Trading Compliance: Managing Regulatory Risk

Schulte Roth & Zabel

25TH ANNUAL

PRIVATE INVESTMENT FUNDS SEMINAR

JANUARY 19, 2016

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David focuses his practice on matters related to fiduciary responsibility, the Employee Retirement Income Security Act of 1974 (ERISA) and qualified plans. Prior to joining Schulte Roth & Zabel, he held positions in both the private sector (as vice president and assistant general counsel of a major investment firm) and government service (with the Department of Labor Employee Benefits Security Administration's Divisions of Regulatory Coordination and Exemptions).

In recognition of his accomplishments, David has been selected for inclusion in *Chambers USA*, *The Best Lawyers in America* and *New York Super Lawyers*, a listing of outstanding attorneys in the New York metro area. He has spoken and written widely on ERISA and benefit fund-related issues, including authoring ERISA compliance guides for broker-dealers for Practising Law Institute and presenting on "Handling ERISA Issues When Managing a Plan Asset Look-Through Fund" for a Financial Research Associates Hedge Fund Tax, Accounting and Administration Master Class and on "Current Topics in Private Equity and Alternative Investments" and "Current Fiduciary Issues" for recent PLI Pension Plan Investments conferences. He is also a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press).

David earned a J.D. from The George Washington University Law School and a B.A. from Columbia University.

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Brian T. Daly

Brian advises hedge fund and private equity fund managers and commodity pool operators on regulatory, compliance and operational matters, including registration and disclosure obligations, trading issues, advertising and marketing, and the establishment of compliance programs. Having spent nearly a decade serving in-house as general counsel and chief compliance officer at several prominent hedge fund management firms, he is well-versed in a wide range of legal and business challenges facing investment advisers, commodity pool operators and commodity trading advisors and has extensive experience designing and improving compliance processes and organizational systems. Brian has represented clients in the context of regulatory examinations, trading inquiries and enforcement actions, and in seeking no-action or similar relief in the United States, the United Kingdom and Asia.

Brian is well known for his thought leadership in the regulatory and compliance area as it affects alternative investment funds and is a key part of Schulte Roth & Zabel's educational outreach. In addition to hosting SRZ webinars, participating in firm-sponsored seminars and workshops, and authoring SRZ alerts and white papers, he recently published "Q&A with Brian T. Daly: SRZ's Systematic and Quantitative Strategies Practice" in *The Hedge Fund Journal* and "Securities, Futures Regulators Increase Scrutiny, Expectations on Cybersecurity" in *Bloomberg Brief — Financial Regulation*. His recent speaking engagements addressed topics including how U.K. fund managers registered as CPOs or CTAs should prepare for NFA examinations, and hedge fund and management company structures. Brian also teaches legal ethics at Yale Law School, focusing on the challenges faced by in-house counsel. He is a chair of the Steering Committee for the Managed Funds Association's CTA/CPO Forum and a member of the CFTC Working Group for the Alternative Investment Management Association and of the New York City Bar Association's Private Investment Funds Committee. He formerly served as co-chair of the MFA's General Counsel Forum, its CTA, CPO & Futures Committee, and as a steering committee member of its Investment Advisory Committee.

Brian received his J.D., with distinction, from Stanford Law School, his M.A. from the University of Hawaii, and his B.A., *magna cum laude*, from Catholic University of America.

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Eleazer Klein

Ele practices in the areas of securities law, shareholder activism, mergers and acquisitions, and regulatory compliance. He serves as co-chair of Schulte Roth & Zabel's global Shareholder Activism Group, assisting activists and companies with matters ranging from corporate governance and control to proxy contests and defensive strategies. Ele has been well known for his expertise since the 1990s for the development and implementation of alternative investment structures for private equity investments and, specifically, the structuring and negotiating of private investments in public equity, or PIPEs, and related products including registered direct offerings, convertible 144A offerings, reverse mergers, equity lines and SPACs. He works on numerous activist campaigns and PIPE or PIPE market-related transactions every year for some of the largest private investment groups and investment banks in the United States and abroad. In addition, he advises on initial public offerings and secondary offerings, venture capital financing, and indenture defaults and interpretation, and he counsels clients in the regulatory areas of short selling, tender offers and short tender offers, Sections 13 and 16, Rules 144 and 144A, insider trading and Regulation M/Rule 105.

Ele is listed in *The Legal 500 United States*, *New York Super Lawyers*, its New York Metro Top 100 list and *Super Lawyers Business Edition* (a national listing selected from the *Super Lawyers* regional awards), and he was named to *The DealFlow Power 20* list for being a top influencer in the small-cap financing market. Ele's extensive PIPEs experience is reflected in his contribution to *PIPEs: A Guide to Private Investments in Public Equity* (Bloomberg Press), a leading treatise in the PIPEs arena. He also contributed to *Shareholder Activism Insight 2014* (SRZ in association with Mergermarket) and authored the "Transaction Reporting" chapter in *Investment Management: Law and Practice* (Oxford University Press), covering Schedules 13D and 13G and Section 16 filings. In addition, he has become a leading source for business journalists and business news organizations, and a much sought-after speaker by sponsors of shareholder activism, PIPEs, SPACs and regulatory conferences. Ele has served as a moderator and speaker at numerous conferences and events addressing shareholder activism, PIPEs, M&A deals, the capital markets and other topics of interest to the alternative investment industry.

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Howard Schiffman

Howard is co-chair of Schulte Roth & Zabel's Litigation Group. Nationally known in the area of securities litigation and regulatory developments, his practice focuses on investigations and enforcement proceedings brought by various exchanges and government agencies, including the SEC, the DOJ and FINRA, as well as a diverse array of civil litigation, including securities class actions and arbitrations. A corporate problem solver, Howard is as adept at dispute containment and resolution as he is at arguing to a jury. He counsels clients, including major financial institutions and investment banks, leading Nasdaq market-makers, institutional and retail brokerage firms and their registered representatives, trade execution and clearing firms, prime brokers, national accounting firms, hedge funds, and public and private companies and their senior officers in risk analysis and litigation avoidance. With his extensive trial experience and solid record of success in numerous SEC enforcement actions, SRO proceedings and FINRA arbitrations, Howard has the confidence to take a case to trial when necessary. He recently represented Goldman Sachs in a FINRA dispute resolution arbitration brought by hedge fund Walrus Master Fund Limited and Adam D. Sender that requested more than $60 million in damages and alleged that claimants suffered losses resulting from liquidating securities positions to meet risk calls during the October 2008 financial crisis. Howard achieved an arbitration award denying all of the claims and assessing forum fees against the claimants, handing Goldman Sachs a resounding victory. He also prevailed in a written opinion from the Grand Court of the Cayman Islands by overseeing the successful defense at trial against a petition for the winding up of Harbinger Class PE Holdings (Cayman) Limited in which shareholders argued that the fund's purpose could no longer be achieved. He has obtained victories in other significant matters, including prevailing in a price adjustment case involving the dispute of several hundred million dollars for a portfolio of real estate mortgages, and he represented the former CEO of the largest Nasdaq market-making firm, Knight Securities, in a federal court action brought by the SEC. After a 14-day bench trial, all parties were completely cleared of wrongdoing. Howard began his career as a trial attorney with the SEC Division of Enforcement. In private practice for more than 30 years, he has long been at the forefront of securities litigation and regulatory developments, including his current representation of hedge funds, leading prime brokers and clearance firms in regulatory and civil litigation.

Howard was included in *Washingtonian* magazine's "800 Top Lawyers" listing (a ranking of "Washington's best — the top one percent") and in *Washington DC Super Lawyers*, and he has been recognized by *Chambers USA*, *The Legal 500 United States* and *Benchmark Litigation: The Definitive Guide to America's Leading Litigation Firms and Attorneys*. He is a member of American Bar Association sections on Litigation, Corporation, Finance and Securities Law and a fellow of the Litigation Counsel of America, and a director and former president of the Association of Securities and Exchange Commission Alumni Inc. He is the author of the "Tipper and Tippee Liability" chapter in the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute) and most recently presented on ethical issues for general counsels and chief compliance officers.

Howard received his J.D., *cum laude*, from Fordham University School of Law and his B.A., *cum laude*, from Colgate University.

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Craig Stein

Craig co-heads Schulte Roth & Zabel's Structured Finance & Derivatives Group. His practice focuses on swaps and other derivative products, including credit- and fund-linked derivatives, prime brokerage and customer trading agreements, and structured finance and asset-backed transactions. He represents issuers, underwriters, collateral managers and portfolio purchasers in public and private structured financings, including collateralized loan obligations (CLOs).

Chambers USA has noted that satisfied clients have praised Craig for his "very broad knowledge of the markets" and for being "incredibly responsive and helpful in thinking through issues." *Chambers* also notes, "He is known for his work in derivative products, representing issuers, underwriters and portfolio purchasers in CLOs. Peers find his work in structured products and derivatives impressive." *The Legal 500 United States* has noted that Craig is "recognized for his thought leadership on regulatory issues affecting both the securitization and derivatives markets." He is also recognized as a leader in his field by *Chambers Global* and *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers* (Structured Finance and Securitization). Craig is a member of the American Bar Association, the New York City Bar Association, the New York State Bar Association, the Loan Syndications and Trading Association, the International Swaps and Derivatives Association and the Structured Finance Industry Group. He is a much sought-after speaker for hedge fund industry conferences and webinars and the author of numerous articles on advanced financial products. He recently co-authored "New Margin Requirements for Uncleared Swaps" in *Harvard Business Law Review Online* and "CLOs and Risk Retention" for *The International Comparative Legal Guide to: Securitisation 2015*, and he spoke on how alternative asset managers and banks work together post-Basel III and on the challenges of launching CLO platforms.

Craig earned his J.D., *cum laude*, from the University of Pennsylvania Law School and his undergraduate degree, *cum laude*, from Colgate University.

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Steven Whittaker

Steven's practice focuses on advising on the establishment and operation of hedge funds in the United Kingdom, Europe and a variety of offshore jurisdictions, and on the structuring and operation of hedge fund management groups, including LLP agreements, and on seed-capital arrangements. Steven also advises on the establishment and listing of closed-end public funds and U.K. onshore funds.

Steven has been recognized by *Chambers UK*, *Expert Guide to the Best of the Best*, *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*, *IFLR1000*, *The Legal 500 United Kingdom* and *Who's Who Legal: The International Who's Who of Private Funds Lawyers* for his preeminence in the investment funds sector, with interviewees describing him as "top notch" and "fantastic." He is "one of the leading partners in investment funds in Europe," according to a client quoted in *Chambers UK*, who adds that "with Steven as counsel, it is easy to navigate the post-AIFMD regulatory landscape." Steven is a member of the International Bar Association and a member of the Collective Investment Schemes Sub-Committee of The Law Society, and is co-chair of the Sound Practices Committee of the Alternative Investment Management Association. He also chaired the AIMA working group which updated the *Fund Directors' Guide*. Steven is the co-author of "AIFMD Update: ESMA Advice on Extension of Marketing Passport Published" in *The Hedge Fund Journal* and "Marketing Alternative Funds in Europe: A Changed Landscape" in *Risk & Compliance Magazine*. He most recently addressed topics at conferences and seminars including "hot topics" for U.K. hedge fund managers, the evolution of fund governance and the marketing of private funds.

Steven graduated with an honors degree in law from Cardiff University and attended the College of Law.

Trading Compliance: Managing Regulatory Risk

I. Rule 105 of Regulation M and Regulation SHO

A. Generally: What Is Rule 105?

Rule 105 makes it unlawful for any person to "sell short" during the "Rule 105 restricted period" an equity security that is being offered for cash pursuant to a registration statement in a firm commitment underwritten offering and purchase the offered securities.

B. Why Is Rule 105 Significant, and Why Does Preparation Matter?

1. Rule 105 enforcement rose sharply in 2010.

2. Rule 105 is a prophylactic rule, and therefore, 105 actions are easy to bring — if there is a violation, there is no legal defense. There is no requirement of intent to manipulate the price of the security.

3. Rule 105 is not intended to catch only systematic "scams" — even a single violation can lead to charges.

4. Charges can be based on even trivial profits, but penalties, in addition to disgorgement of profits, can constitute a significant percentage of the overall resolution.

5. Rule 105 violations are also subject to various reporting requirements (e.g., 13D, ADV) (but note that a Rule 105 violation does not automatically trigger the "bad actor" rule under Regulation D).

6. Rule 105 violations fall under the category of "market manipulation" and can also lead to censure, suspension or a lifetime ban of being associated with an investment adviser or broker-dealer, all of which can cause investor concern and affect a firm's ability to keep and/or raise capital.

C. How to Avoid a Rule 105 Violation: A Checklist of Rule 105 Provisions

1. What types of offerings does Rule 105 apply to? Firm commitment underwritten offerings of equity securities:

(a) How do you distinguish between a firm commitment offering and best efforts offering?

(i) Firm Commitment Underwritten Offering: A firm commitment underwritten offering is generally one where one or more investment banks agree to act as an underwriter and are thereby obligated to purchase a fixed number of securities from the issuer, which they resell to the public.

(ii) Best Efforts Offering: An investment bank agrees to act as placement agent to do its best to sell the offering to the public but does not buy the securities from the issuer and does not guarantee that it will sell any amount of the securities.

(b) What is the subject equity security?

(i) Rule 105 only applies to equity securities.

(ii) An offering of non-convertible debt would not fall under the rule. An offering of convertible debt would fall under the rule, as convertible debt is itself an equity security. However, the rule prohibits only the selling short of the "security that is the subject" of the offering; therefore a short sale of the underlying common stock would not prohibit participation in an offering of the convertible debt. However, the general anti-fraud and anti-manipulation provisions of the federal securities laws still apply.

(iii) Options and other derivatives are not considered equity securities under the rule. However, again, the SEC has made clear that the anti-fraud and anti-manipulation provisions of the federal securities laws still apply in this context.

(c) Global Offerings and Short Sales Abroad

(i) A person cannot participate in an offering in the United States if he or she sold the subject securities short on a foreign exchange during the Rule 105 restricted period.

(ii) In an entirely foreign distribution of a security that has no market in the United States, but whose reference security does have a market in the United States, the foreign distribution is not subject to Regulation M. For example, Rule 105 does not prohibit a short sale of common stock in a foreign offering during the Rule 105 restricted period and participation in an offering for ADRs because they are not the same subject security. However, the general anti-fraud and anti-manipulation provisions of the federal securities laws may apply to any transaction effected in the United States. Be especially careful here because the ADR can essentially be seen as a re-packaging of the common stock.

2. Rule 105 Restricted Period: The shorter of the period: (i) beginning five business days before the pricing of the offered securities and ending at pricing; and (ii) beginning at the initial filing of the registration statement and ending at pricing.

(a) How is the five-business-day period calculated?

(i) "Business day" refers to a 24-hour period determined with reference to the principal market for the securities to be distributed, and that includes a complete trading session for that market.

(ii) If pricing occurs after the principal market closes, then the day of pricing is included in the five-business-day period. For example, if pricing occurs on a Thursday after the principal market closes, then the restricted period would begin at the close of trading on the previous Thursday and end at pricing on the following Thursday.

(iii) Problems with Holidays: If the principal market is closed for a holiday, then such date will not count as a business day within the five-business-day period.

(b) How is the period beginning from the initial filing of the registration statement calculated?

(i) The period begins with the issuer's initial filing of a registration statement for secondary offerings. Oftentimes this is done well in advance (sometimes years) before the secondary offering at hand. But sometimes it is done by WKSIs (because they can file an automatic shelf registration statement) right before the offering, in which case, this period may be shorter than the five-business-day period.

(ii) A prospectus supplement containing the specific information with respect to the offering might be filed right before the offering. This is not the initial registration statement.

3. What is a short sale?

(a) Definition Under Section 200(a) of Regulation SHO: "The term short sale shall mean any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller."

(b) When does a person own a security?

(i) The person has title to it.

(ii) The person has purchased it pursuant to an unconditional contract, binding on both parties, to purchase it but has not yet received it.

(iii) The person owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange.

(iv) The person has an option to purchase it and has exercised the option.

II. Section 13(d) and Section 16 Reporting Requirements Under the Securities Exchange Act of 1934 (the 'Exchange Act')

A. Section 13(d) Reporting Requirement Trigger

1. Upon becoming a greater than 5-percent "beneficial owner" of any voting, equity security registered under the Exchange Act ("Subject Securities")

(a) A beneficial owner of a security includes any person who, *directly or indirectly*, through any contract, arrangement, understanding, relationship or otherwise has or shares *voting power* and/or *investment power* with respect to such security. An investment manager's beneficial ownership should be calculated based on the aggregate positions of all entities it manages that are not disaggregated from each other for purposes of Section 13(d) and Section 16 reporting.

(i) Voting power includes the power to vote, or to direct the voting of, a security.

(ii) Investment power includes the power to dispose, or the power to direct the disposition, of a security.

(b) Rule 13d-3(d)(1)(i) provides that a person is deemed to be the beneficial owner of a security if that person has the right to acquire beneficial ownership of that security within 60 days.[1]

(c) Rule 13d-5(b)(1) provides that when two or more persons agree (whether formal or informal, orally or in writing) to act together for the purpose of acquiring, holding, voting or disposing

[1] However, non-passive holdings confer beneficial ownership for a right to acquire at any time — even after 60 days. This important exception to the 60-day rule provides that any person who has a right to acquire beneficial ownership of a security with the purpose or effect of changing or influencing control of the issuer, or in connection with or as a participant in any transaction having such purpose or effect, is deemed to be a beneficial owner of the security immediately upon acquiring the right to acquire the security regardless of whether that right cannot be exercised within 60 days. Nonetheless, a person does not beneficially own subject securities underlying a derivative security if the right to acquire the underlying subject security is subject to material contingencies outside the control of such person that cannot be waived (e.g., the requirement to obtain a governmental approval or the effectiveness of a registration statement). Such a right does not create beneficial ownership until the contingency is met even where these material contingencies could be met within the 60-day period.

of subject securities, all members of the group formed thereby will be deemed to have beneficial ownership of all subject securities beneficially owned by the other members of the group.

(i) To be a member of a group a person first must be the beneficial owner of subject securities.

(ii) Private investment funds, mutual funds, private equity funds and similar investment vehicles ("Funds") with a common investment manager may be deemed to be a group if the investment manager(s) make similar acquisitions and dispositions of subject securities on behalf of the Funds at the same time or there is a common plan or goal among the investment manager(s) for the Funds. Depending on the facts, it is even possible for a managed account client to be deemed to be a group with the investment manager managing its account. Relevant facts to consider include transparency of trading data or other sharing of information related to a subject security and whether the client trades the subject security outside of the account in a manner that is similar to the trading done in the account.

(iii) If considered a group, the subject securities held by the Funds and/or clients must be aggregated when determining whether the 5-percent threshold has been crossed.[2]

(iv) A group can also be formed with unaffiliated entities or persons if an agreement as to the acquisition, holding, voting or disposition of subject securities exists.

B. Type of Filing Required: Schedule 13D or the Short Form Schedule 13G?

1. Section 13(d) of the Exchange Act requires a beneficial owner that acquires more than 5 percent of a class of subject securities to file on Schedule 13D unless eligible to file on Schedule 13G.

(a) The initial Schedule 13D filing must be made within 10 calendar days of crossing 5 percent.

(b) Amendments must be made "promptly"[3] upon any material change in the information previously reported.

(i) An acquisition or disposition of 1 percent or more of the class of securities is deemed to be a material change requiring an amendment.

(ii) Another common amendment trigger is any material change to a filer's plans or proposals with respect to the issuer (under Item 4 of Schedule 13D).

2. Eligibility to File on Schedule 13G

(a) 13d-1(b) Qualified Institutional Investors: Certain institutional investors (e.g., registered investment advisers, registered investment companies and registered brokers or dealers) may file on Schedule 13G as long as they have acquired the subject securities in the ordinary course

[2] The common investment manager(s) would be deemed to beneficially own the aggregate number of subject securities held across the Funds/client accounts regardless of whether the Funds and/or accounts are deemed to be a group. So, it is the aggregate ownership across the Funds and accounts that would trigger a filing and be reported in either case. Accordingly, the Funds and/or accounts being deemed to be a group is of little consequence in terms of triggering a filing requirement. However, the finding of group status could subject the Funds and accounts to individual reporting and Section 16's short-swing profit rules and require accelerated Schedule 13G reporting under Rule 13d-1(c), as discussed below.

[3] "Promptly" is not defined in the rules but has generally been interpreted by courts to mean not more than two business days.

of business and not with the purpose nor with the effect of changing or influencing the control of the issuer.

(i) The initial Schedule 13G is required to be filed within 45 days after the end of the calendar year if the beneficial ownership of the reporting person(s) exceeds 5 percent as of Dec. 31; provided, that, if the reporting person(s) beneficial ownership exceeds 10 percent prior to the end of the calendar year, the reporting person's or persons' initial Schedule 13G must be filed within 10 days after the end of the first month in which the reporting person's or persons' beneficial ownership exceeds 10 percent on the last day of the month.

(ii) Amendments are required:

(1) Within 45 days of the end of the calendar year if, as of Dec. 31, there is any change in the information previously reported (unless the only change is a change in the percentage beneficially owned and such change is a result of a change in the number of shares of the class outstanding);

(2) Within 10 calendar days after the end of any month in which beneficial ownership exceeds 10 percent as of the end of the month; and

(3) Once over 10 percent, within 10 calendar days of the end of any month in which beneficial ownership increases or decreases by more than 5 percent as of the end of the month.

(b) 13d-1(c) Passive Investors: Investors that are not one of the types of institutional investors permitted to file under Rule 13d-1(b) may file under Rule 13d-1(c) as long as they have not acquired the subject securities with the purpose, or with the effect of, changing or influencing control of the issuer *and* their beneficial ownership does not constitute 20 percent or more of the class of subject securities.

(i) The initial Schedule 13G is required within 10 days of crossing 5-percent beneficial ownership.

(ii) Amendments are required:

(1) Within 45 days of the end of the calendar year if, as of Dec. 31, there is any change in the information previously reported (unless the only change is a change in the percentage beneficially owned and such change is a result of a change in the number of shares of the class outstanding);

(2) "Promptly" upon crossing 10-percent beneficial ownership; and

(3) Once over 10 percent, "promptly" after beneficial ownership increases or decreases by more than 5 percent.

(c) 13d-1(d) Exempt Investors: Investors who are or become the beneficial owner of more than 5 percent of a class of subject securities *but* who have not made an "acquisition" subject to Section 13(d) are permitted to file on Schedule 13G (e.g., those who become beneficial owners of more than 5 percent of a class of subject securities as a result of a stock buy-back or those who owned the subject security prior to the subject security becoming registered under the

Exchange Act).[4] This provision is available regardless of control intent or ownership level. The ability to file under 13d-1(d) is lost if the investor acquires more than 2 percent of the class of subject securities within any 12-month period. For example, if the investor acquired 1.5 percent of the subject security two months prior the Exchange Act registration and one month following the registration acquired another 0.6 percent of the subject security, the ability to file under 13d-1(d) would be lost, and instead of filing under Rule 13d-1(d) after the year-end, the investor would instead file under Rule 13d-1(b), 13d-1(c) or file a Schedule 13D, as appropriate.

(i) The initial Schedule 13G filing is required within 45 days of the end of the calendar year if beneficial ownership exceeds 5 percent as of the end of the calendar year.

(ii) Amendments are required within 45 days of the end of the calendar year if, as of Dec. 31, there is any change in the information previously reported (unless the only change is a change in the percentage beneficially owned and such change is a result of a change in the number of shares of the class outstanding).

C. Section 16 Reporting Requirement Trigger

1. Upon becoming an officer, director[5] or greater than 10-percent "beneficial owner" of any subject security

2. "Beneficial ownership" for determining who is subject to Section 16 is, for the most part, the same as the Section 13(d) beneficial ownership determination. Therefore a Schedule 13D/G filer that is a greater than 10-percent beneficial owner separately will be subject to Section 16 reporting. Accordingly, reporting persons are typically the same as under the Section 13(d) analysis.

D. What Is Reported and Subject to Matching Under Section 16(a)?

1. The beneficial ownership test used to determine whether a person is subject to Section 16 as a greater than 10-percent beneficial owner is different from the test used to determine what is reported under Section 16(a) and what is subject to matching for purposes of Section 16(b). Section 16(a) requires the disclosure of, and Section 16(b) subjects to profit disgorgement under Section 16, any equity securities of the issuer in which the reporting persons have a direct or indirect "pecuniary interest" (discussed below).

2. The use of different tests for determining greater than 10-percent beneficial ownership on the one hand and what is included on Section 16 reports on the other hand can result in a filer not reporting securities that were taken into account when determining whether the filer was subject to Section 16. It can also result in securities that are reported under Section 16 being excluded from Section 13(d) reporting and vice versa.

3. Pecuniary interest is defined as the "opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject securities" (Rule 16a-1(a)(2)(i)).

[4] This comes up most often where an issuer's securities are held, such as by a private equity or venture capital fund, prior to the issuer's initial public offering (concurrently with which the securities will become registered under the Exchange Act).

[5] It is possible for an entity to be treated as a director for purposes of Section 16 if it can be shown that the entity has deputized an individual to sit on the board of an issuer in order to represent the interests of the entity. If an entity is deemed to be a director-by-deputization, the entity will be treated as a director and subject to Section 16 as such regardless of whether the entity beneficially owns more than 10 percent of the issuer's securities.

(a) An indirect pecuniary interest is defined to include a general partner's proportionate interest in the portfolio securities held by a general or limited partnership to the extent of the greater of the partner's share of the partnership's profits or capital account (Rule 16a-1(a)(2)(ii)(B)).

(b) An investment manager will have an "indirect pecuniary interest" with respect to a class of an equity security if it receives a performance fee based, in part, on the security's performance *unless*, with respect to the performance fee: (i) the performance fee is calculated over a period of one year or more; and (ii) the equity securities of the issuer do not account for more than 10 percent of the market value of the portfolio of the applicable fund or account (Rule 16a-1(a)(2)(ii)(C)).[6]

(c) Asset-based fees are excluded from the definition of indirect pecuniary interest (Rule 16a-1(a)(2)(ii)(C)).

(d) A Fund will be deemed to have a direct pecuniary interest in any securities directly held by it.

4. Forms Filed Under Section 16(a)

(a) Form 3 – Initial Statement of Beneficial Ownership of Securities: Must be filed within 10 days of becoming an officer, director or greater than 10-percent "beneficial owner" to report all equity securities in which the filer has a pecuniary interest as of the time of crossing 10 percent (except that if the filing is a result of the initial registration of the issuer's securities under the Exchange Act (e.g., in connection with an IPO) the filing is required to be made on the date the issuer's registration statement is declared effective by the SEC).

(b) Form 4 – Statement of Change of Beneficial Ownership of Securities: Must be filed within two business days after a change in pecuniary interest takes place.

(c) Form 5 – Annual Statement of Beneficial Ownership of Securities: Must be filed within 45 days of the issuer's fiscal year end to report transactions that took place in the prior year that should have been reported but were not. It can also be used to report certain transactions exempt from 16(b). If there are no transactions required to be filed on a Form 5, no such filing is made for the year.

5. Section 16(b) Short-Swing Profit Liability

(a) Section 16(b) imposes liability for short-swing profits from the issuer's equity securities (including derivative securities) upon all persons required to file reports under Section 16(a).

(b) Section 16 insiders must disgorge to the issuer any profits realized as a result of a purchase and sale or sale and purchase of any equity securities of the issuer within a period of less than six months ("short-swing profits").

(c) With respect to 10-percent beneficial owners, the purchase that puts the beneficial owner over the 10-percent threshold does not qualify as a "purchase" subject to Section 16(b); only purchases made after becoming a greater than 10-percent beneficial owner will give rise to short-swing profits when matched against sales occurring within six months and while a Section 16 insider.

[6] The determination of "market value" is not defined. A factor that can be relevant to the determination includes how the Fund or account carries the position on its books.

(d) The "lowest-in, highest-out" method of calculating matching transactions is used to calculate profits under Section 16(b). Under this approach, "the highest sale price during the six month period is matched against the lowest purchase price in that period, followed by the next highest sale price and next lowest purchase price and so on, until all shares have been included" irrespective of the order in which the transactions were executed. Under this approach, it is possible for an insider to have an actual loss but a "realized" profit that is payable under Section 16(b).

Example

Transactions Investment Status	
Transaction 1: Buy 1,000,000 shares at $10 ($10M)	$10,000,000
Transaction 2: Buy 1,000,000 shares at $20 ($20M)	$30,000,000
Transaction 3: Sell 1,000,000 shares at $20 ($20M)	$10,000,000
Transaction 4: Sell 1,000,000 shares at $5 ($5M)	$5,000,000
Total Loss = $5,000,000	

Under §16(b)
Lowest price in = $10 = $10,000,000
Highest price out = $20 = $20,000,000
Total Realized Profit = $10,000,000

III. Rule 14e-4: The Short Tender Rule

A. Rule 14e-4 Generally

1. Rule 14e-4 prohibits a person from tendering shares into a partial tender offer unless the person is "net long" both at the time of tender and at the end of the proration period of the tender offer. Under Rule 14e-4(a)(1) a person's "net long position" is the excess, if any, of its "long position" over its "short position."

2. In adopting Rule 14e-4 (which at the time was Rule 10b-4; it was designated as Rule 14e-4 in 1990), Congress indicated that its intention was for each shareholder to receive equal treatment based upon the shareholder's interest in the securities that are the subject of a tender offer. By short tendering or hedging their tender, market professionals reduce their proration risk while increasing the proration risk of all those who cannot short or engage in hedged tendering, because the short or hedged tendering often leads to over tendering (i.e., the same shares being tendered more than once). The SEC has observed that short and hedged tendering often requires access to borrowed shares, which market professionals have a clear advantage in obtaining access to.[7]

B. Things to Note When Calculating a Person's Long and Short Positions

1. Rule 14e-4(a)(1)(i) defines a person's long position to include the amount of subject securities that such person:

(a) Or his agent has title to or would have title to but for having lent such securities; or

[7] *See* Release No. 34-26609 (March 8, 1989).

(b) Has purchased, or has entered into an unconditional contract, binding on both parties thereto, to purchase but has not yet received; or

(c) Has exercised a *standardized* call option for; or

(d) Has converted, exchanged, or exercised an equivalent security for; or

(e) Is entitled to receive upon conversion, exchange or exercise of an equivalent security.

2. Rule 14e-4(a)(1)(ii) defines a person's short position to include the amount of subject securities that such person:

(a) Has sold, or has entered into an unconditional contract, binding on both parties thereto, to sell; or

(b) Has borrowed; or

(c) Has written a *non-standardized call option*, or granted any other right pursuant to which his shares may be tendered by another person; or

(d) Is obligated to deliver upon exercise of a *standardized* call option *sold on or after the date that a tender offer is first publicly announced* or otherwise made known by the bidder to holders of the security to be acquired, *if* the exercise price of such option is lower than the highest tender offer price or stated amount of the consideration offered for the subject security. For the purpose of this paragraph, if one or more tender offers for the same security are ongoing on such date, the announcement date shall be that of the first announced offer.

IV. Derivatives Update

A. Margin Requirements for Non-Cleared Swaps

1. A final rule was adopted by a group of banking regulators (the "prudential regulators") on Oct. 22, 2015 establishing minimum margin requirements for non-cleared swaps and non-cleared security-based swaps.[8] The rule generally requires dealers to collect and post initial margin with a limited set of counterparties and collect and post variation margin with all others (subject to limited exceptions). The CFTC is expected to issue its own rule for margining non-cleared swaps in the near future.

2. The final rule imposes requirements depending on: (i) whether the relevant entity is a "Financial End User," and (ii) whether such entity has a "Material Swaps Exposure."

(a) The term Financial End User is broadly defined to cover various forms of investment funds, including: (i) a private fund as defined in section 202(a) of the Investment Advisers Act of 1940; (ii) an entity that is deemed not to be an investment company under Section 3 of the Investment Company Act of 1940 pursuant to Rule 3a-7; and (iii) a commodity pool, commodity pool operator or commodity trading advisor.

[8] *See* Final Rule to Establish Margin and Capital Requirements for Covered Swap Entities (unofficial text) (the "Final Rule"). The Final Rule was jointly adopted by the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Farm Credit Administration and the Federal Housing Finance Agency. For ease of reference, the term "swaps" as used herein will refer to both "swaps" and "security-based swaps" unless the context requires otherwise.

(b) An entity has Material Swaps Exposure if it and its affiliates have an average daily aggregate notional amount of non-cleared swaps with all counterparties for business days in June, July and August of the previous calendar year that exceeds $8 billion.[9] Managers likely will be required to represent to dealers whether any fund has a Material Swaps Exposure.

3. Margin Requirements

(a) Initial Margin: Dealers must both collect and post initial margin for swaps entered into with Financial End Users that have a Material Swaps Exposure. Dealers are permitted to apply a threshold of up to $50 million, an exposure below which will not require the exchange of initial margin. Dealers do not have any obligation to collect or post initial margin with non-Financial End Users or Financial End Users without a Material Swaps Exposure. Initial margin may be calculated either by a dealer's pre-approved proprietary model or by using a standardized margin schedule set forth in the final rule. Initial margin collected in excess of the $50-million threshold must be segregated with a third-party custodian.

(b) Variation Margin: Dealers are generally required to collect and post variation margin for all swaps entered into with a Financial End User regardless of material swaps exposure (and without any permissible threshold amount).

(c) Eligible margin types include immediately available cash funds denominated in any major currency or certain types of non-cash collateral subject to a fixed haircut based on asset class.

(d) Parties to an eligible master netting agreement ("EMNA") are generally permitted to calculate initial margin and variation margin on an aggregate net basis across all non-cleared swaps. Parties to an EMNA can elect to maintain a separate set of legacy swaps executed prior to the applicable compliance date that will not be subject to the margin rules.

4. Compliance Dates

The initial margin rule will be phased in between Sept. 1, 2016 and Sept. 1, 2020 depending on the swap activity levels of the two counterparties. Variation margin requirements begin Sept. 1, 2016 for entities with high average daily notional exposure, and March 1, 2016 for all other counterparties.

B. CFTC Aggregation Rules – 2015 Update

1. In September 2015 the CFTC issued proposed modifications to its 2013 proposed rules on position limit aggregation in Part 150 of the CFTC Regulations (The "2015 Proposal" and "2013 Proposal" respectively).[10] Both proposals generally require a person or owner (an "owner") to aggregate its own positions with any account or entity that is not a pooled investment vehicle in which such person has a 10-percent or greater ownership or equity interest (an "owned entity").[11] The proposed

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[9] The term "affiliate" is defined to mean entities that are consolidated on the same financial statements prepared in accordance with GAAP (or similar foreign standards) and is unlikely to include two funds separately managed by the same investment manager. Where the assets of an investment fund are consolidated with the assets of its investment manager, such as during seeding, the entities would be considered affiliated for purposes of the final rule.

[10] CFTC Supplemental Notice of Proposed Rulemaking: Aggregation of Positions, 80 Fed. Reg. 58365 (Sept. 29, 2015); CFTC Notice of Proposed Rulemaking: Aggregation of Positions, 78 Fed. Reg. 68946 (Nov. 15, 2013).

[11] Certain aspects of these aggregation rules and their exemptions are already currently applicable.

position limit rules apply to many futures and options contracts as well as economically equivalent swaps.[12]

2. The 2013 Proposal permitted the disaggregation of positions held by owned entities in the following scenarios:

   (a) An owner that meets certain requirements and who owns between 10 percent and 50 percent of an owned entity may disaggregate positions by filing a notice with the CFTC.

   (b) An owner meeting the same requirements and who owns greater than 50 percent of an owned entity may disaggregate positions only with prior approval from the CFTC.

3. The 2015 Proposal removed the distinction between scenarios described in 2(a) and 2(b) above so that, subject to the below requirements, any owner who owns greater than 10 percent of an owned entity may disaggregate positions by filing a notice with the CFTC. The requirements are as follows:

   (a) No knowledge of the trading decisions of the other.

   (b) The entities trade pursuant to separately developed and independent trading systems.

   (c) The entities have and enforce written procedures to preclude each from having knowledge of, gaining access to, or receiving data about trades of the other.

   (d) The entities do not share employees who control the trading decisions of either.

   (e) The entities do not have risk management systems that permit the sharing of trades or trading strategies.

4. The 2015 Proposal did not modify the 2013 Proposal's requirement that two entities with substantially identical trading strategies must aggregate regardless of whether an exemption would apply.

V. Spoofing

A. What Is Spoofing?

"Spoofing" is defined as "bidding or offering with the intent to cancel the bid or offer before execution."

B. Spoofing Is Unlawful.

1. Spoofing is prohibited by several statutes and regulations, primarily by the anti-spoofing provision of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 747 of the Act added to Section 6c(a) of the Commodity Exchange Act that: "It shall be unlawful for any person to engage in any trading, practice or conduct on or subject to the rules of a registered entity that … is, is of the character of, or is commonly known to the trade as, 'spoofing' (bidding or offering with the intent to cancel the bid or offer before execution)."

2. The Chicago Mercantile Exchange ("CME") also prohibits spoofing under Rule 575, Disruptive Practices Prohibited:

[12] For pooled investment vehicles, aggregation is generally for investors who have a 25-percent or greater ownership in a vehicle where its manager relies on the CFTC Rule 4.13(a)(3) exemption from registration as a commodity pool operator.

(a) "No person shall enter or cause to be entered an order with the intent, at the time of order entry, to cancel the order before execution or to modify the order to avoid execution;

(b) No person shall enter or cause to be entered an actionable or non-actionable message or messages with intent to mislead other market participants."

C. Both the SEC and DOJ have shown a new interest in pursuing spoofing cases, evidenced by the first-ever criminal conviction for spoofing, and various other civil and criminal cases and settlements involving spoofing.

1. *United States v. Coscia*, No. 14-cr-00551 (N.D. Ill. Nov. 3, 2015) represented the first-ever criminal charge and conviction for spoofing. Michael Coscia, a high-frequency trader, was convicted for manipulating commodity future contract markets that were part of CME Group Inc. (including the CME, the Chicago Board of Trade, the New York Mercantile Exchange, and Commodity Exchange Inc.). Coscia traded on various CME Group Markets and ICE Futures Europe, a futures exchange based in London. Coscia would enter large-volume orders and immediately cancel them before they could be executed. The large non-bona fide orders would create a false impression and cause the market to act in a way that allowed Coscia to profit off of bona fide trades in the opposite direction. Coscia also utilized computer programs to implement this scheme, which automatically canceled certain orders and also looked for favorable market conditions such as price stability, low volume at the best price, and narrow bid-ask spreads. Coscia's spoofing also took another form. He would place a series of buy and sell orders in which he would purchase futures contracts in the Euro FX market at a deflated price and immediately sell them for a profit. For example, Coscia would place a small buy order at a price below market price, then place multiple large sell orders to drive the price down and cause his buy order to be executed, and then would immediately close his open sell orders. Coscia would follow that by doing the same thing in the opposite direction, placing one small sell order at above market price and then several large buy orders to drive the price up. After the sell order was executed, Coscia would cancel the buy orders. Coscia could accomplish this whole series of transactions in less than one second. Coscia was convicted on six counts of market manipulation and six counts of spoofing. Sentencing is scheduled for 2016. Coscia also settled a case with the CFTC by agreeing to pay $2.8 million and serve a one-year trading ban without admitting or denying any of the charges.

2. *In the Matter of Behruz Afshar et al.*, Release No. 9983 (Dec. 3, 2015): On Dec. 3, 2015, the SEC charged three individuals with, among other things, perpetrating a spoofing scheme to earn liquidity rebates from the Nasdaq OMX PHLX (the "PHLX"). The respondents allegedly placed bona fide large all-or-none orders (orders that were undisplayed and must be executed in their entirety or not at all) in order to collect a rebate the PHLX offered for orders that created liquidity (as part of its "maker-taker" fee model). The respondents would then spoof the market into executing the large all-or-none orders by placing smaller non-bona fide orders in the same option and at the same price, but on the opposite side. These smaller non-bona fide orders would alter the option's best bid or offer to "spoof" the market into submitting orders at the new best bid or offer to execute the all-or-none order. The respondents then would cancel any open orders. Allegedly, the respondents collected over $225,000 through this spoofing scheme.

3. *United States v. Milrud*, No. 2:15-cr-00455 (Sept. 10, 2015); *SEC v. Milrud*, No. 15-CV-00237 (D.N.J. Jan. 13, 2015): Aleksandr Milrud has simultaneous criminal and civil cases being pursued against him for securities fraud, specifically spoofing. Milrud allegedly orchestrated a spoofing scheme that involved recruiting overseas-based traders, whom he would instruct to place corresponding bona fide and non-bona fide trades in order to earn an illegal profit. Specifically, the traders would place numerous orders in one direction for a certain stock, progressively lowering or increasing the price

in small increments (usually a penny) to increase or decrease the stock price. Milrud took certain steps in an attempt to conceal the spoofing scheme, including giving each trader two accounts (one for bona fide trades and one for non-bona fide trades) and keeping profits intentionally low on each stock. The civil case is currently stayed, but in the criminal case Milrud recently agreed to plead guilty to one count of conspiracy to commit securities fraud in violation of 18 U.S.C. § 371.

4. *United States v. Sarao*, No. 15-cr-00075 (N.D. Ill. April 21, 2015): In a spoofing case related to the "Flash Crash" on May 6, 2010, Navinder Singh Sarao was charged with wire fraud, commodities fraud, commodities manipulation and spoofing. Sarao allegedly would place multiple non-bona fide large volume orders at different price points on the CME for the E-Mini S&P 500, a futures contract based on the S&P 500. The orders would fraudulently cause the market to react by selling E-Mini, causing the price to fall. Sarao used automated trading functions and programs to minimize the risk of actually executing his non-bona fide orders by ensuring that his offers were never the best offer available. The SEC described Sarao's strategy as a "dynamic layering technique" whereby he would almost constantly modify his non-bona fide offers to stay slightly below the market or best price. As Sarao caused the market to move downward, he would repeatedly sell futures contracts and then buy them back at a lower price. As the price moved back upward, Sarao would do the opposite and repeatedly buy futures contracts and then sell them at a higher price. In addition to his primary fraudulent scheme, Sarao would also flash large non-bona fide orders and then place smaller bona fide orders in the opposite direction.

5. *In the Matter of Briargate Trading, LLC and Eric Oscher*, Release No. 9959 (Oct. 8, 2015): A trading firm and one of its principals were charged with utilizing spoofing to manipulate the market. Specifically, the respondents allegedly placed non-bona fide orders on the NYSE, placed bona fide orders in the opposite direction away from the NYSE, and then cancelled the non-bona fide orders all before the market opened. These pre-opening orders would be disseminated through Order Imbalance Messages before the market opened, causing the opening price of a stock to change and allowing the respondents to earn profits on the bona fide orders. The respondents were charged with violating Section 17(a) of the Securities Act and Sections 9(a)(2) and 10(b) of the Exchange Act, and Rule 10b-5 thereunder. Briargate ultimately settled the case, agreeing to pay a civil money penalty of $350,000. Oscher also settled and agreed to pay a $150,000 civil money penalty. The respondents jointly agreed to pay disgorgement of $525,000 and prejudgment interest of $37,842.32. There were no bars or trading suspensions, and the respondents did not admit or deny any of the SEC's findings, except Oscher admitted the findings as true for the sole purpose of Section 523 of the Bankruptcy Code.

VI. Enforcement: Shareholder Activism

A. The SEC has been showing increased attention and interest in shareholder activism. For example, both Chair White and Commissioner Gallagher have recently spoken about activism, its benefits and harms, and the role of the SEC in addressing activism.[13]

B. The SEC has not publicized any activist-focused enforcement decisions, but that does not mean the SEC is not investigating certain activist behavior. In fact, media reports indicate that SEC is investigating certain activist behavior.

C. Although there are various enforcement risks that activists in particular face, acting as a group is one of, if not the, most noteworthy and most of interest to the SEC.

[13] *See* Daniel M. Gallagher, SEC Commissioner, Activism, Short-Termism, and the SEC: Remarks at the 21st Annual Stanford Directors College (June 23, 2015); Mary Jo White, SEC Chair, A Few Observations on Shareholders in 2015 (March 19, 2015) (discussing in part the current activism landscape).

1. Commissioner Gallagher, while discussing the SEC's role with activist hedge funds, recently stated: "The most obvious issue presented to the Commission is the Section 13 reporting obligations that we administer."[14]

2. Section 13(d) deems two or more persons to qualify as a single person for the purposes of reporting under Section 13(d) when they act "as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer."

3. The U.S. Court of Appeals for the Second Circuit has held that "the touchstone of a group within the meaning of section 13(d) is that the members combined in furtherance of a common objective."[15]

4. A recent *Wall Street Journal* article reported that the SEC is conducting multiple investigations into whether some activist investors acted as a group without adequately reporting under Section 13(d).[16] Specifically, the article stated that the SEC had sent a letter to an activist fund inquiring as to whether the fund had any "agreements or understandings" with another fund that was orchestrating its own proxy contest against the same target company.

VII. New Enforcement Initiatives in the Futures and Options World

A. Recent history demonstrates a new willingness on the part of the futures and options exchanges to assert enforcement actions against market participants.

B. This trend is most notable when reviewing recent actions by the CME Group market regulation division.

   1. In recent years, the CME has made a number of enforcement hires in its New York and Chicago offices. Many of these new hires are former criminal prosecutors and defense lawyers who know how to try cases and take them through a trial.

   2. CME enforcement actions that involve market manipulation (including spoofing) are headline events (Attachment A).

   3. However, at the same time, CME enforcement of other rule violations, including technical violations that may not evidence scienter, has increased. Enforcement actions have focused on position limit violations, non-bona fide exchanges for related products ("EFRPs"), transitory EFRPs and improper futures for futures exchanges. For many of these matters, the interpretation of the CME rules is very technical and may be non-intuitive.

   4. Market participants can find themselves on the receiving end of an enforcement inquiry or action even if they are exempt from CFTC registration. Market-level enforcement is triggered by trading, not by any registration or other regulatory status.

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[14] Daniel M. Gallagher, SEC Commissioner, Activism, Short-Termism, and the SEC: Remarks at the 21st Annual Stanford Directors College (June 23, 2015).

[15] *Roth v. Jennings*, 489 F.3d 499, 508 (2d Cir. 2007 (quoting *Wellman v. Dickinson*, 682 F.2d 355, 363 (2d Cir. 1982)).

[16] Liz Hoffman, Aruna Viswanatha and David Benoit, "SEC Probes Activist Funds over Whether They Secretly Acted in Concert," *The Wall Street Journal* (June 14, 2015).

VIII. New Developments in the Market Abuse Regime in Europe

A. Market Abuse Regulation: The Market Abuse Regulation (part of the MAD II legislative package) ("MAR") will enter into force in EU member states on July 3, 2016. The key changes introduced by MAR include:

1. Broadening the scope of financial instruments covered by the market abuse regime to include any financial instruments admitted to trading on a multilateral trading facility or organized trading facility (i.e., a new type of trading venue to be introduced by MIFID II) and any instruments the price or value of which depends, or has an effect, on any such financial instrument (e.g., CDS);

2. Inclusion of emission allowances and related auctioned products within the scope of MAR;

3. Inclusion of spot commodity contracts within the scope of the prohibition against market manipulation where the behavior is likely to have an effect on the price of commodity derivatives within the scope of MAR;

4. The widening of the existing market manipulation offence and the creation of a new offence of "attempted market manipulation";

5. A new regime for reporting suspicious transactions and orders;

6. A new framework for disclosures of inside information in the course of taking market soundings; and

7. A new whistleblowing (to the regulator) and administrative sanctions regime.

B. There has been increased scrutiny of insider dealing and market manipulation by the FCA in the United Kingdom. Recent FCA enforcement actions have focused on insider dealing, improper disclosure of inside information, market manipulation and failure to report a suspicion of market abuse.

IX. ERISA Provisions in Trading Documents

A. ERISA issues often arise, even for non-plan asset funds, in the various trading documents into which a hedge fund enters, such as the Prime Brokerage Agreement, ISDAs, Master Repo Agreements, Master Securities Loan Agreements, FX Prime Brokerage Agreements, Master Futures Agreements, etc., because these documents will almost assuredly contain ERISA representations.

B. The base line starting point is typically a no-plan-asset and no-prohibited-transaction representation and warranty given by the hedge fund and its investment manager. This language is likely to be set forth in the trading documents even if the hedge fund is intended to be a plan asset fund, unless the investment manager's personnel impress on the counterparty that the hedge fund will be a plan asset fund.

C. In a non-plan asset fund, the trading documents will typically contain representations that the assets of the fund are not plan assets, that entering into the agreement does not give rise to a prohibited transaction under ERISA and that the effecting of individual transactions under the agreement does not give rise to a prohibited transaction under ERISA.

D. These representations are legitimate requests, but the key is to attempt to negotiate the agreement in such a way that a violation of the representation should not give rise to a default or an additional termination event unless there is, in fact, a prohibited transaction.

E. In reality, even if the investment manager is not a "qualified professional asset manager" as defined under the Department of Labor's QPAM Exemption and the fund slips into plan asset status by accident, neither entering into the master agreement, nor into any individual transactions thereunder, will give rise to a prohibited transaction because Section 408(b)(17) of ERISA (the so-called "service provider exemption") should exempt these activities as long as the pricing of the transaction is "right." The service provider exemption is available regardless of whether the hedge fund intends to be a plan asset vehicle and even if the hedge fund's governing documents affirmatively stated that the hedge fund will not be a plan asset vehicle.

F. The pricing should always be "right" because the individuals negotiating the documents and causing the individual transactions on behalf of the hedge fund are investment professionals with a strong grasp of the market pricing. Thus, it should be difficult for anyone to argue that the counterparty "pulled the wool" over the investment manager's eyes in connection with any particular transaction, rendering the service provider exemption unavailable.

G. Note the one exception to the availability of the service provider exemption. It is not available if the counterparty caused one of the plans to invest in the particular hedge fund.

H. For a plan asset fund, the counterparty will typically require the hedge fund and the investment manager to represent that the investment manager is a "qualified professional asset manager" within the meaning of the DOL's QPAM Exemption.

I. Normally this should not be an issue, as the investors will also require that the investment manager be a QPAM.

J. Although it may be possible to conduct all of the hedge fund's transactions using the service provider exemption, it is much more difficult negotiating for such a provision with various of the counterparties. Even if this goal is attainable, the counterparties will pick and choose the transactions for which they will agree to use the service provider exemption. Further, because of a DOL Advisory Opinion, the service provider exemption will typically not be available in connection with cleared swaps. No such limitations should be expected when the investment manager is a QPAM.

K. Some counterparties will negotiate the ERISA provisions so that the investment manager can either be a QPAM or rely on the service provider exemption. This is particularly important if a plan asset fund intends to enter into repos, as the DOL has declared that the QPAM Exemption is not available for repo transactions and the QPAM Exemption by its terms does not apply to securities-lending transactions.

Attachment A: Selected CME Enforcement Settlements with Buy-Side Market Participants (October 2013 Through October 2015)

Date	Violator	Alleged Facts of Settlement	Remedies
10/2/15	BBL Commodities LP	Violated Rule 562 by holding a futures equivalent position in excess of the standard expiration month limit by 1,553 contracts (38.83%)	Fine of \$25,000; disgorgement of \$195,384.40
8/21/15	Blenheim Capital Mgmt. LLC	Violated Rule 538.H with insufficient documentation of two EFRPs	Fine of \$10,000
7/24/15	Pac. Inv. Mgmt. Co.	Violated Rule 562 by holding end-of-day net short positions in excess of the single-month position limit by 44 contracts (0.676%) and in excess of the all-months position limit by 375 contracts (5.769%); and by holding end-of-day net short positions in excess of the single-month position limit by 107 contracts (1.646%) and the all-months position limit by 1,090 contracts (16.769%)	Fine of \$35,000
6/1/15	Hayman Capital Mgmt. LP	Violated Rule 562 by holding a long position in excess of the standard expiration month limit by 300 contracts (43.33%)	Fine of \$25,000; disgorgement of profits of \$709,270
4/17/15	SummerHaven Inv. Mgmt. LLC	Violated Rule 538.H with insufficient documentation of one EFRP	Fine of \$7,500
4/17/15	Daniel Shak (SHK Asset Mgmt.)	Violated NYMEX Legacy Rule 443 by exceeding accountability limits for three days	Fine of \$25,000
3/23/15	Citadel Sec. LLC	Violated CME Rule 432.Q when, because of a software malfunction, it entered a series of unintentional orders on the Globex platform, which caused an atypical short-term increase in trading volume and affected prices	Fine of \$70,000
12/19/14	Rahul Seksaria (PIMCO)	Violated Rules 432.G, 432.Q, 539.A by orchestrating trades in futures contracts opposite one of his employer's client suspense accounts	Fine of \$65,000; restitution of \$2,675; suspension from all CME platforms for three months
10/27/14	Sun Life Fin. Inc.	Violated Rules 432.W, 534 by executing two trades totaling 989 contracts on both sides of the transactions; firm also failed diligently to supervise its employees	Fine of \$50,000
9/25/14	Weidong Ge (Shanghai Chaos)	Violated Rules 534, 432.W by directing traders on two occasions to execute wash trades and by failing diligently to supervise them	Fine of \$35,000 Fine of \$15,000
8/15/14	Vermillion Asset Mgmt. LLC	Violated Rule 538.H with insufficient documentation of EFRPs	Fine of \$20,000
7/3/14	EMF Fin. Prods. LLC	Violated Rule 538 by inaccurately reporting transactions as EFRPs and by failing to ensure proper documentation for EFRPs	Fine of \$12,500 Fine of \$12,500
6/16/14	RCG Holdings LLC	Violated Rule 562 by holding a position in excess of the standard expiration month limit by 81 contracts (8.1%)	Fine of \$15,000; disgorgement of \$5,482.68

Date	Violator	Alleged Facts of Settlement	Remedies
5/2/14	Ontario Teachers' Pension Plan Bd.	Violated Rule 562 by holding positions in excess of the single month speculative position limit by 2.1% and 2.6%	Fine of $15,000; disgorgement of $17,899.82
5/1/14	D.E. Shaw & Co. LP	Violated Rule 562 by holding a position in excess of standard position limit by 807.5 contracts (80.75%)	Fine of $75,000
		Violated Rule 562 by simultaneously holding financial contracts and physical contracts	Fine of $25,000
2/7/14	Vermillion Asset Mgmt. LLC	Violated Rule 562 by simultaneously holding financial contracts and physical contracts	Fine of $45,000
		Violated Rule 562 by simultaneously holding financial contracts and physical contracts	Fine of $35,000
2/7/14	GMT Capital Corp.	Violated Rule 562 by holding a position in excess of the standard expiration month limit by 1,555 contracts (155.50%)	Fine of $40,000; disgorgement of $8,820
12/23/13	Iken Capital LLP	Violated Rules 432.Q and 432.W by failing adequately to monitor its auto-spreader	Fine of $90,000
10/24/13	Karya Capital Mgmt. LP	Violated Rule 562 by holding an aggregate intraday long position in excess of the all contract months combined speculative position limit by 261 contracts (5%); then by 64 contracts (1%); then by 264 contracts (5%)	Fine of $10,000, and disgorgement of $166,325, in connection with first violation; fined $30,000 in connection with latter two violations
9/30/13	Cypress Energy Capital Mgmt. LP	Violated Rule 562 by holding a short position in excess of the expiration month limit by 77 contracts (7.7%)	Fine of $15,000; disgorgement of $5,900
9/24/13	AQR Capital Mgmt. LLC	Violated Rule 562 by holding a position in excess of the single month speculative position limit by 323 contracts (2%); firm had violated position limit rules twice before within seven-month period	Fine of $70,000; disgorgement of $925

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