below are two enforcement actions involving spoofing, including an update on the first-ever federal criminal trial involving spoofing in the commodities markets.

In re Briargate Trading LLP

On October 8, 2015, Briargate Trading LLP ("Briargate") and co-founder Eric Oscher consented to the entry of an administrative order alleging that Briargate and Oscher placed and subsequently canceled non-bona fide security orders on the New York Stock Exchange ("NYSE") to knowingly create, and take advantage of, artificial changes in the market's perception of the demand and price of the securities.[48]

The SEC alleged that, from October 2011 through September 2012, Briargate and Oscher knowingly engaged in manipulative trading in 242 instances, with an average aggregate size of approximately 200,000 shares.[49] Specifically, Oscher allegedly placed pre-opening orders on the NYSE of 10,000 or more shares of securities that were identified as having large order imbalances in the NYSE's Order Imbalance Message ("Imbalance Message"), which is a message disseminated periodically by NYSE to subscribers and traders before the opening and which is used as an indicator to identify increases or decreases in demand for a security on the NYSE and other exchanges. Typically, Oscher's orders had the effect of influencing the pre-opening Imbalance Message and the price of the security on other exchanges. For instance, for a NYSE-listed stock with a sell imbalance, Oscher's non-bona fide buy

orders reduced the sell imbalance and, in turn, had the effect of increasing the price of that stock on other exchanges.[50] After placing the non-bona fide orders, Briargate would purchase opposite positions in the same stock on other exchanges where the price had been artificially affected. Ultimately, Oscher would cancel the non-bona fide orders, typically reversing their effect on the stock's price, and Briargate would realize profits from its positions on the other exchanges.

According to the SEC, Oscher and Briargate were well aware that the Imbalance Messages reflected their non-bona fide orders and were thus artificial. Overall, Oscher and Briargate collected approximately $525,000 in illicit profits.[51]

The SEC alleged that Oscher and Briargate violated Section 9(a)(2) of the Exchange Act, Section 17(a)(1) and 17(a)(93) of the Securities Act, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Without admitting or denying the charges, Oscher and Briargate consented to cease-and-desist from violating these provisions and to pay collectively $525,000 in disgorgement and prejudgment interest of $37,842.32. Briargate and Oscher also agreed to pay civil money penalties of $350,000, and $150,000, respectively.

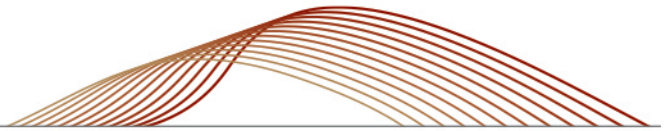
United States v. Coscia

On November 3, 2015, a jury in U.S. District Court in Chicago, Illinois found Michael Coscia, a high frequency trader and the sole owner of Panther Energy Trading LLC, guilty on all criminal counts pending against him, which included six counts of commodities fraud and six counts of spoofing. Coscia will be sentenced in March, and he faces up to 25 years in prison and a $250,000 fine on each commodities fraud count, and 10 years and a $1 million fine for each spoofing count. This trial represented the first criminal trial under the commodities anti-spoofing provision of the Dodd-Frank Act.[52] The conviction will likely bolster the federal government's efforts to pursue such criminal charges.

In April 2015, the trial judge for the United States District Court for the Northern District of Illinois denied Coscia's motion to dismiss the spoofing claims, holding that Coscia's intent to cancel the large-volume of Coscia's orders distinguished his trades from other legitimate trading strategies.[53]

Our prior Reports are available here:
Spring 2015, Fall 2014, Spring 2014, Fall 2013, Spring 2013, Fall 2012, Spring 2012, Fall 2011, Spring 2011, and Fall 2011.

✧ ✧ ✧



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Hedge Fund Regulatory and Tax

London

Arun Birla
1.44.20.3023.5176
arunbirla@paulhastings.com

Christian Parker
1.44.20.3023.5161
christianparker@paulhastings.com

Los Angeles

Arthur L. Zwickel
1.213.683.6161
artzwickel@paulhastings.com

Peter M. Connolly
1.213.683.6267
peterconnolly@paulhastings.com

David Hong
1.213.683.6223
davidhong@paulhastings.com

New York

Michael R. Rosella
1.212.318.6800
mikerosella@paulhastings.com

Orange County

Erika Mayshar
1.714.668.6262
erikamayshar@paulhastings.com

Palo Alto

Thomas S. Wisialowski
1.650.320.1820
thomaswisialowski@paulhastings.com

San Francisco

David A. Hearth
1.415.856.7007
davidhearth@paulhastings.com

Sasha Burstein
1.415.856.7240
sashaburstein@paulhastings.com

Hedge Fund Litigation and Enforcement

London

Michelle Duncan
1.44.20.3023.5162
michelleduncan@paulhastings.com

Los Angeles

Joshua G. Hamilton
1.213.683.6186
joshuahamilton@paulhastings.com

Howard M. Privette II
1.213.683.6229
howardprivette@paulhastings.com

William F. Sullivan
1.213.683.6252
williamsullivan@paulhastings.com

New York

Kenneth M. Breen
1.212.318.6344
kennethbreen@paulhastings.com

Maria E. Douvas
1.212.318.6072
mariadouvas@paulhastings.com

Barry G. Sher
1.212.318.6085
barrysher@paulhastings.com

John P. Nowak
1.212.318.6493
johnnowak@paulhastings.com

Kevin P. Broughel
1.212.318.6483
kevinbroughel@paulhastings.com

Spencer Bruck
1.212.318.6347
spencerbruck@paulhastings.com

Palo Alto

Edward Han
1.650.320.1813
edwardhan@paulhastings.com

Peter M. Stone
1.650.320.1843
peterstone@paulhastings.com

San Diego

Christopher H. McGrath
1.858.458.3027
chrismcgrath@paulhastings.com

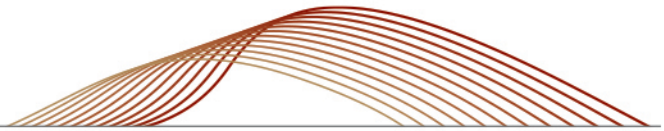
San Francisco

Grace A. Carter
1.415.856.7015
gracecarter@paulhastings.com

Kevin Kraft
1.415.856.7038
kevinkraft@paulhastings.com

Washington, D.C.

Morgan J. Miller
1.202.551.1861
morganmiller@paulhastings.com



[1] Directive 2011/61/EU of the European Parliament and of the Council of June 8, 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.

[2] An "alternative investment fund" is defined as a non-exempt collective investment undertaking that 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).

[3] 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.

[4] http://www.esma.europa.eu/system/files/2015-1235_opinion_to_ep-council-com_on_aifmd_passport_for_publication.pdf.

[5] http://www.esma.europa.eu/system/files/2015-1236_advice_to_ep-council-com_on_aifmd_passport.pdf.

[6] See Internal Revenue Code Sections 6221-6234.

[7] United States Government Accountability Office, Large Partnerships: Growing Population and Complexity Hinder Effective IRS Audits 13-17 (July 22, 2014).

[8] Pub. L. No. 114-74, Sec. 1101(a), (c), 129 Stat. 584, 625.

[9] Internal Revenue Code Sections 1471-1474, 6038D.

[10] Notice 2015-66.

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

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

[13] Citigroup Alternative Investments LLC and Citigroup Global Markets Inc., No. 3-16757 (S.E.C).

[14] *Beach et al v. Citigroup Alternative Investments LLC et al.*, No. 1:12-cv-07717 (S.D.N.Y.).

[15] *Public Sector Pension Investment Board v. Saba Capital Management LP*, No. 653216 (New York State Supreme Court, New York County 2015).

[16] An arrangement where dealers are allowed to make bids on listed securities.

[17] *LV Highland Credit Feeder Fund LLC et al. v. Highland Credit Strategies Fund LP et al.*, No. 05-13-01118-CV, (Texas Court of Appeals for the Fifth District).

[18] *Umbach v. Carrington Investment Partners et al.*, No. 3:08-cv-00484 (D. Conn.).

[19] Julia La Roche, *Hedge Fund Manager Kyle Bass is Going After Big Pharma and Their 'BS Patents,'* BUSINESS INSIDER (Jan. 7, 2015), http://www.businessinsider.sg/kyle-bass-going-after-us-pharma-2015-1/#.VmDrrnPlvct.

[20] *See* H.R. Rep. No. 112-98, pt. 1, at 48.

[21] IPR2015-00858, IPR2015-01046, IPR2015-01047.

[22] Support Technology and Research for Our Nation's Growth Patents Act of 2015, S. 632, 114th Cong. § 103 (2015).

[23] SEC Press Release No. 2015-245, *SEC Announces Enforcement Results for FY 2015*, http://www.sec.gov/news/pressrelease/2015-245.html.

[24] *Id.*

[25] Mary Jo White, Chair, SEC, Keynote Address at the Managed Fund Association: "Five Years On: Regulation of Private Fund Advisers After Dodd-Frank," http://www.sec.gov/news/speech/white-regulation-of-private-fund-advisers-after-dodd-frank.html.

[26] SEC Release No. 2015-245 ¶ 1.

[27] SEC's Order Determining Whistleblower Award Claim, Securities Exchange Act Release No. 75477 (July 17, 2015), https://www.sec.gov/rules/other/2015/34-75477.pdf.

[28] SEC Press Release No. 2015-252, *SEC Announces Whistleblower Award of More Than $325,000*, http://www.sec.gov/news/pressrelease/2015-252.html.

[29] *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014).

[30] *United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015).

[31] SEC Release No. 2015-205, SEC Charges Consultant and Friend with Insider Trading in Advance of P.F. Chang's Merger, Sept. 23, 2015, http://www.sec.gov/news/pressrelease/2015-205.html.

[32] Complaint ¶ 4, *SEC v. Richard Condon et al.*, Case No. 2:15-cv-07443, (C.D. Cal. Sept. 23, 2015), https://www.sec.gov/litigation/complaints/2015/comp-pr2015-205.pdf.

[33] Order ¶ 1, *In re Wolverine Trading LLC et al.*, Exchange Act Release No. 76109, (Oct. 8, 2015), https://www.sec.gov/litigation/admin/2015/34-76109.pdf.

[34] *Id*. ¶¶ 3,7-44.

[35] Order ¶ 2, *In re Pekin Singer Strauss Asset Management Inc., et al.*, Investment Advisers Act Release No. 4126 (June 23, 2015), https://www.sec.gov/litigation/admin/2015/ia-4126.pdf.

[36] *Id*. ¶ 14.

[37] *Id*. ¶ 23.

[38] *Id*. ¶ 47.

[39] *Id*. ¶ 56.

[40] *Id.*

[41] SEC Release No. 2015-177, SEC Charges Advisory Firm with Fraud for Improperly Retaining Fees, Sept. 2, 2015, http://www.sec.gov/news/pressrelease/2015-177.html.

[42] Order at Section III, *In re Taberna Capital Management LLC et al.*, Securities Exchange Act Release No. 78514 (Sept. 2, 2015), http://www.sec.gov/litigation/admin/2015/34-75814.pdf.

[43] SEC Release No. 2015-177.

[44] SEC Release No. 2015-178, SEC Charges Seattle-Area Hedge Fund Adviser with Taking Unearned Management Fees, Sept. 4, 2015, http://www.sec.gov/news/pressrelease/2015-178.html.

[45] Complaint ¶ 25, *SEC v. Summit Asset Strategies Investment Management LLC et al.*, Case No. 2:15-cv-01429, (W.D. Wash. Sept. 4, 2015), https://www.sec.gov/litigation/complaints/2015/comp-pr2015-178.pdf.

[46] Order ¶ 1, *In re Alphabridge Capital Mgmt. LLC, et al.*, Investment Advisers Act Release No. 4135 (July 1, 2015); https://www.sec.gov/litigation/admin/2015/ia-4135.pdf.

[47] *Id*. ¶ 15.

[48] Order ¶¶ 2, 16-17, *In re Briargate Trading LLC*, Securities Act Release No. 9959 (Oct. 8, 2015), https://www.sec.gov/litigation/admin/2015/33-9959.pdf.

[49] *Id*. ¶ 15.

[50] *Id*.

[51] *Id*. ¶ 5.

[52] Reuters, *High-Frequency Trader Convicted in First U.S. Spoofing Case*, Nov. 4, 2015.

[53] Memorandum Opinion and Order, *United States v. Coscia*, No. 14-CR-551 (N.D. Ill. Apr. 16, 2015).