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SCHULTE ROTH & ZABEL LLP

SEC Sanctions Hedge Fund Advisers

for Violation of Private Placement Rules and Section 3(c) of the Investment Company Act of 1940

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SUMMARY

On July 8, 2005, the Securities and Exchange Commission (the "SEC") issued an administrative order and brought cease-and-desist proceedings (the "Order") under the Securities Act of 1933 (the "Securities Act"), the Investment Advisers Act of 1940 and the Investment Company Act of 1940 (the "Investment Company Act") against Gerald Klein & Associates, Inc. ("GKA") and Klein Pavlis & Peasley Financial, Inc. ("KPP"), two Southern California-based registered investment advisers.

Sections 5(a) and 5(c) of the Securities Act generally prohibit any person from offering or selling a security unless an appropriate registration statement is in effect or a valid exemption from registration exists. In the offer and sale of Invest Talk Partners I, L.P. ("Fund I") and Invest Talk Partners II, L.P. ("Fund II") (hereinafter Fund I and Fund II are collectively referred to as the "Funds"), no registration statement was in effect, and because the offerings included a *general solicitation* and were made to over 35 non-accredited investors (because of integration as described below), there was no valid exemption from registration. Accordingly, the SEC found GKA and KPP willfully violated Sections 5(a) and 5(c) of the Securities Act.

Section 7(a) of the Investment Company Act generally prohibits any investment company from engaging in the business of buying and selling securities unless it has registered with the SEC or has a valid exemption from registration. Section 3(c)(1) of the Investment Company Act generally excludes from the definition of investment company an issuer whose outstanding securities are beneficially owned by not more than 100 persons, and that is not making and does not presently propose to make a *public offering* of its securities. Similarly, Section 3(c)(7) of the Investment Company Act generally excludes from the definition of investment company an issuer whose outstanding securities are owned by persons who, at the time of acquisition, are qualified purchasers, and that is not making and does not presently propose to make a *public offering* of securities. The SEC found that the Funds violated Section 7(a) of the Investment Company Act because (i) Fund I and Fund II had (on an integrated basis) 112 investors (making Section 3(c)(1)'s exclusion unavailable), (ii) not all investors were qualified purchasers at the time of the acquisition of the securities (making Section 3(c)(7)'s exclusion unavailable), and (iii) the hedge funds were offered by means of a general solicitation (making both Sections 3(c)(1) and 3(c)(7) unavailable). In addition, the SEC found that because GKA and KPP were responsible for forming, offering, and selling the Funds, they willfully aided, abetted and caused the Funds' violation of Section 7(a) of the Investment Company Act.

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SEC Brings Enforcement Action Involving Trade Errors

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On April 6, 2005, the Securities and Exchange Commission ("SEC") settled an enforcement action against a registered investment adviser and its principal (in the matter of Michael T. Jackson and EGM Capital, Advisers Act Release No. 2374) in which the SEC alleged that the advisory firm wrongly passed to its clients losses resulting from a trade error caused by the firm. Although the enforcement action leaves unresolved many questions involving trade errors, it underscores the SEC's general view that advisers should bear losses due to trade errors and should maintain policies and procedures to address trade errors.

According to the SEC's settlement order, the advisory firm and its personnel engaged in the following conduct that led to the enforcement action. The firm's portfolio managers decided to liquidate a 122,000-share position in an issuer's securities that was held collectively by four hedge funds and two individually managed accounts. The firm's head trader sold the shares, but due to human or computer error another trader sold an additional 100,000 shares of the same issuer a few days later, resulting in an unintended short position spread over the various accounts. When the error was discovered shortly thereafter, the firm's trading desk covered the short position. An increase in the price of the shares, however, caused a loss of approximately $404,000.

According to the SEC settlement order, the firm's principal determined internally that the accounts in which the shares were "oversold" should bear the losses. Moreover, the firm concealed the trade error by creating records that gave the false impression that the firm had intentionally sold short the shares on behalf if its clients. The firm did so by backdating trade tickets purporting to show that the portfolio managers had instructed the trading desk to sell the shares short on a date prior to the short sales, even though no such instructions had been provided to the trading desk at that time.

In determining that the alleged conduct violated Sections 206(1) and 206(2) of the Investment Advisers Act of 1940 (*i.e.*, the antifraud provisions), the SEC noted that the advisory firm had no policy or procedure specifying how trade errors were to be handled. In addition, the SEC settlement order stated that "consistent with industry practice and an investment adviser's fiduciary duty to its clients, losses caused by an investment adviser's own trade error were the responsibility of the adviser and should not be borne by clients." Notwithstanding that the advisory firm repaid its clients the full amount of the losses with interest during the course of the SEC's inquiry, the firm agreed to settle the enforcement proceeding by paying a fine of $75,000 and the principal agreed to a suspension from association with any investment adviser for a period of nine months.

The SEC's recent case reemphasizes that an adviser generally should bear responsibility for losses due to trade errors and should maintain policies and procedures for trade errors. However, the SEC has not stated, for example, whether an adviser and its clients may agree that at least in certain situations trade error losses may be borne by clients, including, for instance, where a trade error results only in *de minimis* losses. In addition, the SEC has not stated whether an adviser and its clients may agree to some form of netting whereby over a discrete period of time, losses that result from trade errors can be offset by gains that result from trade errors. Moreover, the SEC has not clarified whether an adviser may seek a client's consent to bear a trade error loss after the fact.

Finally, although the SEC's recent enforcement case alleged conduct that appeared somewhat egregious (*e.g.*, the creation of false books and records in an attempt to conceal the error), the settlement order did not allege a breach of recordkeeping requirements. It is not clear whether the adviser's conduct rose to the level of an enforcement action due to this conduct or merely because a trade error loss was borne by clients. In addition, it is unclear whether an enforcement action would have been brought had the adviser maintained written policies and procedures on trade errors or what those policies and procedures should have contained.

While the recent enforcement action leaves open many questions regarding trade errors, we recommend that our clients consider the following points:

- The SEC will focus on trade errors and their resolution during examinations of registered advisers;
- An adviser should have policies and procedures for addressing trade errors;
- An adviser should maintain accurate records of its trades, including those relating to erroneous trades; and
- An adviser who determines that clients may bear trade error losses should at least fully and explicitly disclose this policy to its clients and understand that the SEC, nevertheless, may disagree with this position and require an adviser to make its clients whole for such losses. ■

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Hedge Funds in Private Equity

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In recent years, we have seen increasing activity by hedge fund managers who are expanding beyond the traditional arena of hedged public securities investing to embrace a broader range of assets and strategies, including activist investing, distressed investing and private equity/debt investing. In some cases, these less liquid strategies are limited to a portion of a fund's portfolio; in other cases, they comprise the fund's core strategy, and fund terms are modified to address reduced liquidity by incorporating some of the terms traditionally used by private equity funds. These hybrid strategies and structures have blurred the line between private equity and hedge investing and have enabled hedge fund managers to become meaningful players in the private equity marketplace.

The increased participation by hedge funds in private equity-style investment strategies has been facilitated by a variety of trends, including increased use of gates; use of longer (often rolling) lockups and increased use of side pockets. It is no longer uncommon to see a hedge fund with two- or even three-year rolling lockups, side pockets of up to 30% of total portfolio size and 20% gates on annual redemptions. Taken together, these terms ensure that the bulk of a fund's portfolio can endure limited liquidity and, as a result of side-pockets, endure periods when valuations are uncertain.

The vast sums of capital now available to and held by hedge funds have also resulted in increased activism by hedge funds in their roles as stockholders. As of early 2005, the hedge fund industry comprised approximately $1 trillion in assets, and there are many hedge funds that individually control over $1 billion, with the largest hedge fund managers controlling tens of billions of dollars in investments apiece. Although many of these funds focus on passive investing, it is increasingly common for larger hedge funds to hold meaningful stakes in public companies. These larger positions encourage activist activity, either as part of a fund's intended strategy or as a result of portfolio positions gone awry.

Hedge fund terms differ significantly from the terms of the private equity funds that compete for opportunities in the private equity space. Unlike private equity funds, whose terms permit capital to be invested only during the first few years and that limit the fund's ability to take in new capital, hedge funds constantly invest and reinvest all capital and have no limit in occupying additional capital. Additionally, the liquid portion of a hedge fund's portfolio can be quickly levered (using the fund's margin facility) or liquidated. This flexibility enables activist hedge funds to rapidly deploy capital towards large, concentrated investment opportunities when needed.

As hedge funds move further into the private equity sphere and as philosophies converge, hybrids have become more common. "Crossover" funds combine private equity and hedge fund strategies within a single vehicle and often bifurcate the fee and liquidity structure accordingly. Other hybrid structures may involve, for example, private equity liquidity (fixed term; no redemptions) and hedge fund-style mark-to-market fees. These hybrid structures can present marketing difficulties, especially in the case of institutional investors that have earmarked allocations to hedge and private equity strategies. However, they can be the best alternative when a manager's investment style encompasses a range of liquid and illiquid assets where the ability to limit liquidity (through lock-ups, side pockets and gates) and minimize mark-to-market uncertainty (through use of side pockets) does not provide enough flexibility.

As hedge fund managers join the private equity marketplace, they are bringing with them investment techniques traditionally used to manage liquid investments, including, of course, the use of hedging to limit risk exposures. Additionally, these managers bring with them different methods of compensating professional employees, resulting from the current-pay fee structure of profits on the mark-to-market (non-side pocket) portfolio. Compensation structures in private equity funds must address the fact that incentive fees are often back-end loaded and subject to hurdles and clawback, and they typically involve complex vesting provisions to address the influx and outflux of employees at various times during the funds' scheduled term. By contrast, the incentive fee in a hedge fund (apart from its side pockets) is accrued annually; can remain invested indefinitely in the fund; may (in the case of offshore funds) achieve tax deferral for up to ten years; and is not subject to a hurdle or a clawback. As a result, employees at hedge funds are often less locked in than their private equity counterparts. These differences have facilitated the acquisition of private equity talent by hedge fund firms to manage their expanding private equity strategies.

It remains to be seen how the increased participation of hedge funds in private equity investing will affect the private equity industry. What is clear, however, is that the amount of assets now available to hedge funds who wish to engage in private equity investing has made them – and hybrids – meaningful players in the marketplace. ■

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Offerings Included a General Solicitation

GKA and KPP formed the Funds, relying on Section 3(c)(1) of the Investment Company Act, and offered interests to non-accredited investors. GKA and KPP marketed their investment advisory services generally through radio programs, investment seminars and the Internet. During at least one radio program, GKA and KPP principals mentioned the Funds, including their reasons for starting the Funds, the Funds' investment strategies and the minimum amounts for investment.

The Funds were also discussed by GKA and KPP principals during one or more investment seminars. In addition, performance figures for the Funds, the Funds' strategies and contact information were posted for a brief period on GKA's and KPP's shared website, which was accessible to the general public. As a result of these activities, the SEC concluded that the offerings of the Funds involved a general solicitation in violation of the private placement rules under the Securities Act.

Hedge Funds Should Have Been Integrated

Fund I's stated investment strategy was to take long positions in stocks of domestic companies that exhibited recent trends of advancing prices and short positions in stocks with recent trends of declining prices. Fund II's investment strategy was almost identical, but included an intention also to invest a minimum of 15% of its net assets in fixed income securities. However, the SEC found that the actual management of Fund I and Fund II resulted in the Funds holding essentially the same portfolio investments. The SEC pointed out that, as of November 2002, 23 of the 24 long equity positions held by Fund II were also held by Fund I, and that both funds had one short position in the same security. Accordingly, the SEC determined that the Funds should be integrated because in looking at the investment strategies and the portfolio holdings, the SEC concluded that the Funds were "nearly identical." As a result of the SEC's determination, the integrated Funds had 112 investors (and, therefore, did not meet the exclusion provided by Section 3(c)(1)), more than 35 of whom were non-accredited investors. Furthermore, because either some or all of the investors were not qualified purchasers, the Funds could not rely on the exclusion provided by Section 3(c)(7) of the Investment Company Act.

Violations

The SEC ordered GKA and KPP to cease and desist from committing or causing any violations and any future violations of Sections 5(a) and 5(c) of the Securities Act and Section 7(a) of the Investment Company Act. Additionally, GKA and KPP were each censured and ordered to pay a $20,000 civil penalty. Finally, GKA and KPP were ordered to comply with certain undertakings that included engaging an independent consultant to conduct quarterly compliance reviews of GKA's and KPP's investment advisory operations for a period of three years, with a report to the SEC on the results of each compliance review within 30 days of completion. ■

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