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New Anti-Fraud Rule Under the Investment Advisers Act of 1940

The Securities and Exchange Commission (the "SEC") on Aug. 3, 2007, issued a release (the "Adopting Release") adopting the new investment adviser anti-fraud rule it had proposed on Dec. 27, 2006. Rule 206(4)-8 (the "Rule") under the Investment Advisers Act of 1940 (the "Advisers Act") makes it a fraudulent, deceptive or manipulative act, practice or course of business within the meaning of Section 206(4) of the Advisers Act for an investment adviser of a "pooled investment vehicle": (a) to make any false or misleading statements or to omit any material fact to an investor or prospective investor in a pooled investment vehicle; or (b) to otherwise engage in any fraudulent, deceptive or manipulative act with respect to an investor or prospective investor in the pooled investment vehicle.

The Rule applies to investment advisers to "pooled investment vehicles," which are defined by the Rule to include "investment companies" as defined in Section 3(a) of the Investment Company Act of 1940 (the "1940 Act") and those investment pools, including many hedge funds, private equity funds, and venture capital funds, that rely on an exclusion from the definition of an investment company contained in either Section 3(c)(1) or Section 3(c)(7) of the 1940 Act. The Rule became effective as of Sept. 10, 2007.

The impetus for the Rule was the June 2006 decision of the U.S. Court of Appeals for the D.C. Circuit in *Goldstein v. SEC*, which overturned the SEC's hedge fund adviser registration rule. In the view of the SEC, the *Goldstein* decision "created some uncertainty" as to whether Sections 206(1) and 206(2) of the Advisers Act (which make it unlawful to defraud clients and prospective clients) apply to the defrauding of investors in pooled investment vehicles because the court in *Goldstein* interpreted the term "client" to mean the pool itself and not the investors in the pool. Rule 206(4)-8 provides that investors and prospective investors in a pooled investment vehicle may not be defrauded.

The Adopting Release specifies that:

- The Rule applies to both registered and unregistered investment advisers.
- There is no scienter requirement under the new Rule 206(4)-8. The SEC need only show negligent—not intentional—misconduct.
- The Rule is not limited to situations "in connection with the purchase or sale of a security." The pooled investment vehicle need not be offering, selling or redeeming securities to trigger a violation of the Rule.
- The Rule applies both to current and prospective investors.

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New Anti-Fraud Rule

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- Only the SEC may enforce the Rule; there is no private right of action.
- The Rule applies to conduct, not just statements. For example, collecting fees that an adviser is not entitled to might be the basis for a fraud claim under the Rule.

Practical Implications of the Rule

The Adopting Release, and public statements by SEC commissioners and staff, indicate some areas where the impact of the Rule is likely to be felt:

- **Investor Communications.** As noted above, the Rule is not limited to situations “in connection with the purchase or sale of securities.” Therefore, all investor communications are subject to the Rule. SEC staff have, in particular, noted that there may be situations where account statements and shareholder reports misrepresent the value of assets or the performance of a fund. The SEC also noted other topics that may be misrepresented by advisers in violation of the Rule, including the nature of the investment strategies that a vehicle intends to pursue, the credentials of the adviser’s key personnel and the risks associated with investing in the vehicle.

- **Marketing Materials.** The Rule applies to marketing materials, whether or not the recipient of the materials ever becomes an investor. In addition, the absence of a scienter requirement means that unintentional errors in a pitchbook might be the subject of a fraud allegation under the Rule.
- **Side Letters.** The failure to disclose a side letter to all investors may be the subject of a fraud allegation under the Rule. While acknowledging that the analysis will depend heavily on the particular facts and circumstances at issue, the SEC staff indicated that if there is a contractual or legal obligation to disclose a side letter, then failure to do so would be fraud under the Rule.

The manner in which the SEC’s enforcement and examination divisions will apply the new anti-fraud Rule remains to be seen. The SEC can be expected to carefully review side letters, offering memoranda, ADV disclosures, and due diligence questionnaire responses for compliance with the Rule. Advisers to pooled investment vehicles should evaluate their compliance programs—particularly in connection with communications and operating procedures—in light of the new Rule. ■

Update on Registration, Compliance and Examinations

SEC Guide for Newly Registered Advisers

On July 24, 2007, the Securities & Exchange Commission’s (“SEC”) Division of Investment Management and Office of Compliance Inspections and Examinations came out with a guide for recently registered investment advisers. (According to the SEC, approximately 30% of all registered investment advisers became registered since January 2005.) The guide identifies many of the important compliance areas, including fiduciary duties, Form ADV and other filings, code of ethics, best execution, and books-and-records requirements. Because it provides a general overview of these areas, the guide will likely be the starting point of the analysis of most issues. It is available on the SEC’s website at www.sec.gov/divisions/investment/advoverview.htm.

SEC “Compliance Alert”

The SEC’s Office of Compliance Inspections and Examinations published its first “Compliance Alert” in June 2007 in the form of a letter to Chief Compliance Officers. The letter describes issues recently reviewed by SEC examination staff—such as performance advertising and disaster-recovery plans—and encourages firms to implement improvements in these areas. With respect to performance advertising, the SEC notes that it has observed a lack of policies and procedures, or ineffective policies and procedures, governing marketing and performance advertising. With respect to disaster-recovery plans, the SEC used the experience of advisers in Louisiana and Mississippi after Hurricane Katrina as a case study to evaluate the effectiveness of such plans. Critical to effective recovery-plan components, the Alert concluded,

are alternate communication protocols, a prearranged remote location for short-term and possible long-term use and remote access to business records. The Alert also includes topics of particular interest to mutual funds and broker-dealers. The Alert is available at www.sec.gov/about/offices/ocie/complialert.htm

Enforcement Activity Arising Out of SEC Examinations

On Aug. 15, 2007, the SEC issued administrative cease-and-desist orders against two advisers for violations uncovered during the examination process. One case involved an alleged scheme to use soft dollars outside of the 28(e) safe harbor. The adviser and its principal were cited for antifraud and books-and-records violations and agreed to \$150,000 in penalties in addition to a censure and cease-and-desist order and an undertaking to provide investors and prospective investors with copies of the SEC’s order. The other case was based on the alleged failure to file any 13Fs during a three-year period—the SEC asserted that the issue came up during an examination and the manager only then filed for the first time (including corrective historical filings). The SEC also alleged that the 13F filing obligation was referenced in the firm’s compliance manual, as well as in memos from the firm’s outside counsel and auditors. The firm agreed to a \$100,000 penalty in addition to a censure and cease-and-desist order.

California Proposes Investment Adviser Registration Requirement

The Commissioner of the California Department of Corporations (the “Department”) has proposed to require

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registration of certain investment advisers that (1) have a place of business in California; and (2) are not registered with the SEC. Under current law, investment advisers not registered with the SEC doing business in California are required to be licensed by the Department. An exemption adopted in 2002 provides that investment advisers with fewer than 15 clients and more than \$25 million under management, or those who provide advice only to venture

capital funds, need not register with the Department, even if they have a place of business in California. The current proposal would limit the exemption to advisers to venture capital funds. If the proposal is adopted, investment advisers that have a place of business in California will have to choose between being registered by the State of California or by the SEC. Comments on the proposal are due by Nov. 26, 2007. ■

SEC Examination Staff Issues Expanded Request Letter Targeting Inside Information and Other Areas

The examination staff in the New York Regional Office of the Securities and Exchange Commission (the "SEC") has recently been using a new and expanded form of request letter in connection with its periodic examinations of registered investment advisers (the "Request Letter"). The SEC's New York Regional Office generally provides a copy of the Request Letter to the adviser two weeks prior to the start of the examination, and asks that the adviser have available the requested documents or information to the examination staff at the outset of the examination. The Request Letter used by the New York Regional Office has varied over the past several years. The most recent version requests several new categories of information that are noteworthy.

The Request Letter is only directly applicable to registered investment advisers in the SEC's New York Region. However, because the Request Letter reflects the focus of the SEC's examinations, and potentially the SEC's enforcement activities, all investment advisers should be aware of it. Investment advisers should review their compliance policies and procedures in light of the new items sought by the Request Letter. Because of the breadth of the Request Letter, we anticipate that many firms will need to consider whether new or revised policies and procedures are appropriate. The issues relating to insider trading are particularly significant and should be carefully considered by all advisers. In addition, the new items sought by the Request Letter may implicate the SEC's new anti-fraud rule 206(4)-8, which applies to all investment advisers to "pooled investment vehicles," including hedge funds, private equity funds and venture capital funds.

Some of the areas of new and increased focus in the Request Letter are discussed below. *Please note that this is not a list of all areas that are covered by the Request Letter.*

Insider Trading

The Request Letter significantly expands the scope of information sought with respect to the potential misuse of material, non-public information. The Request Letter asks advisers to provide information concerning:

- A list of employees, employees' relatives, investors, and clients of the adviser that serve as officers or directors of public companies. If the adviser permits such service, the adviser will need to consider adopting policies and procedures to

restrict and monitor contact between covered persons and portfolio managers and traders.

- A list of companies where an adviser's employees or affiliates serve on a creditors' committee.
- A list of all corporate insiders, hedge fund executives or brokerage executives that have invested in any of the adviser's private investment funds during the examination period. For any such investors, the subscription documents are requested along with a statement of any such investor's ownership interest in the fund.
- A list of access persons that invested in private placements or hedge funds during the examination period, including the date of the investment and the name of the company.
- Copies of procedures regarding adding or removing securities from the restricted and watch lists, identification of individuals with access to the lists, a description of controls on access to the lists, and copies of the lists themselves.
- A list of joint ventures or any other businesses in which the adviser or any officer, director, portfolio manager, or trader participates or has any interest (other than their employment with the adviser), including a description of each relationship.

PIPEs

There have been a number of SEC enforcement actions brought alleging insider trading and market manipulation in connection with offerings of private investments in public equities ("PIPEs"). The Request Letter asks for a significant amount of information related to PIPEs in which the adviser's clients have invested, including detailed trade information for all PIPE transactions in spreadsheet format, a list of all PIPE transactions offered during the examination period, all confidentiality agreements entered into, a journal of securities borrowed by the adviser's clients in connection with PIPEs offerings, and a description of the services and compensation of finders, brokers, promoters or other third parties involved with PIPEs offerings in which the adviser's clients invested. For PIPE transactions offered to the adviser that the adviser declined to participate in, the Request Letter asks for the justification for the decision not to participate. The Request Letter also requests information on any

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compensation received by the adviser, its access persons, or affiliates involved with the PIPE transactions.

Trading Processes

The SEC staff has typically requested information about trade allocations, best execution, soft-dollar arrangements and other brokerage issues. The Request Letter expands the trade allocation information requested to cover secondary offerings in addition to initial public offerings. The name of the trade order management systems used by the adviser is requested, along with a description of any circumstances under which a portfolio manager could trade outside the system. Additional requests in the Request Letter include:

- The hard dollar cost of each product or service for the current year to date and the previous year.
- Information about commission recapture programs.
- A list of electronic communications networks ("ECNs") used to execute trades during the examination period.
- A copy of any commission schedules that were in effect, including the use of ECNs.
- A written description of any step-out arrangements used by the adviser, and the purpose of such arrangements.
- Information about broker-dealers that have referred clients or investors to the adviser, including a list of all business relationships with such broker-dealers.

Conflicts of Interest

The Request Letter expands the scope of information sought with respect to conflicts of interest, asking for:

- A description of the process for obtaining client approval of principal transactions, such as electronic delivery, and an indication of the frequency of the review process for principal transactions.
- Additional information concerning certain service providers' arrangements with an adviser (for instance, the Request Letter asks if any broker-dealer or registered representative used by the adviser has an investment in any pooled investment vehicle advised by the adviser).
- A "catch-all" request asks whether there are any arrangements that the adviser has with any broker-dealers and/or registered representatives during the period that are otherwise not covered by the request.
- A list of all independent research providers and a list of the issuers that the research providers provided research on, including details about the format and date of delivery of the research, and an indication of whether the research provider and its affiliates are investors in pooled investment vehicles managed by the adviser or its affiliates.

Broker-Sponsored Conferences

The Request Letter asks for a list of all "one-on-one" meetings with public company management at conferences sponsored by brokers, including the date of the meeting, the names and titles of employees who attended, the name of the broker, and the names of the corporate insiders and their companies. In light of the prevalence of such meetings and conferences, this request may create a significant new record keeping step for many firms.

Portfolio Management Processes and Structure

The Request Letter asks for identification of all individuals involved in the portfolio management process. It asks for a list of portfolio managers who make investment decisions for more than one type of client (e.g., funds, advisory clients, hedge funds, etc.), along with an identification of the clients.

Position Reports

The Request Letter asks for a list of the adviser's ten most profitable positions and ten least profitable positions during the examination period.

Short Sales/Futures and Options/Derivatives

The Request Letter asks for a description of how the following investment strategies are monitored for compliance: short sales, futures and options, derivatives and other forms of leverage.

Sub-Advisers/Fund of Funds Managers

The Request Letter asks for a description of all business activities (e.g., securities-lending, client referrals, principal trades, etc.) between the adviser and/or its affiliates and the money managers and/or their affiliates recommended by the adviser to manage client portfolios. The Request Letter also asks: (1) if the adviser has access to the clients' accounts managed by sub-advisors; (2) for documentation of due diligence reviews of recommended money managers; and (3) for information about any directed brokerage arrangements with clients.

Valuation

A list of valuation methods is requested for each type of security held by client accounts during the examination period. A list of all securities internally priced by the adviser also is requested. With respect to securities that were fair-valued, the Request Letter asks for detailed data in spreadsheet form as to the date of acquisition, purchase price, basis for determining value, and copies of any relevant valuation committee minutes. Also requested is information about any changes in the pricing of such securities and data with respect to any sales of such securities. Finally, the Request Letter asks for a list of securities for which the price provided by a pricing service was overridden, and the justification for such override.

Custody

With respect to private funds and funds of funds, the SEC staff asks that the custodian of each such fund provide a confirmation of all positions, including cash balances and short positions, as well as any loans or other creditor positions it has outstanding with the fund. Access to the reconciliation of portfolio securities transactions for the funds/clients during the examination period also is

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SEC Examination Staff Issues Expanded Request Letter

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requested, as is a list of the adviser's employees who have the authority to order clients' funds or securities withdrawn from the client's accounts.

Performance Advertising/Marketing

The SEC staff appears increasingly interested in performance advertising and marketing. The Request Letter asks for detailed information about any benchmark index, including any internally constructed benchmark, to which fund performance has been compared. Dealer-only pieces used during the examination period are requested. The Request Letter asks for a list of registered representatives who have referred investors or clients to the adviser during the examination period and for the terms of the compensation, along with a list of all entities involved in marketing and distribution of the funds. A list of all RFPs completed by the adviser during the examination period also is requested.

Compliance Reports

Prior request letters had sought exception reports, but the Request Letter expands the focus on such "outputs" of the compliance program. There is a general request for a copy of a completed exception report to demonstrate the effectiveness of the compliance program for each area referenced in the Request Letter. Additional specific requests for compliance reports include requests for:

- A list of any reports prepared by external auditors relating to the adviser's privacy compliance efforts.
- A list of compliance breaches involving PIPEs.
- A schedule of internal audit reviews.
- A list that describes any mandatory training of personnel regarding compliance issues.
- A list of employees subject to disciplinary action, including the reason for the action and the date.
- A log, if maintained, of any shareholder correspondence for advisory clients and hedge fund investors during the examination period.
- Documentation to substantiate the adviser's or fund's oversight of service providers.
- Information with respect to any compensation, whether direct or indirect, received by the adviser from any of its client's service providers.

Advisers to Pooled Investment Vehicles

The Request Letter asks advisers to pooled investment vehicles to provide:

- a) a complete description of all positions held in side pockets or special situation accounts, with their valuations on the date of the related calculation of net asset values;
- b) a list and description of all side agreements/arrangements in which investors are participants; and
- c) a description of business activities of the adviser

affiliated with each fund that are not covered by the required compliance programs of such advisers and oversight by the CCO.

If someone other than the adviser maintains records regarding interests of investors in a pooled vehicle managed by the adviser, the Request Letter asks for confirmation from that entity of:

- 1) the total number of shares outstanding if the fund is in corporate form;
- 2) the total number of limited partners; and
- 3) the most recently calculated value of each limited partner's interest in the fund.

Alternative Investment Vehicles

A list of all privately offered hedge funds in which the adviser's clients or funds purchased an interest during the examination period is requested.

Sections 13 and 16 Filings

All Schedule 13D, 13G and 13F filings, as well as filings on Forms 3, 4, and 5 are requested, in electronic format.

Bankruptcy Workout-Related Investments

The Request Letter asks advisers to identify any securities held in a client account during the past two years that were involved in a bankruptcy workout. In addition, it asks for identification of all accounts that held equity or fixed income positions in those issuers at the time of bankruptcy filing are requested, with portfolio holdings reports.

Code of Ethics

The Request Letter also seeks documentation from the adviser demonstrating how its code of ethics on personal trading is made available to the public. (Presumably, this refers to an adviser's obligation to include disclosure in its Form ADV Part II about making its code of ethics available to investors.)

Registration and Disclosures

The Request Letter also asks the adviser for the names and titles of the individuals responsible for updating and approving disclosure documents, including the Form ADV, and the names and titles of the individuals responsible for ensuring compliance with the firm's policies and procedures.

Proxy Voting

With respect to proxy voting, the Request Letter asks whether or not the adviser has delegated proxy voting authority to a third party, for the name of any such third party, and for a copy of any policy addressing who is the responsible party for voting the proxies with respect to securities on loan.

Gifts and Entertainment

The SEC staff had previously asked for logs of gifts and entertainment *received* by the advisers. The Request Letter asks for logs of gifts and entertainment *provided* by advisers during the examination period.

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Political Contributions

The Request Letter asks for a list of all political and charitable contributions made by the adviser or any of its related persons (e.g., its officers and non-administrative employees).

Privacy of Client Information

The Request Letter also asks for documentation regarding encryption of electronic customer information located in or transmitted through systems or facilities vulnerable to access by unauthorized individuals. This includes email sent to places beyond the adviser's control and any disks stored at outside vendors' storage facilities.

Final Thoughts

The Request Letter being used by the SEC's New York Regional Office expands the scope of the information

requested at the outset of a periodic examination of a registered investment adviser. While some of the additional information requested may be maintained in the ordinary course by many registered advisers, other such information may not be maintained and may not even be available. It may be difficult for firms, and particularly smaller firms, to pull together the responsive information in the two-week period from the date of the Request Letter. It is unclear whether this form of the Request Letter will continue to be used, and how the SEC staff will respond to advisers whose books and records do not capture the information requested. The staff of the SEC appear willing to discuss the scope of these requests if there are items that would be unduly burdensome. Advisers should review their compliance programs to understand the applicability of each of the new issues and areas of focus to the adviser's particular business. ■

Proposed Amendments to Regulation D

The Securities and Exchange Commission (the "SEC" or the "Commission") on Aug. 3, 2007, issued a proposing release (the "Proposing Release") regarding amendments to Regulation D under the Securities Act of 1933. The proposed amendments would, among other things: (a) amend the definition of "accredited investor" under Rule 501(a) of Regulation D to add an alternative "investments owned" test to determine eligibility and to add new categories of entities covered as accredited investors; (b) add a new exemption, Rule 507 of Regulation D, that would relax some of Regulation D's general advertising prohibitions for the offer and sale of securities solely to a new category of sophisticated investors called "large accredited investors"; and (c) apply a "bad actor" disqualification provision to all offerings under Regulation D. The SEC also requested additional comments on its Dec. 27, 2006, proposing release (the "Private Pooled Investment Vehicle Release") to heighten investor qualification standards for investments in pooled investment vehicles by adding a new category of accredited investors called "accredited natural persons."

Proposed Amendment of the Definition of "Accredited Investor"

The Commission has proposed amending the definition of "accredited investor" contained in Rule 501(a) of Regulation D, which serves as the investor qualification standard for issuers offering securities in reliance on the safe harbors provided in Rules 504 through 506 of Regulation D. With respect to individuals, the Commission has proposed adding an alternative "investments-owned" test to supplement the alternative income and net worth tests currently used to qualify an individual as an accredited investor. The proposed investments-owned test would allow an individual to qualify as an accredited investor if he or she has at least \$750,000 in qualifying investments, excluding personal residences and places of business. Individuals could continue to qualify as accredited investors if they have more than \$200,000 in income (or more than \$300,000 in income combined with a spouse) or at least \$1 million in net worth. With respect to entities referenced in Rule 501(a), the Commission has proposed an alternative investments-owned test that

would allow entities to qualify if they own more than \$5 million in investments. Entities could continue to qualify as accredited investors if they have at least \$5 million in assets as set forth in Rule 501(a). To address the effects of inflation, the Commission has proposed adjusting the investment thresholds starting on July 1, 2012, and every five years thereafter.

The Commission also has proposed adding a number of entities that may qualify as accredited investors if they satisfy Regulation D's investor qualification standards. While the current list of entities includes not-for-profit organizations, corporations, Massachusetts and similar business trusts and partnerships, it does not include limited liability companies, Indian tribes, labor unions, government bodies, and similar legal entities. To eliminate uncertainty about what entities may qualify as accredited investors, the Commission has proposed adding those entities not currently listed in Rule 501(a), as well as a "catch-all" category for all entities with "substantially similar legal attributes" to the listed entities.

Proposed Exemption for Limited Offers and Sales to "Large Accredited Investors"

In 2003, the staff of the SEC's Division of Investment Management released a report of its fact-finding study titled "Implications of the Growth of Hedge Funds." One of the staff's recommendations was that the Commission consider eliminating the prohibition on general solicitation or advertising in offerings by Section 3(c)(7) hedge funds whose investors are required to be qualified purchasers. In the Aug. 3, 2007 Proposing Release, the SEC has proposed a relaxation of some of the advertising prohibitions imposed on certain Regulation D offerings, *but specifically excluded from this exemption pooled investment vehicles that rely on the exclusion from the definition of an "investment company" contained in Section 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 (the "Investment Company Act")*. Proposed Rule 507 provides that if purchasers of securities are limited to "large accredited investors," a "tombstone" ad may announce the issuer's name and provide a brief description of the issuer's business and the issuer's contact information.

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The exclusion of 3(c)(1) and 3(c)(7) funds from the proposed exemption is made explicit in the Proposing Release. Rules 504 through 506 of Regulation D were adopted as safe harbor provisions under Section 4(2) of the Securities Act, which exempts private offerings of securities from the Securities Act's registration requirements. Pooled-investment vehicles often rely on Section 4(2) (by utilizing Rules 504 through 506) as the basis for satisfying the Section 3(c)(1) and Section 3(c)(7) requirement that an offering must be a private, not public, offering. Proposed Rule 507, however, would be adopted using the Commission's general rule-making authority granted under Section 28 of the Securities Act. Because Section 4(2) does not serve as the basis for the Commission's rule-making authority with respect to Rule 507, pooled investment vehicles would not be eligible to utilize this exemption while simultaneously relying on Section 3(c)(1) or 3(c)(7). In the Proposing Release, the SEC indicated that it specifically avoided rule-making under Section 4(2) so that there would not be advertising in connection with offerings under Section 4(2): "Because some advertising would be permitted in Rule 507 transactions, we have chosen not to propose the exemption under Section 4(2) of the Securities Act, which the Commission in the past has viewed as incompatible with a non-public offering under Section 4(2)."

To qualify as a "large accredited investor" under the proposed exemption, a natural person must satisfy at least one of the following requirements: (a) have an individual annual income of more than \$400,000 (or joint income with a spouse of more than \$600,000) in the last two years with an expectation of achieving such income in the current year; or (b) own more than \$2.5 million in qualifying investments.¹ Entities that have at least \$5 million in assets that qualify as "accredited investors" pursuant to Rule 501(a) under Regulation D would also be required to own more than \$10 million in investments in order to qualify as "large accredited investors." Additionally, banks, registered investment companies, private business development companies, and other regulated entities identified in Rule 501(a)(1) and (2) that are not subject to an assets test to qualify for accredited investor status also would qualify for large accredited investor status without being subject to an income, assets, or investments requirement. Note that, unlike Rule 506, which permits offers and sales to up to 35 non-accredited investors, Rule 507 requires that *all* purchasers must be "large accredited investors."

Proposed "Bad Actor" Disqualification Provision

The Commission has proposed to adopt new Rule 502(e) to extend disqualification provisions, currently only applicable to Rule 505 offerings, to all offerings made in reliance on Regulation D to disqualify certain "bad actors" from repeatedly offering or selling securities in reliance on Regulation D. The rule would subject the following entities to the disqualification provision: (a) the issuer, any predecessor of the issuer, and any affiliated issuer; (b) any director, executive officer, general partner, or managing member of the issuer; (c) any beneficial owner of 20 percent or more of any class of the issuer's equity securities; and (d) any promoter connected with the issuer. Note that broker-dealers, underwriters and placement agents are not covered by the proposed disqualification provision.

The disqualification provision would apply to a covered person if such covered person: (a) filed a registration statement within the last five years that is the subject of a currently effective permanent or temporary injunction or an administrative stop order; (b) was convicted of a criminal offense in the last 10 years that was in connection with the offer, purchase or sale of a security or involved the making of a false statement with the Commission; (c) has been subject to an adjudication or determination within the last five years by a federal or state regulator that the person violated federal or state securities or commodities law or a law under which a business involving investments, insurance, banking or finance is regulated; (d) is subject to an order, judgment or decree by a court entered within the last five years that restrains or enjoins the issuer or a person from engaging in any conduct or practice involving securities and other similar businesses, including an order for failure to comply with Rule 503; (e) is subject to a cease-and-desist order entered within the last five years issued under federal or state securities or similar laws; or (f) is subject to a suspension or expulsion from membership in or association with a member of a national securities exchange or national securities association for an act or omission constituting conduct inconsistent with just and equitable principles of trade.

The proposed amendment would be a significant expansion of the disqualification provision and might affect a large number of firms. While the proposed amendment specifies that the Commission would be permitted to waive the disqualification "upon a showing of good cause," it does not provide any detail as to how the process for obtaining such a waiver would work. The SEC has requested comment on the proposed amendment, asking, *inter alia*, how many issuers will be affected by the disqualification provision, and whether some alternative to disqualification might be equally effective, such as mandatory disclosure of the prior order, conviction or censure.

Further Comment Sought on the Proposed "Accredited Natural Person" Rule

In December 2006, the SEC proposed new rules regarding persons investing in a private fund that relies on Section 3(c)(1) of the Investment Company Act, which exempts from registration vehicles not offered publicly and held by no more than 100 beneficial owners. Rule 506 of Regulation D provides that a 3(c)(1) fund can have 35 non-accredited investors, but the remainder must meet the "accredited investor" criteria: natural persons with annual income in excess of \$200,000 (or joint income with a spouse of \$300,000) or a personal net worth (or joint net worth with a spouse) of \$1 million. The rules proposed in the Private Pooled Investment Vehicle Release would require that investors also meet the criteria for being an "accredited natural person": an individual with \$2.5 million in securities and financial holdings, excluding the value of personal residences and places of business.

The Aug. 3, 2007 Proposing Release acknowledges the negative commentary received by the SEC in response to the proposed rules, and requests additional comments. Specifically, the Commission asks whether the threshold for qualifying as an "accredited natural person" should

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Proposed Amendments to Regulation D

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be higher or lower than the proposed \$2.5 million in investments. One option noted in the Proposing Release would be to use the same thresholds being proposed for the definition of “large accredited investor” in proposed Rule 507 (income of \$400,000, or \$600,000 with one’s spouse, or investments of \$2.5 million).

Other Proposed Revisions

The Commission has also sought comment on a number of other proposals, including: (a) revisions to Rule 504 of Regulation D, an exemption limited to offerings by non-reporting companies that do not exceed an aggregate annual amount of \$1 million; (b) conforming changes to Rule 215’s definition of “accredited investor” to conform

with that contained in Rule 501(a); and (c) adjusting the safe harbor time frame between offerings, so that two offerings will not be treated as integrated into a single offering as long as they are 90 days or more apart (the existing rule requires that offerings be 180 days apart to avoid being treated as a single offering). Comments on all aspects of these proposals were due on Oct. 9, 2007. ■

¹ The Commission has essentially adopted the definition of qualifying “investments” that was used in its December 2006 release in which it proposed adoption of a heightened accredited investor standard for investments in pooled investment vehicles. Most notably, this definition of “investments” does not include a personal residence as such personal real estate is not held for investment purposes.

SEC Finalizes New Rule on Short Selling in Connection with a Public Offering

The Securities and Exchange Commission (“SEC”), on Aug. 6, 2007, announced the final amendments to Rule 105 of Regulation M under the Securities Exchange Act of 1934, establishing a new bright line rule that prohibits selling short an equity security during a restricted period and then purchasing the same security in a public offering. The rule as amended (the “Final Rule”) includes exceptions for: (1) a “bona fide purchase” made prior to pricing of the offering; (2) trading by separate accounts in certain circumstances; and (3) trading by registered investment companies in certain circumstances. The Final Rule also clarifies some additional modifications to the rule. The Final Rule has been effective since Oct. 9, 2007. Special attention to the Final Rule should be paid by advisers to multiple funds, because a decision that one fund will put on a short position, or will seek an allocation in a public offering, may restrict affiliated or related funds from trading unless they fit into the separate-accounts exception.

New Bright Line Rule

Rule 105 is a prophylactic rule intended to prevent manipulative short-selling that drives down the price of a secondary offering. The old Rule 105 prohibited a person from covering a short sale effected during the Rule 105 restricted period with securities purchased in the public offering. Under the old rule, the restricted period began five business days prior to the pricing of the offering, or with the initial filing of the relevant registration statement, and ended with the pricing, whichever was shorter. In recent years, the SEC has charged, in a series of enforcement actions against hedge funds, that Rule 105 is being undermined through “manipulative” and “sham” transactions designed to evade Rule 105. The amendments to Rule 105 do away with the requirement that the SEC prove that the short position was covered using stock acquired in the public offering. Instead, a new bright line rule has been established that requires an investor to choose between shorting and participating in the offering. Under the new rule, a person may *either* short an equity security within the restricted period *or* purchase shares in the public offering, but may not do both.

In response to comment letters indicating that the proposed bright line rule would restrict the capital-raising process by limiting the number of possible purchasers in secondary and follow-on offerings, the SEC added the following three exceptions to the Final Rule.

(1) Exception for Bona Fide Purchases Prior to Pricing of the Offering

The Final Rule creates an exception allowing restricted period short sellers to purchase the offered securities if they make a “bona fide purchase” of the same security prior to pricing. To qualify as a “bona fide purchase,” the purchase must be: (a) equivalent in quantity to the amount of the restricted period short sale(s); (b) effected during regular trading hours; (c) reported pursuant to an effective transaction reporting plan; (d) made after the last Rule 105 restricted period short sale; and (e) made no later than the business day prior to the day of pricing. Even where these criteria are satisfied, however, the SEC also will look to the surrounding facts and circumstances to determine whether a purchase is bona fide. The SEC stressed that transactions that are part of a plan or scheme to evade the rule would not be bona fide even if made in technical compliance with the exception. As an example, the SEC referred to transactions that do not include the “economic elements of risk associated with a purchase for value.” In light of the “facts and circumstances” nature of the analysis, any reliance on the bona fide purchase exception should be carefully analyzed.

(2) Exception for Certain Separate Accounts

The second exception permits a purchase of the offered security in an account of a person where such person sold short during the restricted period in a separate account, “if decisions regarding securities transactions for each account are made separately and without coordination of trading or cooperation among or between accounts. . . . even though the accounts may be affiliated or otherwise related.” The SEC enumerated a list of indicia of separate accounts:

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SEC Finalizes New Rule on Short Selling

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- The accounts have separate and distinct investment and trading strategies and objectives;
- Personnel for each account do not coordinate trading among or between the accounts;
- Information barriers separate the accounts, and information about securities positions or investment decisions is not shared between accounts;
- Each account maintains a separate profit and loss statement;
- There is no allocation of securities between or among accounts; and
- Personnel with oversight or managerial responsibility over multiple accounts in a single entity or affiliated entities, and account owners of multiple accounts, do not have authority to execute trades in individual securities in the accounts and in fact do not execute trades in the accounts, and do not have the authority to pre-approve trading decisions for the accounts and, in fact do not pre-approve trading decisions for the accounts.

As with the bona fide-purchase exception, the SEC stressed that these conditions are not necessarily determinative. Rather, the entire facts and circumstances must be considered. One example noted by the SEC of separate accounts that may fit into the exemption would be an adviser providing capital to two private investment funds that are separate legal entities with different accounts and profit and loss statements, and without any coordination of trading or sharing of information or allocating securities between accounts. Other examples of accounts possibly eligible for the “separate accounts” exemption noted by the SEC would be: (a) an individual investor with multiple accounts with full discretionary authority in separate managers; (b) a money manager that provides capital to separate advisers where there is no coordination between the advisers; and (c) black box trading, if each black box is separate. The SEC also indicated that it is more likely to view accounts as separate if there are policies and procedures in place to ensure the separateness of the accounts, in addition to regular reviews to make sure that the policies and procedures are updated and implemented.

(3) Exception for Registered Investment Companies in Certain Circumstances

The Final Rule also makes an exception relating to registered investment companies, which already are subject to provisions of the Investment Company Act that prohibit concerted action between funds in a complex and between different series of the same fund. Section 17(d) of the Investment Company Act and Rule 17d-1 prohibit an affiliated person of a registered investment company, and the affiliates of that affiliated person, acting as principal, from participating in any joint enterprise, or other joint enterprise or arrangement with their affiliated investment company. Under these provisions, an arrangement by

which one fund sells short while another affiliated fund intentionally goes long in the same security to cover the short position would generally be the type of coordinated strategy that is prohibited. Accordingly, for registered investment companies, the Final Rule provides that “an individual within a fund complex, or a series of a fund, is not prohibited from purchasing the offered security if another fund within the same complex or a different series of the fund sold short during the Rule 105 restricted period.”

Additional Amendments

In announcing the Final Rule, the SEC explained some additional modifications to the rule, and some suggested modifications that were not included:

- The prior Rule 105 had been interpreted to apply only to equity securities. The Final Rule makes this explicit by adding the word “equity” to the text. At the same time, in the adopting release, the SEC indicated that it will monitor whether trading in debt securities raises concerns of manipulation.
- The SEC decided not to create an exception to Rule 105 for “actively-traded securities” within the meaning of Rule 101(c)(1) of Regulation M. Some commenters had argued that such securities are not susceptible to the manipulation targeted by Rule 105, but the SEC noted that many of the securities that were involved in enforcement actions brought under Rule 105 were actively traded.
- The Final Rule encompasses offerings made pursuant to Form 1-E, Notification under Regulation E, which relate to securities issued by small business investment companies or by business development companies regulated under Section 54(a) of the Investment Company Act. The SEC was concerned that short-selling of securities issued pursuant to Regulation E raised the same manipulation concerns that Rule 105 is intended to prevent.
- The Final Rule states that it is unlawful for any person to sell short the security that is the “subject” of the offering and purchase offered securities. The SEC explained that the term “subject” is consistent with other provisions of Regulation M, and clarifies that the amended rule does not apply to reference securities. Thus, “in an offering of securities convertible into common equity, even though the convertible securities are themselves equity securities, a person may still sell short the underlying common equity and purchase the convertible security in the offering without violating Rule 105.”
- Derivatives trading is not specifically covered by the Final Rule, but the SEC indicated its intent to monitor the use of derivative strategies that may replicate the economic effect of the activity that Rule 105 is designed to prevent. Importantly, the anti-fraud and anti-manipulation provisions of the securities laws are still applicable to any transaction or series of

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transactions that are not covered by the amended Rule 105.

Conclusion

The SEC's new Rule 105 changes the landscape for short-selling in connection with secondary offerings. Managers should determine how to implement the new bright line rule, so that they either short within the restricted period,

or participate in the public offering, but not both. If one of the three exceptions to the new rule is to be relied upon, the applicability of that exception should be carefully analyzed prior to trading in reliance on the exception. In particular, care must be taken to determine whether multiple private investment funds managed by the same adviser will be treated as one for purposes of Rule 105, or as separate accounts. ■

Changes to Regulation SHO

The summer of 2007 brought changes to the Securities and Exchange Commission's ("SEC") short-selling rules under Regulation SHO. Most significantly, the SEC eliminated Rule 10a-1 under the Securities Exchange Act of 1934 (commonly known as the "tick" test) and other price restrictions. Additionally, the SEC will eliminate the "grandfather" exception to Regulation SHO's requirement that fail-to-deliver positions be closed out within 13 days of failure. The SEC also proposed or re-proposed other amendments related to the short-selling rules. The SHO amendments are largely technical in nature, designed to eliminate a small but persistent population of securities consistently found on the threshold securities list.

A. Repealing the "Tick" Test and Other Price Tests

Effective July 6, 2007, the SEC repealed Rule 10a-1 and amended Regulation SHO to eliminate any price test that prohibits short-selling in a "down" market. The "tick" test allowed short sales of exchange-listed securities only when the price was not falling. Under the then-existing regulation, short sales generally were only allowed to be made at a "plus tick"—a price above the price at which the immediately preceding sale was effected—or at a "zero-plus tick"—the last sale price if higher than the last different price. Meanwhile, the NASD and Nasdaq had their own price restrictions, called "bid" tests, which provided that short sales could not be made at prices below the stock's best published bid price when that bid price fell below the previous different best published bid price.

In 2004, the SEC ordered a pilot study for certain specified markets and securities suspending the tick test and any other short-sale price test so that it could study how short-sale price tests affect the markets. The resulting data was analyzed by the SEC's Office of Economic Analysis as well as by independent economists. The SEC also sponsored a roundtable on Sept. 25, 2006, to address the data from the pilot study. The overall conclusion was that price-test restrictions reduce liquidity and are not necessary to prevent manipulation.

The Commission voted unanimously to repeal Rule 10a-1 and to prohibit any self-regulatory organization (SRO) from having a price test. Potential benefits to market participants from the elimination of price restrictions may be increased liquidity and more pricing efficiency. The repeal may also result in a decrease in compliance costs, as the technology and human capital necessary to ensure compliance with the price restrictions no longer is needed. There will also be regulatory consistency (between the SEC and the SROs) on the issue.

B. Regulation SHO Close-Out Requirement

The SEC also took active steps to end instances of "naked shorting" in the market. Regulation SHO was enacted in part to reduce the frequency of "fail to deliver" positions. The regulation requires, among other things, that a broker-dealer "close out" short positions (i.e., purchase securities of like kind and quantity) in so-called "threshold securities" (i.e., securities that experience designated levels of "fails to deliver") if that broker-dealer has a "fail to deliver" position in a threshold security for thirteen (13) consecutive settlement days. Although the enactment of Regulation SHO significantly reduced the number of fail-to-deliver securities, certain threshold securities have remained on the threshold lists since the adoption of Regulation SHO, prompting the SEC to seek the elimination of existing exemptions as a means of eliminating persistent fails to deliver.

1. Amendments Adopted to Eliminate Grandfather Exception and Change Close-Out Requirements for Rule 144 Securities

When Regulation SHO was adopted in 2004, it contained a "grandfather" exception, Rule 203(b)(3)(i), that does not apply the close-out requirement to positions established prior to the security becoming a listed threshold security or subject to Regulation SHO. These situations were "grandfathered" because the SEC was concerned that Regulation SHO might cause a "short squeeze" on large pre-existing fail-to-deliver positions and result in sharp increases to the market price in threshold securities.

On June 13, 2007, the SEC voted to eliminate Rule 203(b)(3)(i), meaning that all fail-to-deliver positions in threshold securities will have to be closed out within 13 consecutive settlement days. This change became effective on Oct. 15, 2007. For securities that were previously grandfathered, the close-out requirement will be 35 consecutive settlement days from Oct. 15, 2007. In addition, the SEC extended the close-out requirement from 13 days to 35 consecutive settlement days for fail-to-deliver positions resulting from sales of threshold securities pursuant to Rule 144 under the Securities Act of 1933. The pre-borrow requirement of Rule 203(b)(3)(iii) will also be extended for such fails to deliver.

2. Amendments Re-Proposed to Eliminate Options Market-Maker Exception

The options market-maker exception safeguards certain fails to deliver from the close-out requirements of Regulation SHO. Specifically, fails to deliver in threshold

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Changes to Regulation SHO

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securities resulting from short sales that are effected by a registered options market-maker to hedge an option do not need to comply with the close-out requirements, provided the option was created *before* the underlying security became a threshold security. The exception was originally designed to address concerns regarding liquidity, as many predicted that options market-makers would not make a market without the ability to hedge by short-selling the underlying security. The SEC noted that persistent fails to deliver may be attributable to reliance on this exception, and that the exception may give participants in the options market an advantage over participants in the equities market. The proposal, which eliminates the exception, will address these issues by ensuring that once a security becomes a threshold security, any fail to deliver—whether occurring in the options market or in the equities market—will be closed out.

The proposal would eliminate the exception, so that *all* fails to deliver in threshold securities that result from short sales effected to hedge options positions would have to be closed out within 13 settlement days, regardless of whether the options were created before the underlying security became a threshold security. To reduce any adverse impact on the market, the SEC proposed a phase-in period for previously excepted fail-to-deliver positions which would give participants 35 days (from the effective date of the amendment) within which to close out the position.

In anticipation of comments regarding the absolute need for an exception, the Commission proposed two alternatives. Although each alternative provides that fails to deliver in threshold securities would have to be closed out eventually, they provide a longer period of time within which to do so. The alternatives also would require participants to document eligibility for the exception, which would augment the ability of the Commission and the SROs to effectively monitor for compliance. This documentation could include, for example, documentation of when the hedge was created, when the underlying security became a threshold security and the age of the fail-to-deliver position.

Alternative 1 would require a participant with a fail-to-deliver position to close out the entire position within 35 settlement days of the security becoming a threshold security. After 35 days, any additional fails to deliver would be subject to the mandatory 13 day close-out requirement, even if associated with options created before the security became a threshold security.

Alternative 2 would require a participant to close-out the entire fail-to-deliver position within the *earlier* of: (i) 35 settlement days from the date on which the security became a threshold security, or (ii) 13 settlement days from the last date on which the options have expired or are liquidated. Any additional fails to deliver, including those associated with options created before the security became a threshold security, would be subject to the mandatory 13 day close-out requirement of Regulation SHO.

Each of the three variations on the options market-maker exception incorporates the pre-borrow requirements of Regulation SHO, so that if a fail to deliver persists beyond the applicable time-frame, a participant may not engage in further short sales, without borrowing or arranging to borrow the security, until the entire position has been closed out by purchasing securities of like kind.

3. Amendment to Long-Sale Marking Provisions Proposed

Finally, the SEC proposed to amend the long-sale marking provisions. Regulation SHO provides that, prior to marking a sell order “long,” a broker must determine whether the customer is “deemed to own” the securities. To facilitate this process, the SEC proposed that brokers document the present location of securities prior to marking the order. If the seller cannot provide the present location of the securities, the broker would have reason to believe that the seller is not “deemed to own” the securities, in which case the broker would need to obtain securities for delivery. The proposed amendment seeks to reduce the amount of fails to deliver, and also to address the SEC’s concern that brokers are not making a determination as to whether the customer is “deemed to own” the securities sold, as required by the rule. ■

Coming Events

SRZ Investment Management Hot Topics

Oct. 30: SRZ Office

Crisis Management for Fund Managers

SRZ Partners Stephanie R. Breslow,
Mark E. Brossman and David Momborquette;
and Marcia Horowitz, Rubenstein Associates

SRZ 17th Annual Private Investment Funds Seminar

Jan. 15, 2008: New York Marriott Marquis Times Square

SRZ partners and guest speaker, Kevin J. O’Connor,
United States Attorney, District of Connecticut

For more information, contact Wesley Gross at 212.610.7285 or wesley.gross@srz.com

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