Schulte Roth & Zabel

24TH ANNUAL

PRIVATE INVESTMENT FUNDS SEMINAR

JANUARY 21, 2015

GC and CCO Risks and Safeguards: Ethics in Practice

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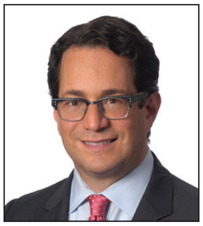


Partner
New York Office
+1 212.756.2553
marc.elovitz@srz.com

Practices

Regulatory & Compliance
Hedge Funds
Investment Management
Litigation

Marc E. Elovitz

Marc is the chair of SRZ's Investment Management Regulatory & Compliance Group. He advises private fund managers on compliance with the Investment Advisers Act of 1940 and other federal, state and self-regulatory organization requirements, including establishing compliance programs, registering with the SEC and CFTC, and on handling SEC and NFA examinations. Marc provides guidance to clients on securities trading matters and represents them in regulatory investigations and enforcement actions, arbitrations and civil litigation. He also regularly leads training sessions for portfolio managers, analysts and traders on complying with insider trading and market manipulation laws, and has developed and led compliance training sessions for marketing and investor relations professionals. Marc works closely with clients undergoing SEC examinations and responding to deficiency letters and enforcement referrals. He develops new compliance testing programs in areas such as trade allocations and conflicts of interest. He also leads macro-level compliance infrastructure reviews with fund managers, identifying the material risks specific to each particular firm and evaluating the compliance programs in place to address those risks.

The Legal 500 United States, *Who's Who Legal: The International Who's Who of Private Funds Lawyers* and *New York Super Lawyers* have recognized Marc as a leading lawyer in his field. He is a member of the Steering Committee of the Managed Funds Association's Outside Counsel Forum, the American Bar Association's Hedge Funds Subcommittee and the Private Investment Funds Committee of the New York City Bar Association. A prolific writer in his areas of expertise, Marc recently co-authored "JOBS Act Update: CFTC Relief Removes Impediment to General Solicitation" for *The Hedge Fund Journal*. He is also a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), the "Protecting Firms Through Policies and Procedures, Training, and Testing" chapter in the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute, 2011-2015) and the "Market Manipulation" chapter in the leading treatise, *Federal Securities Exchange Act of 1934* (Matthew Bender). He also wrote the chapter on "The Legal Basis of Investment Management in the U.S." for *The Law of Investment Management* (Oxford University Press). Marc is also frequently invited to discuss current industry-related topics of interest at leading professional and trade association events. He most recently presented "Staying Ahead of the Curve(ball): How to Respond as Authorities Shift Focus from Creating New Regulations to Enforcing Them," at the Houlihan Lokey 2014 Alternative Asset Valuation Symposium, and "SEC Inspections and Examinations of Hedge and Private Equity Funds," at the PLI Hedge Fund and Private Equity Enforcement and Regulatory Developments 2014 conference.

Marc received his J.D. from New York University School of Law and received his B.A., with honors, from Wesleyan University.

Partner
New York Office
+1 212.756.2044
bill.gussman@srz.com

Practices

Litigation

Bankruptcy & Creditors' Rights Litigation

Complex Commercial Litigation

Insurance

Real Estate Litigation

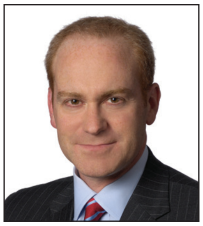
Securities Litigation

William H. Gussman, Jr.

Bill represents financial institutions and officers and directors in complex commercial litigation, including securities fraud actions, fraudulent transfer actions, mergers and acquisitions litigation, private post-acquisition disputes and derivative actions. His clients have included leading hedge funds, private equity firms, major corporations, investment banks, prime brokers, lenders and individuals. Bill has substantial trial experience, having tried cases in federal and state courts throughout the United States and in a variety of alternative dispute resolution venues, including AAA, FINRA and JAMS arbitrations. He frequently litigates in bankruptcy court, often representing creditors in enterprise valuation and asset ownership disputes, and he has broad experience representing both buyers and sellers in deal-related disputes, including in shareholder class actions. He has also assisted clients in connection with SEC investigations. Bill's jury trial experience includes the successful defense of a leading prime broker in a $141.4-million fraudulent transfer action brought by the trustee of a defunct hedge fund. In that two-week federal trial, he helped to secure a unanimous verdict in favor of the prime broker. He is currently representing a former officer and director of Merck & Co. in connection with proceedings relating to the painkiller Vioxx. That high-profile matter has included the defense of federal and state securities law claims, breach of duty claims, product liability claims and other matters.

Recognized as a leading litigator by *The Legal 500 United States*, Bill is a frequent speaker and writer on a wide range of topics. He recently co-authored "Beyond *Halliburton*: Securities Fraud Class-Action Appeals to Watch" for *Westlaw Journal — Securities Litigation & Regulation*, and he contributed "Obtaining Information from Corporate Insiders" to the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute). His speaking engagements include addressing the FEA's Private Equity Litigation and Liability Avoidance: Practical Advice Regarding "Alter Ego" Liability and Post-Acquisition Disputes conference and presenting "Recent Court Decisions Affecting Distressed Investors" at the SRZ 3rd Annual Distressed Investing Conference.

Bill received his J.D. from Harvard Law School and his B.A., *summa cum laude*, from Dartmouth College, where he was Phi Beta Kappa.



Partner
New York Office
+1 212.756.2227
david.nissenbaum@srz.com

Practices

Investment Management

Energy

Financial Institutions

Hedge Funds

Private Equity

David Nissenbaum

David's practice focuses on corporate, bank regulation and securities matters and he primarily represents institutional and entrepreneurial investment managers, financial services firms and private investment funds in all aspects of their business. David structures and advises investment management and financial services firms as well as hedge, private equity, credit, distressed investing and hybrid funds, funds of funds and scalable platforms for fund sponsors. He also advises on management company partnerships, succession planning, seed capital deals, mergers and acquisitions of investment firms and on all aspects of U.S. banking laws that affect investment and financial services firms and investment funds, including investments in banking organizations, bank-sponsored funds and investments in funds by banking organizations.

David has been recognized by *Chambers Global*, *Chambers USA*, *Expert Guide to the World's Leading Investment Funds Lawyers*, *The International Who's Who of Private Funds Lawyers*, *The Legal 500 United States* and *PLC Cross-border Private Equity Handbook*. A member of the advisory board of The Financial Executives Alliance and past member of the Banking Law Committee of the New York City Bar Association, David is a sought-after writer and speaker in his areas of expertise. "Just Like Starting Over: A Blueprint for the New Wall Street Firm," published by *The Deal*, "Hedge Fund Manager Succession Planning" and "Federal Reserve Provides Greater Flexibility for Non-Controlling Investment in Banks and Bank Holding Companies" are among his publications, and he also co-authored the chapter "Management Company Structures and Terms" in *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). David recently participated in "The Final Volcker Rule: What Private Fund Managers Not Affiliated with a Bank Need to Know," an SRZ webinar, and presented a talk on capital raising at a prior SRZ Annual Private Investment Funds Seminar.

Partner

New York Office
+1 212.756.2511

Washington DC Office
+1 202.729.7479

lisa.prager@srz.com

Practices

Litigation

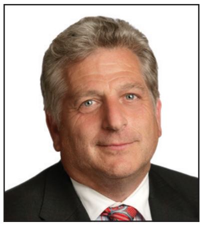
Securities Enforcement & White Collar Defense

Lisa A. Prager

Lisa represents corporations and individuals in a wide variety of federal criminal and regulatory matters. She focuses on government investigations and enforcement actions relating to the Foreign Corrupt Practices Act (FCPA), U.S. export controls and economic sanctions laws, anti-money laundering laws, the Dodd-Frank Act's whistleblower provisions and government contracts matters. She represents clients before multiple U.S. enforcement agencies and bodies, such as the U.S. Department of Justice, Department of Commerce, Department of State, Department of the Treasury's Office of Foreign Assets Control, Securities and Exchange Commission, and other authorities. Lisa conducts extensive internal investigations on behalf of multinational corporations and has represented them and their boards in FCPA and export control matters involving issues arising around the world. In connection with these investigations, she provides advice to general counsels and senior management regarding company practices, remedial measures such as compliance program enhancements and disciplinary action for company employees, and settlement options. She also works with companies in the administration of consent decrees, monitorships and other post-settlement agreements. In addition, she represents individuals in white collar criminal matters, including representing senior management in FCPA and export control investigations. Prior to entering private practice, Lisa was an Assistant U.S. Attorney for the District of Columbia and Acting Assistant Secretary and Deputy Assistant Secretary for Export Enforcement at the U.S. Department of Commerce's Bureau of Industry and Security. Her work at the Department of Commerce included managing many of the agency's largest export control settlements and indictments to date, including criminal investigations related to Chinese exports and the freight-forwarding industry. As an Assistant U.S. Attorney, Lisa handled federal cases involving terrorism, wire and mail fraud, economic espionage, and export control violations, among many other matters.

Recognized by *The Legal 500 United States* in the area of White Collar Criminal Defense, *The International Who's Who of Investigations Lawyers* and *New York Super Lawyers*, Lisa is a member of the American Bar Association, the AUSA Association and the International Bar Association. She frequently speaks on topics in the area of the FCPA and U.S. export controls. She recently participated in "FCPA, M&A and Private Equity," an SRZ webinar, and she presented "Regulatory Examinations and Enforcement" at the SRZ 23rd Annual Private Investment Funds Seminar. She is a co-author of "Sanctions Update: Sectoral Sanctions Against Russia Escalate," which was published in the *Westlaw Journal — Securities Litigation & Regulation*.

Lisa earned her J.D., *magna cum laude*, from Western New England College School of Law and her B.A. from Yale University.



Partner

Washington DC Office
+1 202.729.7461

New York Office
+1 212.756.2733

howard.schiffman@srz.com

Practices

Litigation

Complex Commercial Litigation

Regulatory & Compliance

Securities Enforcement & White Collar Defense

Securities Litigation

Howard Schiffman

Howard is co-chair of SRZ'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. Recently, he won dismissal on statute of limitations grounds in the U.S. Court of Appeals for the Second Circuit for The Royal Bank of Scotland Group, as successor to National Westminster Bank PLC, of a suit brought by investors alleging fraud in connection with loans related to a tax shelter scheme known as Bond Linked Issue Premium Structure, or BLIPS. He also 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. He also 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*, *Benchmark Litigation* and *Lawdragon* as a leading individual in the securities regulation area. He is a member of American Bar Association sections on Litigation, Corporation, Finance and Securities Law and was 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 "Insider Trading and Dealing with Reputational and Operational Risk" at the HFMWeek U.S. Operational Leaders Summit.

Howard received his J.D., *cum laude*, from Fordham University School of Law, where he was a member of the *Fordham Law Review*, and his B.A., *cum laude*, from Colgate University.

GC and CCO Risks and Safeguards: Ethics in Practice

I. Regular Operations of the Business

A. Who Is the Client?

1. Entity Theory: A Lawyer Represents *the Organization*

(a) General Rule

(i) A lawyer employed or retained by an organization *represents the organization* acting through its duly authorized constituents.[1]

A lawyer representing only an organization does not owe duties of care, diligence or confidentiality to constituents of the organization.[2]

(ii) A lawyer *shall explain* the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.[3]

(1) By representing the organization, a lawyer does not thereby also form a client-lawyer relationship with all or any individuals employed by it or who direct its operations or who have an ownership or other beneficial interest in it, such as its shareholders.[4]

(iii) Rule 4.3 of the Model Rules of Professional Conduct reinforces a lawyer's obligation to explain the identity of the client by stating that "[w]hen the lawyer knows or reasonably should know that an unrepresented person misunderstands the lawyer's role in the matter, the lawyer shall make reasonable efforts to correct the misunderstanding."[5]

(b) Corporate Form Variations

(i) Closely Held Corporation

Even where a corporation only has one shareholder, a corporation exists as an entity apart from its shareholders. Therefore, in such a case, the attorney's client is the corporation and not the shareholder(s).[6]

(ii) Representation of a [General] Partnership[7]

(1) A lawyer who represents a partnership represents the "entity" and not the individual partners that constitute the partnership.

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[1] Model Rules of Prof'l Conduct R. 1.13(a) (1983).

[2] Restatement (Third) of the Law Governing Lawyers § 96 cmt. b (2000).

[3] Model Rules of Prof'l Conduct R. 1.13(f) (1983).

[4] Restatement (Third) of the Law Governing Lawyers § 96 cmt. b (2000).

[5] Model Rules of Prof'l Conduct R. 4.3 (1983).

[6] *See Fassihi v. Sommers, Schwartz, Silver, Schwartz & Tyler, P.C.*, 107 Mich. App. 509, 514 (Mich. App. 1981).

[7] ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 91-361 (1991).

(2) As such, a lawyer undertaking to represent a partnership with respect to a particular matter does not enter into an attorney-client relationship with each member of the partnership.

(3) Therefore, information received by a lawyer during his representation of the partnership from individual members of the partnership may not be withheld from other members of the partnership.

(iii) Conflicts of Interest in the Corporate Family Context[8]

An affiliate of a lawyer's corporate client is not also a client for conflict of interest purposes unless:

(1) The two companies operate as alter egos;

(2) The two companies have integrated operations and management;

(3) The two companies have the same in-house legal counsel; *or*

(4) The representation of the client has provided the law firm with confidential information about the affiliate that is relevant in any matter adverse to the affiliate.

2. Reporting Bad Officer Conduct

(a) Cause for Reporting

If a lawyer knows that an officer, employee or other person associated with the organization is engaged in, or intends to engage in, something illegal that will hurt, or be imputed to, the organization and will likely result in substantial injury to the organization, then the lawyer *shall proceed* as is reasonably necessary *in the best interest of the organization*.[9]

(b) [Internal] Reporting "Up the Ladder"

(i) "[T]he lawyer shall refer the matter … including, if warranted by the circumstances, to the highest authority that can act on behalf of the organization as determined by applicable law."[10]

(ii) If the highest authority within the corporation fails to address the violation and the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to organization, the attorney can reveal information necessary to prevent substantial injury to the organization (even confidential information protected by the attorney-client privilege under Rule 1.6).[11]

B. Advising Principals and Employees on Personal Matters

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[8] *See* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 95-390 (1995) (Conflicts of Interest in the Corporate Family Context).

[9] Model Rules of Prof'l Conduct R. 1.13(b) (1983).

[10] *Id.*

[11] Model Rules of Prof'l Conduct R. 1.13(c) (1983).

1. General counsel should advise principals and other firm employees seeking the general counsel's advice that the general counsel is operating in his/her capacity as the firm's counsel.

2. General counsel should be mindful of any conflicts of interest arising out of the general counsel's relationships with the firm's principals and employees.

C. Responding to Investor and Counterparty Requests for Information

1. In the course of representing a client, a lawyer shall not knowingly:

(a) Make a false statement of material fact or law to a third person; or

(b) Fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, *unless* disclosure is prohibited by another Rule.[12]

2. A lawyer generally has no affirmative duty to inform an opposing party of relevant facts. A misrepresentation can occur if a lawyer incorporates or affirms a statement of another person that the lawyer knows to be false.[13]

D. Taking on a Business Role at the Firm

1. A general counsel who takes on a business function at the firm and serves in an executive capacity may be considered a "supervisor" of other employees, which may result in liability for failure to supervise such employees.[14]

2. A general counsel who takes on a business function at the firm may be subject to additional conflicts of interest.

II. When Compliance Issues Arise

A. Failing to Identify or Act on "Red Flags"

1. *Sands Bros. Asset Mgmt., LLC*, Inv. Adv. Act Rel. No. 3960 (Oct. 29, 2014) (action against hedge fund CCO who is alleged to have "substantially assisted" the manager's violations of the custody rule, where the CCO reminded colleagues of the custody rule deadlines but took no actions when they missed the deadlines, and where he was allegedly aware of prior Securities and Exchange Commission ("SEC") deficiency letters and consent orders regarding custody rule noncompliance but failed to implement policies and procedures to ensure compliance).

2. *Parallax Investments, LLC*, Sec. Exch. Act Rel. No. 70944 (Nov. 26, 2013) (investment adviser's CCO and principal charged with willfully aiding and abetting firm's violations of its principal trading disclosure obligations, failure to comply with custody rule, failure to adopt and implement written procedures, and failure to adopt and implement written code of ethics).

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[12] Model Rules of Prof'l Conduct R. 4.1 (1983).

[13] *See* Model Rules of Prof'l Conduct R. 4.1 cmt. 1 (1983).

[14] *See Theodore W. Urban*, Adm. Proc. File No. 3-13655 (Sept. 8, 2010) (initial decision); Division of Trading & Markets, U.S. Sec. & Exch. Comm'n, Frequently Asked Questions about Liability of Compliance and Legal Personnel at Broker-Dealers under Sections 15(b)(4) and 15(b)(6) of the Exchange Act, U.S. Sec. & Exch. Comm'n (Sept. 30, 2013), *available at* http://www.sec.gov/divisions/marketreg/faq-cco-supervision-093013.htm.

3. *Ronald S. Rollins*, Sec. Exch. Act Rel. No. 70058 (July 29, 2013) (CCO of registered investment adviser charged with, inter alia, failure to supervise employee who misappropriated $16,000,000 from firm's investment advisory accounts; because of CCO's inability to pay civil monetary penalty, SEC barred him from securities industry for one year; firm required to retain independent compliance consultant, censured by SEC and settled for $120,000 penalty).

4. *Equitas Capital Advisors, LLC*, Inv. Adv. Act Rel. No. 3704 (Oct. 23, 2013) (investment adviser assessed civil penalty of $100,000 and its principal fined $35,000 after the firm, its principal and its CCO violated the securities laws by, inter alia, disseminating misleading marketing materials; failing to disclose that the firm was not directly responsible for the $1,000,000,000 that, as the firm advertised, its clients had earned since the firm's inception; failing to disclose conflicts of interest in connection with increased fees associated with certain investments; and inadvertently over- and under-billing clients).

5. *Wunderlich Sec., Inc.*, Sec. Exch. Act Rel. No. 64558 (May 27, 2011) (registered broker-dealer and investment adviser settled with SEC for violations of Advisers Act after failing to satisfy the disclosure and consent requirements for principal trades; firm settled for disgorgement of $369,366.15 and civil penalty of $125,000; firm's CCO also charged with aiding and abetting those violations by failing to tailor firm's compliance policies to those of an investment adviser after it became one (in addition to its preexisting broker-dealer business); CCO settled for $50,000, a cease-and-desist order, and a censure).

B. Failing to Address Custody Rule Noncompliance

1. *Sands Bros. Asset Mgmt., LLC*, Inv. Adv. Act Rel. No. 3960 (Oct. 29, 2014) (see Section II.A.1, below).

2. *Further Lane Asset Mgmt., LLC*, Sec. Exch. Act Rel. No. 70759 (Oct. 28, 2013) (investment adviser and its principal/CCO sanctioned for, inter alia, failing "to form a reasonable belief that a qualified custodian was sending account statements to fund investors at least quarterly" and to subject the firm to annual surprise examinations; firm to retain external compliance consultant, and it is censured and assessed disgorgement of $347,122; CCO is censured, suspended for 12 months and assessed a civil penalty of $150,000).

3. *Knelman Asset Mgmt. Group, LLC*, Inv. Adv. Act Rel. No. 3705 (Oct. 28, 2013) (sanctioning investment adviser and its principal/CCO for, inter alia, failing to arrange surprise examinations of assets and failing to provide fund members with audited financial statements, despite SEC notification that firm was in custody of client assets although the firm was not a qualified custodian; firm to designate new CCO, and it is censured and assessed civil penalty of $60,000; CCO barred from acting as CCO and assessed civil penalty of $75,000).

C. Disclosures to Investors and Prospective Investors

1. *CapitalWorks Investment Partners, LLC*, Inv. Adv. Act Rel. No. 2520 (June 6, 2006) (hedge fund manager and its head of compliance charged where RFP responses and other communications with investors and prospective investors misrepresented that prior SEC examinations resulted in no violations).

2. *Aletheia Research & Mgmt., Inc.*, Sec. Exch. Act Rel. No. 64442 (May 9, 2011) (hedge fund manager, principal and CCO charged where RFP responses and other communications with investors and prospective investors misrepresented that prior SEC examinations resulted in "no significant findings").

3. *Signalpoint Asset Mgmt., LLC*, Sec. Exch. Act Rel. No. 72515 (July 2, 2014) (CCO charged where Form ADV Schedules A and B did not identify affiliated broker-dealer principals as owners of the registered investment adviser despite their actual control of the firm).

4. *Strategic Capital Group, LLC*, Inv. Adv. Act Rel. No. 3924 (Sept. 18, 2014) (settling with investment adviser that violated Advisers Act, and its CEO/CCO, who caused firm's violations by failing to implement compliance policies and procedures and by signing untrue Forms ADV; firm agreed to hire independent compliance consultant, to be censured, and to pay disgorgement of $386,290.50 and civil penalty of $200,000; CCO agreed to pay civil penalty of $50,000).

5. *Edgar R. Page*, Inv. Adv. Act Rel. 3904 (Aug. 26, 2014) (SEC proceeding against investment adviser and its principal/CCO for hiding conflicts of interest from clients by, inter alia, making material misrepresentations in its Forms ADV).

D. Dealing with Whistleblowers

1. *Paradigm Capital Mgmt., Inc.*, Sec. Exch. Act Rel. No. 72393 (June 16, 2014) (hedge fund charged with retaliating against whistleblowing employee; note that firm is criticized for taking away whistleblower's responsibilities, which raises questions about how to proceed if you believe a whistleblower is not being truthful and not acting in the firm's and investors' interests).

E. Communications with Examiners

1. *Fredrick D. Scott*, Inv. Adv. Act Rel. No. 3894 (June 3, 2014) (finalizing initial decision of *Fredrick D. Scott*, Rel. No. 592 (April 22, 2014), in which hedge fund manager who pled guilty to one count of conspiracy to commit wire fraud and one count of knowingly and willfully making materially false statement to SEC staff during examination was barred from associating with any broker, dealer, etc.).

2. *George B. Franz III*, Sec. Exch. Act Rel. No. 72058 (April 30, 2014) (investment adviser and its principal/CCO sanctioned for, inter alia: (1) lying to the SEC during its investigations of the principal's son, who, during his employment by the firm, stole over $490,000 from its clients; (2) destroying evidence of the son's thefts; (3) giving the SEC fabricated documents related to the son's thefts; and (4) lying under oath during the SEC's investigation; sanctions include: (1) barring CCO from association with any broker, dealer, etc.; (2) revoking firm's registration as investment adviser; and (3) requiring firm and CCO jointly and severally to pay disgorgement of $425,000 and civil penalties of $675,000).

F. Recidivism: Potential GC/CCO Liability Where Firms Fail to Correct Deficiencies

1. *Sands Bros. Asset Mgmt., LLC*, Inv. Adv. Act Rel. No. 3960 (Oct. 29, 2014) (see Section II.A.1, below).

2. *Transamerica Financial Advisors, Inc.*, Sec. Exch. Act Rel. No. 71850 (April 3, 2014) (a 2009 examination revealed fee calculation issues that were still problematic when the exam staff came back in 2012; firm was charged despite the fact that it had taken steps to correct the miscalculations).

3. "The [National Examination Program] conducts a limited number of Corrective Action Reviews in order to verify whether entities, including investment advisers, investment companies, and transfer agents, take the corrective actions discussed in their response to a deficiency letter."[15]

III. Internal Investigations

A. Landscape

1. It is no secret that federal law enforcement agencies, including both the Department of Justice ("DOJ") and SEC have, in the last several years, stepped up enforcement efforts.

(a) In the last year, the DOJ, working with other federal and state agencies, has conducted investigations of, and insisted on record-setting corporate penalties for, major U.S. corporations and banks. For example:

(i) In January 2014, Preet Bharara, U.S. Attorney for the Southern District of New York, announced an agreement with JPMorgan, under which the bank agreed, among other things, to pay a $1,700,000,000 penalty to the victims of the Madoff fraud.

(ii) In March 2014, Credit Suisse AG pleaded guilty to conspiracy to aid and assist U.S. taxpayers in filing false income tax returns and other documents with the Internal Revenue Service ("IRS"). The plea agreement required that Credit Suisse pay a total of $2,600,000,000 — $1,800,000,000 to the DOJ for the U.S. Treasury, $100,000,000 to the Federal Reserve, and $715,000,000 to the New York State Department of Financial Services.

(iii) In June 2014, BNP Paribas S.A. agreed to pay total financial penalties of $8,973,600,000, including forfeiture of $8,833,600,000 and a fine of $140,000,000 and enter a guilty plea to conspiring to violate the International Emergency Economic Powers Act and the Trading with the Enemy Act by processing billions of dollars of transactions through the U.S. financial system on behalf of Sudanese, Iranian and Cuban entities subject to U.S. economic sanctions.

(iv) In August 2014, U.S. Attorney General Eric Holder announced that the DOJ had reached a $16,650,000,000 settlement with Bank of America Corporation — the largest civil settlement with a single entity in American history — to resolve federal and state claims against Bank of America and its former and current subsidiaries, including Countrywide Financial Corporation and Merrill Lynch.

(b) In Mary Jo White's Message from the Chair in the SEC's 2014 Financial Report, she touted that: "The Division of Enforcement continued to mount increasingly sophisticated investigations, redoubling efforts in traditional areas, like accounting fraud, and expanding its focus on gatekeepers who must act in investors' interests."[16]

2. We can expect these aggressive enforcement activities to continue throughout 2015, with the aid of whistleblowers, and with additional focus on individuals.

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[15] *See* Office of Compliance Inspections & Examinations, U.S. Sec. & Exch. Comm'n, Examination Information for Entities Subject to Examination or Inspection by the Commission 4 (2014), *available at* http://www.sec.gov/about/offices/ocie/ocie_exambrochure.pdf.

[16] Mary Jo White, Message from the Chair, in U.S. Sec. & Exch. Comm'n, Agency Financial Report 2, 2 (2014), *available at* http://www.sec.gov/about/secpar/secafr2014.pdf.

(a) During a September speech at New York University Law School, Attorney General Holder projected charges against bank executives are on the horizon. Citing a re-emergence of "some of the very same profit-driven risk-taking that contributed to the 2008 collapse," he emphasized "the inherent value of bringing enforcement actions against individuals, as opposed to simply the companies that employ them."[17]

(b) During the same speech, Attorney General Holder noted that "since no financial fraud case is prosecutable unless we have sufficient evidence of intent — we should seek to better equip investigators to obtain this often-elusive evidence. This means, among other things, thinking creatively about ways to incentivize witness cooperation and encourage whistleblowers at financial firms to come forward."[18]

3. In connection with their enforcement priorities, federal law enforcement agencies have increasingly focused on firms' "culture of compliance," two key components of which are the extent to which business lines understand their responsibility to report potential wrongdoing up the ladder to GCs and compliance personnel like you, as well as CCOs' related responsibility to report wrongdoing to their firms' CEOs.

(a) During a keynote speech at the Compliance Week 2014 conference, SEC Enforcement Director Andrew Ceresney observed that "companies that have done well in avoiding significant regulatory issues typically have prioritized legal and compliance issues, and developed a strong culture of compliance across their business lines." Among the factors that will determine the likelihood of an enforcement action is whether "legal and compliance officers report to the CEO and have significant visibility with the board."[19]

(b) In fact, the DOJ's guidance on the FCPA specifically states that, when appraising compliance programs, the DOJ and SEC alike consider, among other things, whether compliance executives have "appropriate authority within the organization" and "adequate autonomy from management." According to the guidance, "[a]dequate autonomy generally includes direct access to an organization's governing authority, such as the board of directors and committees of the board of directors (e.g., the audit committee)."[20]

(c) In a FinCEN advisory released in August 2014, FinCEN advised firms that they can strengthen their compliance culture by ensuring that "relevant information from the various departments within the organization is shared with compliance staff to further BSA/AML efforts."[21]

4. With increased enforcement activity by federal regulators, a focus on individual liability (and, therefore, responsibility), "culture of compliance" issues and use of whistleblowers, we can expect to see more internal investigations and more pressure on you to ensure that they are done properly and to ensure that privilege is protected.

B. Protecting the Privilege in Internal Investigations

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[17] Eric Holder, Attorney General Remarks on Financial Fraud Prosecutions at NYU School of Law (Sept. 17, 2014), *available at* http://www.justice.gov/opa/speech/attorney-general-holder-remarks-financial-fraud-prosecutions-nyu-school-law.

[18] *Id.*

[19] Andrew Ceresney, Dir. of the Div. of Enforcement, Keynote Address at Compliance Week 2014 (May 20, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370541872207.

[20] Criminal Div. of the U.S. Dep't of Justice and Enforcement Div. of the U.S. Sec. & Exch. Comm'n, A Resource Guide to the U.S. Foreign Corrupt Practices Act 58 (2012), *available at* http://www.justice.gov/criminal/fraud/fcpa/guide.pdf.

[21] Financial Crimes Enforcement Network, U.S. Dep't of the Treasury, Advisory to U.S. Financial Institutions on Promoting a Culture of Compliance 1 (2014), *available at* http://www.fincen.gov/statutes_regs/guidance/pdf/FIN-2014-A007.pdf.

1. Establishing the Privilege

There are a few relatively simple things you should do at the outset of an investigation to establish the attorney-client privilege:

(a) Ensure that a lawyer — either in-house counsel or outside counsel — is directing the investigation, and document that fact.

(i) Compliance personnel should not conduct the investigation themselves if they want documents created in connection with the investigation to be privileged. They need to involve lawyers acting in a legal capacity to direct the investigation.

(1) Compliance-driven inquiries generally are not privileged, nor are investigations undertaken for business, rather than legal, purposes.

(2) The mere fact that a company is structured so that the compliance department operates under the supervision and oversight of the legal department does not necessarily render compliance department documents or communications privileged.

(3) It is likewise not enough that compliance personnel have law degrees, which is increasingly the case.

(ii) This is a critical component of establishing the privilege, as reiterated by the U.S. Court of Appeals for the District of Columbia Circuit in a June 2014 decision in *In re Kellogg Brown & Root* — also known as the KBR decision.[22]

(1) In that case, the plaintiff worked for KBR, a defense contractor, and filed a False Claims Act complaint alleging that KBR defrauded the U.S. government by inflating costs and accepting kickbacks while administering military contracts in Iraq. In the course of his litigation against KBR, the plaintiff sought documents relating to KBR's prior internal investigation regarding the alleged fraud. The district court ordered KBR to produce the documents.

(2) The D.C. Circuit reversed, and one of the primary factors motivating the court's decision was the fact that the internal investigation was overseen by the company's law department. The court wrote, for example: "As in *Upjohn*, KBR initiated an internal investigation to gather facts and ensure compliance with the law after being informed of potential misconduct. And as in *Upjohn*, KBR's investigation was conducted under the auspices of KBR's in-house legal department, acting in its legal capacity. The same considerations that led the Court in *Upjohn* to uphold the corporation's privilege claims apply here."[23]

(b) Make clear at the outset of the investigation in a written memorandum that the investigation is being conducted for the purpose of obtaining legal advice and/or in anticipation of litigation.

(i) Ideally, the purpose of the investigation should be documented in the written memorandum.

[22] *See In re Kellogg Brown & Root, Inc.*, 756 F.3d 754 (D.C. Cir. 2014).

[23] *Id.* at 757 (referring to *Upjohn Co. v. United States*, 449 U.S. 383 (1981), in which U.S. Supreme Court held the attorney-client privilege applies to corporations).

(ii) The memorandum should remind the team that: (1) the investigation is being directed by counsel and is privileged; (2) the investigation should not be discussed with anyone without counsel's permission; and (3) documents generated in connection with the investigation should be marked with a header "Privileged and Confidential; Attorney-Client Privilege; Attorney Work Product."

(1) To the extent the reports and other documents are prepared at the request of counsel by non-attorneys in connection with an investigation, the documents should bear the header "Privileged and Confidential; Attorney-Client Privilege; Work Product Prepared at the Request of Counsel in Anticipation of Litigation."

(2) To the extent documents or communications are prepared by non-attorneys for the purpose of requesting legal advice, the documents or communications should bear the header "Privileged and Confidential; Attorney-Client Privilege; Prepared for Purposes of Requesting Legal Advice."

(iii) The memorandum should also advise employees to segregate legal from business communications.

2. Conducting the Investigation

To maintain privilege during the course of the investigation, your firm should take the following additional steps:

(a) If the investigation is ongoing for some time, the memorandum previously described should be redistributed periodically as a reminder.

(b) When conducting interviews, the following steps should be taken:

(i) Limit those present at interviews or meetings to those with common legal interests and their lawyers.

(1) Anyone whose conduct is potentially at issue (including senior management or board members) should not be present (and should not be informed of substance of investigation).

(2) Avoid the use of investigators or non-lawyers in conducting interviews.

(ii) Always give clear "*Upjohn* warnings" to witnesses that:

(1) The lawyer represents the corporation (or other corporate body) and *not* the witness.

(2) The interview is being conducted so that the lawyer can provide legal advice to the client, which is the corporation. You may wish to provide a more detailed explanation of the purpose and scope of the investigation.

(3) The substance of the interview is privileged, and the employee must keep confidential the contents of the interview except from his or her own attorney.

(4) The privilege belongs to the corporation (or corporate body), which may or may not elect to waive the privilege and disclose some or all of the communications to third parties (including, possibly, the government, regulators or law enforcement).[24]

(iii) In situations where counsel, particularly outside counsel, represents multiple parties and/or the firm as well as employees, proper warnings should be given in writing, and the employee should provide a written indication that he or she has read the warnings, understands them and agrees to various conditions. Specifically, counsel should:

(1) Disclose the joint representation, e.g.:

Counsel also represents ______ and other current ________ employees with respect to the same matter. Counsel also represents and has represented ______with respect to other matters.

(2) Make clear that the representation will not cover personal acts or conduct engaged in by the employee outside the scope of employment.

(3) Disclose right and opportunity, at employee's own cost, to have his or her own personal counsel represent him or her. Recommend that employee consult with independent counsel, at a minimum, prior to agreeing to being represented by same counsel as others.

(4) Document that, at present, no conflicts of interest exist in connection with joint representation, but conflicts of interest can arise.

(5) Disclose that counsel's obligation to each represented party is to provide advice on an equal and open basis to all represented parties.

(6) Have client confirm understanding and intent that:

a. Information provided by client to counsel in the course of the counsel's representation may be used by counsel not only in connection with its representation of client, but also in connection with the counsel's representation of the other clients;

b. To the extent that counsel shall cease to represent specific client but shall continue to represent others, counsel shall be free to continue to use information obtained from client in connection with its representation of the others. In connection with that, counsel shall be permitted, but shall not be required, to disclose to the other clients, including management, information received from client that is received in the course of its representation; and

c. The attorney-client privilege that applies to and protects communications between a specific client/employee and the firm may be waived by the firm and therefore disclosed to others, including regulators, even over employee's objection.

(7) Have client agree that if any actual dispute or actual conflict should arise between or among clients, or if counsel no longer believes that it can adequately represent the interests of all clients, counsel shall have the right to withdraw at such time from

[24] *See* American Bar Ass'n and The Bureau of Nat'l Affairs, ABA/BNA Lawyers' Manual on Professional Conduct §§ 91:2201, 91:2203-4 (2014).

representing specific client, and shall have the absolute right to continue its representation of some or all of the other clients with respect to the matter or any other dispute or conflict, and client shall not take the position, by motion to disqualify or otherwise, that counsel's prior representation of him or her (or it) precludes counsel from further continued representation of some or all of the other clients.[25]

(iv) When the witness is not an employee, board member or individual with a common legal interest to the corporate client, recognize that the interview will not be privileged but may be subject to protection under the work-product doctrine.

(v) When creating memoranda of interviews or meetings, include the headers mentioned above, as well as an initial paragraph stating explicitly that the writing is not a verbatim transcription of the interview but contains the mental impressions of the lawyer preparing the document.

3. Sharing Information

(a) To maintain maximum protection for privileged information, ensure that those who receive that information share a common legal interest and understand the need to maintain the confidentiality of the communication.

(b) Where possible, limit distribution of the relevant documentation to counsel.

(i) Some courts have held that where communications are sent to both lawyers and non-lawyers, the corporation will not be able to establish that the communication was primarily for purposes of seeking legal advice.

(c) When contemplating sharing information with someone outside the zone of common interest — such as a regulator, external auditor or insurance carrier — consider:

(i) Whether disclosure of any information is really necessary, and, if it is, disclosing only the minimum amount of information required.

(ii) The possibility of delaying or deferring disclosure.

(iii) Whether an oral presentation or communication may suffice.

(iv) Whether a summary is acceptable in lieu of providing interview memos or direct communications between attorney and client, if a writing is required.

(v) Whether you can provide the writing only on a temporary basis and retrieve the document at the end of a presentation.

(vi) Whether you can obtain assurances of confidentiality and non-disclosure from the party to whom you are making the disclosure. If the party is a government entity or regulator, make

[25] *See*, *e.g.*, Ass'n of the Bar of the City of N.Y., Frequently Asked Ethics Questions, New York City Bar, http://www.nycbar.org/ethics/ethics-faq (last visited Dec. 30, 2014); N.Y. Rules of Prof'l Conduct R. 1.7 (2013), *available at* https://www.nycourts.gov/rules/jointappellate/NY-Rules-Prof-Conduct-1200.pdf; *Lieberman v. City of Rochester*, 681 F. Supp. 2d 418, 423 (W.D.N.Y. 2010) (noting that "the court is charged with ensuring that each client is fully aware of any conflict and its potential impact upon his or her interests and nonetheless desires to proceed with joint representation," and, once that assurance is provided, "the court may not interfere with or obstruct a party's knowing choice of counsel"); *Frontline Commc'ns Int'l, Inc. v. Sprint Commc'ns Co. L.P.*, 232 F. Supp. 2d 281, 288 (S.D.N.Y. 2002) ("When an attorney represents an employer and an employee jointly, the employee cannot reasonably expect the attorney to keep any information from the employer.").

sure you request exemption from disclosure under Freedom of Information laws, rules and regulations.

(d) If a document is disclosed inadvertently, take immediate steps to request its return.

4. Presenting Findings

(a) Consider whether your findings can or should be presented orally, through a PowerPoint presentation or in some other summary form before providing written findings. This is a particularly important consideration in connection with investigations of foreign companies or subsidiaries.

(b) If written materials are provided to the client, consider collecting or retrieving them after the presentation.

C. Special Considerations with Privilege

1. Use of In-House Counsel

(a) Under U.S. law, no distinction exists between a corporation's in-house counsel, acting in that capacity, and its outside counsel for purposes of establishing attorney-client privilege.

(b) However, if you believe the investigation will be particularly sensitive or your firm will likely be the subject of civil litigation as a result of alleged wrongdoing, you should consider carefully the merits of retaining outside counsel.

(i) Courts recognize that in-house counsel frequently have multiple roles at a firm and provide both legal and business advice. Because business advice is not privileged, courts can and likely will closely scrutinize communications involving in-house counsel to ensure that they are truly made for the purpose of securing legal, as opposed to business, advice.

(ii) Moreover, in the European Union, communications between firm executives and in-house lawyers are generally not protected by the attorney-client privilege.[26]

2. Recognition of Privilege Generally in Foreign Jurisdictions

(a) Foreign jurisdictions accord varying degrees of privacy protection to documents, emails and communications involving individuals within the jurisdiction, whether done at the direction of in-house or outside counsel. Consequently, when conducting an internal investigation involving entities outside of the United States, particularly where foreign regulators or litigants may have an interest in the results of your investigation, you may wish to consult with counsel familiar with the applicable privilege rules to maximize their effect.

(b) For example, Chinese law does not recognize any attorney-client privilege or the work-product doctrine.[27]

3. Crime-Fraud Exception

[26] *See, e.g.*, *Akzo Nobel Chemicals, Ltd. and Akcros Chemicals, Ltd. v. Comm'n.*, Case 550/07 P (Sept. 14, 2010).

[27] *See* Leah M. Christensen, A Comparison of the Duty of Confidentiality and the Attorney-Client Privilege in the U.S. and China: Developing a Rule of Law, 34 T. Jefferson L. Rev. 171, 180-85, 191-3 (2011); Preston M. Tobert, Other Chinese Laws, Compliance Programs & Corp. Sent. Gdlns. § 21A:18 (2012).

(a) Courts will not protect attorney-client communications if they were made in connection with future wrongdoing, as opposed to past wrongdoing. Pursuant to the "crime-fraud exception," the privilege can be overcome when, at the time of the communication: "(1) the client was committing or intending to commit a fraud or crime, and (2) the attorney-client communications were in furtherance of that alleged crime or fraud."[28]

(i) It is important to note that the focus of this inquiry is the client's intentions, not the attorney's.

(ii) Because the attorney's state of mind is irrelevant, unwitting attorney communications made in connection with even facially innocent acts may be discoverable.

(b) There have been a number of high-profile and significant decisions in this area this year.

(i) The most significant case is *In re Grand Jury Subpoena*, 745 F.3d 681 (3d Cir. 2014). In that case, which has been highly publicized, a president and managing director (the "client") of a consulting corporation hired to obtain financing from a bank for various projects consulted an attorney regarding payments that the client planned to make to an officer of the bank (the "banker") to ensure that the project proceeded quickly. The attorney shared office space with, but practiced law independently of, the corporation. After conducting some preliminary research and learning about the FCPA, the attorney asked the client whether the bank was a government entity or the banker was a government official. Ultimately, the attorney was unable to determine whether the conduct was illegal but nevertheless advised the client not to make the payments. Notwithstanding the attorney's advice, the client informed the attorney that he did not believe that the payments violated the FCPA and that he intended to make the payments. The corporation ultimately made payments totaling $3,500,000 to the banker's sister, who was not affiliated with the bank and was not apparently involved with any of the projects.

After an FBI investigation, a grand jury served the attorney with a subpoena seeking his testimony about his conversation with the client. Although the corporation and the client tried to prevent the attorney from testifying based on privilege, the district court allowed the testimony under the crime-fraud exception. The U.S. Court of Appeals for the Third Circuit affirmed. First, the Third Circuit held that there was sufficient evidence showing that the client had a pre-existing intent to make the payment based on two facts: (1) the client told the attorney that he was going to make the payment notwithstanding the attorney's advice that he should not do so; and (2) the corporation made the payment in the same month the bank approved the project financing. Second, the Third Circuit held that the advice was used by the client to fashion its conduct in furtherance of its crime. According to the Third Circuit, the "[a]ttorney's questions about whether or not the [b]ank was a governmental entity ... would have informed [the] [c]lient that the governmental connection was key to violating the FCPA" and "would lead logically to the idea of routing the payment through [b]anker's sister ... in order to avoid the reaches of the FCPA or detection of the violation."[29] In other words, the court found that the attorney's questions suggested ways that the client could make an end-run around the FCPA.

The defendant filed a petition for certiorari to the U.S. Supreme Court; that petition was denied.

[28] *In re Grand Jury*, 705 F.3d 133, 151 (3d Cir. 2012).

[29] 745 F.3d at 693.

(c) This decision suggests, among other things, that, in order to preserve privilege:

(i) Counsel need to be careful when discussing the subject matter of investigations with employees and take steps to ensure that they are not enabling obstructive conduct;

(ii) When requesting advice from counsel, employees should be careful about how they phrase their inquiries. Specifically, employees need to avoid conveying the impression that the decision is a foregone conclusion or that legal review is a formality. Employees may want to consider phrasing their requests in terms of hypotheticals; and

(iii) Counsel should be brought in to evaluate the legality of conduct at the earliest possible stage, so as to avoid the perception that the action is predetermined.

IV. Regulatory Investigations

A. Areas of Consistent SEC Interest

1. Cases over the past year highlight several areas of SEC focus. Compliance policies and procedures for these areas have been heavily scrutinized by the SEC, and failures to have sufficient compliance policies and procedures in place for these areas have resulted in fines for the compliance officer in his or her individual capacity.

2. Insider Trading

(a) *Thomas E. Meade*, Inv. Adv. Act Rel. No. 3855 (Jun. 11, 2014)

(i) Meade, the president and CCO of Private Capital Management Inc. ("PCM Inc."), knew of a unique risk for misuse of material nonpublic information by a vice president at PCM Inc. The vice president's father served on the board of at least one public company, but despite knowing this, Meade failed to design PCM Inc.'s compliance policies and procedures in light of the risk that the vice president might trade on information he received from his father. Additionally, Meade failed to collect, review and maintain reports of the vice president's personal securities transactions as required under Section 204A of the Advisers Act. Furthermore, Meade failed to put the securities of the company where the vice president's father served as a board member on a restricted or watch list of securities as required by PCM Inc.'s insider trading policy and also failed to investigate suspicious trading made by the vice president in that security. Pursuant to an offer of settlement, Meade was censured, ordered to pay a civil money penalty of $100,000, and barred from associating in a compliance capacity and supervisory capacity with any broker, dealer, investment adviser, etc.

(ii) *Meade* demonstrates that compliance personnel can be held individually liable for significant fines and can receive bars when the SEC believes they have failed to do certain aspects of their jobs properly, and that these personal penalties are imposed even if the compliance officer did not personally engage in any misconduct or personally profit from another's misconduct. This case also demonstrates that the risks compliance officers must protect against are not limited to those relating to information their firms' employees obtain in the course of business; they also include information the compliance officer has reason to know an employee might learn in his or her personal capacity, such as from a family member. In *Meade*, the CCO happened to have known that the vice president's father was on the board of a particular public company, but the case sets a precedent that could allow the SEC to argue in future cases that compliance officers must determine whether their employees have relatives who are insiders at public companies and put those companies' securities on their watch list if they do.

(b) *Judy K. Wolf*, Sec. Exch. Act Rel. No. 73350 (Oct. 15, 2014)

(i) Judy K. Wolf, a compliance officer at Wells Fargo Advisors LLC, is alleged to have altered a document turned over to the SEC as part of an insider trading investigation. Wolf was responsible for reviewing the trade under investigation and had closed the review with a label of "no findings." The SEC found other versions of the document that, coupled with the document's metadata, showed that Wolf had added a statement to a document to the effect that rumors about an acquisition had been circulating for several weeks before the acquisition was announced and before the trade was under investigation by the SEC. The SEC believes Wolf violated Section 17(a) of the Exchange Act and Section 204(a) of the Advisers Act.

(ii) Although most people do not need an SEC enforcement release to make them aware that one should not alter documents when responding to regulatory requests, *Wolf* serves as a reminder that attempts to mislead regulators usually do not succeed and can create more serious problems. The case also demonstrates the importance of contemporaneously and comprehensively documenting the reasons for, and factors considered in, resolving internal reviews of potentially suspicious trading or other types of potential misconduct. Had Wolf conducted a thorough review at the time of the trading, including noting the pre-announcement rumors and attaching copies of relevant press reports, the case never would have occurred.

(c) *United States v. Newman*, 2014 WL 6911278 (2d Cir. Dec. 10, 2014)

(i) *Newman* reverses the conviction of two portfolio managers for insider trading. The court found, first, that the government failed to provide evidence that the alleged insiders received any personal benefit sufficient to establish tipper liability, and without tipper liability no tippee liability can arise; and second, that the government failed to present evidence showing that the portfolio managers knew that they were trading on information obtained from insiders in violation of the fiduciary duties of those insiders. The Second Circuit held that tipper liability requires a personal benefit of some consequence be received in exchange for confidential information. The court furthermore held that knowledge of a breach of the fiduciary duties of an insider cannot be inferred from the disclosure of confidential information alone, even when the information in question is detailed and accurate.

(ii) While *Newman* makes it more difficult for the government to prove tippee liability, legal and compliance personnel should understand — and make sure their portfolio managers understand — that it is not a get-out-of-jail-free card. Policies and procedures designed to prevent insider trading are still needed just as they were before, and *Newman* makes clear that conscious avoidance of the source of a disclosure will not allow one to avoid liability.

3. Conflicts of Interest

(a) *Alan Gavornik*, Sec. Exch. Act Rel. No. 73678 (Nov. 24, 2014)

(i) Concord Equity Group Advisors, LLC ("Concord"), through its principals Gavornik (the firm's CCO), Mariniello (the firm's president) and Argush (the firm's CEO, CFO and CTO), entered an arrangement where an unaffiliated broker-dealer would provide execution for Concord's clients at a commission rate of $0.01 per share but would charge those clients between $0.04 and $0.06 per share. The amount charged above the $0.01 per share commission rate was then paid to Concord's affiliated broker-dealer, Tore Services LLC ("Tore") as a "referral fee." This commission-sharing arrangement was not adequately disclosed to Concord's clients, with Concord's Form ADV Part II disclosures stating that Tore "may receive referral fees," which the SEC found not to be a complete and accurate disclosure. Because the arrangement resulted in a higher commission rate for clients, the respondents also failed to seek to obtain best execution for Concord's advisory clients. The SEC noted that the failure to disclose the arrangement accurately "rested principally" with Gavornik as CCO. As a result, and pursuant to an offer of settlement, Gavornik was suspended from associating with any broker, dealer, investment adviser, etc. for 12 months and was ordered to pay a $150,000 civil money penalty. Mariniello and Argush were not suspended, but they were each ordered to pay a $150,000 civil money penalty, and all three individuals were found jointly liable for disgorgement of $1,005,000, plus interest.

(ii) *Gavornik* highlights the fact that the SEC often holds compliance personnel to a higher standard than business personnel, as here the agency suspended only Gavornik even though it was Mariniello who was the "principal architect" of the arrangement with the executing broker. The case also demonstrates that compliance personnel must ensure that their firms specifically and accurately disclose any situation wherein money paid by their clients ends up going to the adviser, or where the adviser receives remuneration from a third party with which it has an arrangement to provide services to the adviser's clients.

4. Procedures for Internal Matters

(a) *Knight Capital Americas LLC*, Sec. Exch. Act Rel. No. 70694 (Oct. 16, 2013); *George B. Franz III*, Sec. Exch. Act Rel. No. 72058 (April 30, 2014)

(i) In *Knight Capital Americas LLC*, an error in Knight Capital Americas LLC's ("Knight's") automated routing system for equity orders resulted in Knight losing over $460,000,000. Following that incident, the SEC found that Knight had violated Exchange Act Rule 15c3-5, which requires that a broker or dealer have a system of risk management controls and supervisory procedures reasonably designed to limit the risks associated with market access. Perhaps more importantly, the SEC found that Knight did not have adequate supervisory procedures concerning incident response. Pursuant to an offer of settlement Knight was censured and ordered to pay a civil money penalty of $12,000,000.

(ii) In *Franz*, George Franz was founder, owner and CCO of investment adviser Ruby Corporation. An employee of Ruby Corporation, Andrew Franz (who was also respondent George Franz's son), committed acts of fraud and theft of client funds, but even once he had been made aware of these acts, George Franz failed to implement policies and procedures to keep such actions from happening again. Furthermore, George Franz did not disclose the actions of his son and instead covered up the acts of fraud and theft. After George Franz failed to put in place policies and procedures reasonably designed to prevent the unauthorized withdrawal of advisory client funds, Andrew Franz committed additional acts of fraud and theft of client funds. As a result of these failures and his attempt to cover up the actions of his son, George Franz agreed to an Offer of Settlement, under which he was barred from associating with any broker, dealer, investment adviser, etc., and was ordered (jointly and severally with Ruby Corporation) to pay civil penalties of $650,000.

(iii) *Knight* and *Franz* emphasize the need to have policies and procedures addressing how a firm and its compliance officers should respond in the event a problem arises, whether that problem is an accidental computer error or deliberate wrongdoing by an employee. It is important to look at your own organization and think of areas where problems could occur, and to proactively put in place safeguards and policies to follow in the event that a problem does occur.

V. Civil Litigation

A. Tension Between Requirements of Zealous Advocacy and Court Rules

1. Requirement of Zealous Advocacy

(a) Each state has its own code of professional conduct.

(b) The New York Disciplinary Rules provide: "A lawyer shall not intentionally … [f]ail to seek the lawful objectives of the client through reasonably available means permitted by law and the Disciplinary Rules."[30]

(c) The zealous advocacy provision of the American Bar Association's Model Code of Professional Responsibility reads identically to that of the New York Disciplinary Rules.[31]

2. Court Rules

(a) Each state court system has its own set of rules, as does the federal court system.

(b) Federal Rule of Civil Procedure 11

(i) Every pleading, written motion or other paper must be signed by at least one attorney of record (unless the party is unrepresented). The paper must state the signer's address, email address and telephone number.[32]

(ii) What's represented to court: By presenting to the court a pleading, written motion or other paper — whether by signing, filing, submitting or later advocating it — an attorney certifies that to the best of his or her knowledge, formed after a reasonable inquiry, the paper:

(1) Is not being presented for any improper purpose, such as to harass, cause unnecessary delay or needlessly increase the cost of litigation;

(2) The legal contentions are warranted by existing law or by a non-frivolous argument for extending, modifying or reversing existing law or for establishing new law;

(3) The factual contentions have evidentiary support or, if specifically so identified, will likely have evidentiary support after a reasonable opportunity for further investigation; and

[30] New York Lawyer's Code of Prof'l Responsibility DR 7-101 (2007) ("Representing a Client Zealously").

[31] *See* Model Code of Prof'l Responsibility DR 7-101 (1980) ("Representing a Client Zealously").

[32] Fed. R. Civ. P. 11(a).

(4) The denials of factual contentions are warranted on the evidence or, if specifically so identified, are reasonably based on belief or a lack of information.[33]

(iii) "Rule 11 permits sanctions against a litigant who submits a pleading or motion that, evaluated under an objective standard of reasonableness, … [has] no chance of success and [makes] no reasonable argument to extend, modify or reverse the law as it stands."[34]

(iv) Who can be sanctioned: "If … the court determines that Rule 11(b) has been violated, the court may impose an appropriate sanction on any attorney, law firm, or party that violated the rule or is responsible for the violation."[35]

(1) The court may sanction the parties themselves.[36]

(2) A court may sanction individuals it concludes are responsible for the violation, and in-house counsel have been sanctioned.[37]

(v) A "sanction may include nonmonetary directives; an order to pay a penalty into court; or, if imposed on motion and warranted for effective deterrence, an order directing payment to the movant of part or all of the reasonable attorney's fees and other expenses directly resulting from the violation."[38]

B. Discovery Issues

1. States have their own rules about document preservation; federal courts have their own rules, and there may be differences among the circuits. The Second Circuit is one of the most authoritative.

(a) Documents must be preserved once litigation is anticipated, not merely when it's actually filed. "Once a party reasonably anticipates litigation, it must suspend its routine document retention/destruction policy and put in place a 'litigation hold' to ensure the preservation of relevant documents."[39]

(b) Documents that must be preserved include documents in a party's possession, custody or control.

(c) Hard copies as well as electronic documents must be preserved.

(d) Inside and outside counsel should participate in the process of determining what documents are relevant and in assuring their preservation.

2. Potential Sanctions for Document Spoliation

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[33] Fed. R. Civ. P. 11(b).

[34] *Smith v. Westchester Cnty. Dep't of Corr.*, 577 Fed. Appx. 17, 17 (2d Cir. 2014) (internal quotation marks omitted).

[35] Fed. R. Civ. P. 11(c)(1).

[36] *See, e.g.*, *Fraige v. American-Nat'l Watermattress Corp.*, 996 F.2d 295, 296 n.1 (Fed. Cir. 1993) (sanctioning defendant corporation under Rule 11 after corporation's president forged documents in an attempt to defeat plaintiff's motion for preliminary injunction).

[37] *See, e.g.*, *Empire State Pharmaceutical Soc. v. Empire Blue Cross*, 778 F. Supp. 1253 at 1260 (S.D.N.Y. 1991) (sanctioning, for submitting meritless contentions to the court, a corporation and its general counsel, who was also the corporation's executive director, because "the legal activity of the corporation's counsel [was] virtually indistinguishable from the business activity of the client corporation").

[38] Fed. R. Civ. P. 11(c)(4).

[39] *Zubulake v. UBS Warburg LLC*, 220 F.R.D. 212, 218 (S.D.N.Y. 2003).

(a) "Spoliation is the destruction or significant alteration of evidence, or the failure to preserve property."[40]

(b) Sanctions imposed for spoliation should accomplish three goals: (1) correcting prejudice suffered by the non-spoliating party; (2) placing the risk of an erroneous judgment on the spoliating party; (3) and deterring future spoliation. As a rule, courts impose the least harsh sanction that will provide an adequate remedy, but that does not mean the sanctions will not be harsh.[41]

(c) The range of sanctions — from least harsh to most harsh — include requiring additional discovery, cost-shifting, fines (including the payment of the non-spoliating party's attorneys' fees), special jury instructions (such as an adverse inference), preclusion and termination of sanctions, and the entry of a default judgment or dismissal.[42]

(d) A party seeking sanctions based on spoliation of evidence must establish that: "(a) the party having control over the evidence had an obligation to preserve it; (b) the records were destroyed with a 'culpable state of mind'; and (c) the destroyed evidence was relevant to the moving party's claim or defense, 'such that a reasonable trier of fact could find that it would support that claim or defense.'"[43]

(e) Although courts disagree as to the level of culpability necessary to secure certain sanctions, "in the Second Circuit even the mere negligent destruction of evidence may be sufficient to warrant sanctions."[44]

(f) In 2012, the Second Circuit held that "the better approach is to consider [the failure to adopt good preservation practices] as one factor" in the determination of whether discovery sanctions should issue.[45]

(g) Individuals in-house may be sanctioned for document spoliation.[46]

C. Liability for Misrepresentations/Omissions to Investors

1. Liability is provided for by federal statutes, as well as by state statutes and common law.

2. Basic federal liability is under Section 10(b) of the Securities and Exchange Act of 1934 and Rule 10b-5 promulgated thereunder.

(a) The elements of a private action under Rule 10b-5 are: "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or

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[40] *West v. Goodyear Tire & Rubber Co.*, 167 F.3d 776, 779 (2d Cir. 1999).

[41] *See id*.

[42] *See, e.g.*, *id.* at 780; *Coleman (Parent) Holdings Inc. v. Morgan Stanley & Co.,* 2005 WL 674885 (Fla. Cir. Ct. March 23, 2005) (sanctioning Morgan Stanley by ordering jury to presume that Morgan Stanley had helped to defraud Coleman, where Morgan Stanley technology executive had certified that the firm had produced all responsive emails even though he had previously told Morgan Stanley's lawyers that there were others).

[43] See *Sekisui America Corp. v. Hart,* 2013 WL 2951924 *3 (S.D.N.Y. 2013) (citing *Chin v. Port Auth. of N.Y. & N.J.*, 685 F.3d 135, 162 (2d Cir. 2012), *cert. denied*, 133 S. Ct. 1724, 185 L. Ed 785 (2013)).

[44] *Id.* (citing *Residential Funding Corp. v. DeGeorge Fin. Corp.,* 306 F.3d 99, 107 (2d Cir. 2002)).

[45] *Chin v. Port Auth. of N.Y. and N.J.*, 685 F.3d 135, 162 (2d Cir. 2012).

[46] *See, e.g.*, *Metropolitan Opera Ass'n, Inc. v. Local 100*, 212 F.R.D. 178 (S.D.N.Y. 2003) (sanctioning in-house counsel to a union for, inter alia, allowing the union to destroy documents responsive to its adversary's subpoenas).

omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation."[47]

(b) Besides the entity making the pronouncement, individuals involved may have liability as well.

(i) *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011)

(1) Shareholders of Janus Capital Group ("JCG") brought suit against its subsidiary Janus Capital Management ("JCM") for violation of Rule 10b-5(b).

(2) The U.S. Supreme Court held that JCM, as the investment adviser, did not "make" any of the statements in the Janus Investment Fund prospectuses, as it did not have "ultimate authority" over the statements. Therefore, it could not be held liable under Rule 10b-5(b).

(ii) *Janus* established that an individual may be liable when he or she "is the person … with ultimate authority over the statement, including its content and whether and how to communicate it."[48]

(c) In-house counsel may be liable for drafting investor documents.[49]

3. The Southern District of New York has allowed an adversary to access documents that would ordinarily be considered privileged — including notes written by outside counsel — where the fund had "voluntarily supplied" those documents to the SEC during an earlier internal investigation.[50]

D. Representation of Multiple Firms by One Outside Counsel

1. General counsel should participate in making judgments about the appropriateness of having one outside counsel represent multiple firms.

2. Different states have different rules regarding multiple representation depending on their code of professional responsibility.

3. The New York Rules of Professional Conduct provide:

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if a reasonable lawyer would conclude that either:

(1) the representation will involve the lawyer in representing differing interests; or

(2) there is a significant risk that the lawyer's professional judgment on behalf of a client will be adversely affected by the lawyer's own financial, business, property or other personal interests.[51]

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[47] *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2301 n.3 (2011).

[48] *Id.* at 2302.

[49] *Touchtone Group, LLC v. Rink*, 913 F. Supp. 2d 1063, 1079 (D. Colo. 2012) (declining to dismiss, under the *Janus* standard, a Section 10(b) claim against a general counsel who had drafted allegedly false statements).

[50] *Gruss v. Zwirn*, 2013 WL 3481350 at *1 (S.D.N.Y. July 10, 2013).

[51] N.Y. Rules of Prof'l Conduct R. 1.7(a) (2009).

(b) *Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:*

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) each affected client gives informed consent, confirmed in writing.[52]

4. Conflicts can be waived, but counsel, outside and inside, should be comfortable that outside counsel can effectively represent all involved, whether the clients are co-plaintiffs or co-defendants, or are working together as an ad hoc group (such as similarly situated creditors in bankruptcy).

5. Issues arise more frequently when multiple clients are defendants or potential joint counterclaim defendants.

6. One consideration, expressly reflected in the New York rule, is whether there are likely to be cross-claims between the parties. This would typically arise when clients are defendants, not plaintiffs.

7. Another consideration is whether some of the jointly represented parties have defenses or arguments in support of claims that are not available to the other represented parties. Assertion of such defenses or arguments in support of claims can cast the defenses or affirmative arguments of other represented parties in a less favorable light.

8. Sometimes problems may not appear, or be anticipated, at first, in which case joint representation may be appropriate, subject to separate counsel being obtained later if problems arise.

9. Joint representations should be subject to clear agreements providing for the terms of the representation and the rights of all involved should the joint representation terminate.

[52] N.Y. Rules of Prof'l Conduct R. 1.7(b) (2009).

Information Security: Obligations and Expectations

24TH ANNUAL
PRIVATE INVESTMENT FUNDS SEMINAR
JANUARY 21, 2015

Schulte Roth & Zabel

Jason S. Kaplan

Partner
New York Office
+1 212.756.2760
jason.kaplan@srz.com

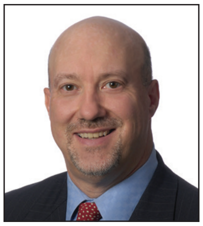
Practices

Investment Management
Hedge Funds
Private Equity
Regulatory & Compliance

Jason's practice concentrates on corporate and securities matters for investment managers and alternative investment funds. He represents institutional and entrepreneurial investment managers, financial services firms and private investment funds in all aspects of their business. Jason's practice focuses on advising managers of hedge, private equity and hybrid funds regarding the structure of their businesses and on day-to-day operational, securities, corporate and compliance issues; structuring and negotiating seed and strategic investments and relationships and joint ventures; and advising investment managers with respect to regulatory and compliance issues.

Jason's recent speaking engagements include discussing "Marketing Opportunities and Challenges" at the SRZ London Investment Management Hot Topics conference and "Current Terms: Hedge Funds" at the IBA 15th Annual International Conference on Private Investment Funds. He co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and was recently quoted in "Co-Investments Enable Hedge Fund Managers to Pursue Illiquid Opportunities While Avoiding Style Drift (Parts One, Two and Three)" in *The Hedge Fund Law Report*.

Jason earned his J.D. from Fordham University School of Law, where he was a member of the *Fordham Law Review*, and his B.S. from the University of Michigan.



Partner
New York Office
+1 212.756.2008
robert.kiesel@srz.com

Practices

Intellectual Property, Sourcing & Technology

Finance

Vendor Finance

Robert R. Kiesel

Rob is chair of SRZ's Intellectual Property, Sourcing & Technology Group and a member of the firm's Finance and Vendor Finance groups. His practice focuses on the preparation and negotiation of various types of commercial agreements, including agreements for information technology transactions (outsourcing, software, data and content licensing, hardware supply and strategic alliances); equipment finance and leasing transactions with emphasis on vendor finance programs (private label programs, virtual and actual joint ventures and referral programs) and financing of commercial and corporate aircraft, computer hardware and software, manufacturing equipment and motor vehicles; and supply agreements for components and finished goods; as well as "take-or-pay" agreements, joint engineering, research & development relationships and technology-sharing arrangements. Rob also handles a broad range of services agreements, including transition and long-term services in mergers & acquisitions transactions.

Selected by *New York Super Lawyers* as a top Business/Corporate lawyer, Rob has been a member of the executive committee of the New York State Bar Association's Intellectual Property Section and is a former chair of that section's Committee on the Proposed Uniform Computer Information Transactions Act. He is the co-author of "IP and IT Issues in M&A Deals," an SRZ white paper, and he recently presented "Executing Successful IP and IT Strategies in Connection with M&A" at the DealFlow Media IP Investment Conference.

Rob earned his J.D., with honors, from the George Washington University Law School, where he was managing editor of *The George Washington Law Review*, and his B.A., with honors in political science, from the University of Louisville.

Partner
New York Office
+1 212.756.2515
holly.weiss@srz.com

Practices

Employment & Employee Benefits

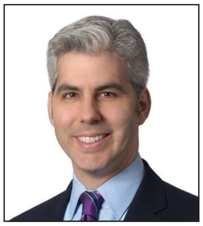
Executive Compensation

Holly H. Weiss

Holly focuses her practice on the representation of employers in all aspects of employment law and employee relations. She litigates disputes involving restrictive covenants, ERISA claims, executive compensation, employment agreements, statutory employment discrimination claims, and common law tort and contract claims, in federal and state courts, before administrative and government agencies and in arbitral forums. She also advises employers on employment law compliance, best practices, human resources matters, hiring and termination, and litigation avoidance; drafts and negotiates employment agreements, separation agreements and other employment-related agreements; provides training; and conducts investigations.

Holly has authored or co-authored numerous articles of interest to employers in the investment management industry, a recent example of which, "Anti-Arbitration Provisions and Dodd-Frank Act," appeared in the *New York Law Journal*. She is also the author of "Effective Client Communication," which appeared in *Labor and Employment Client Strategies: Leading Lawyers on Preventing Litigation, Minimizing Risks and Dealing with Employee Legal Problems*, and a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). A much sought-after speaker, she recently addressed the NYU 67th Annual Conference on Labor and presented "Accommodating Disabilities in the Workplace: Best Practices" at The Five O'Clock Club 60th HR Network Breakfast Seminar.

Holly earned a B.A. from Emory University and a J.D. from the University of Virginia School of Law.



Special Counsel
New York Office
+1 212.756.2290
michael.yaeger@srz.com

Practices

Litigation

Securities Enforcement & White Collar Defense

Michael L. Yaeger

Michael focuses on white-collar criminal defense and investigations, securities enforcement, internal investigations, accounting fraud, cybercrime and data security matters, as well as related civil litigation. He spent six years serving in the U.S Attorney's Office for the Eastern District of New York, where he investigated and prosecuted cases in the Criminal Division and the Business and Securities Fraud Section involving securities fraud, investment adviser fraud, bank fraud, cyber crime, intellectual property crimes, tax fraud, money laundering, health care fraud, false claims act cases, Federal Food, Drug, and Cosmetic Act violations, and other regulatory offenses. He also served as the co-coordinator for Computer Hacking and Intellectual Property crimes. Michael clerked for the Hon. Samuel A. Alito, Jr., U.S. Court of Appeals for the Third Circuit (now a Justice of the United States Supreme Court), and the Hon. Milton Pollack, U.S. District Court for the Southern District of New York.

A frequent speaker and writer, Michael most recently co-authored "2nd Circuit Limits Government Searches of Electronic Records" for *Westlaw Journal – Securities Litigation & Regulation* and "The Right of the People to Be Secure in Their Digital Papers" for *Bloomberg BNA Privacy and Security Law Report*. He participated in the Bank of America Merrill Lynch Hedge Fund Technology, Cybersecurity and Due Diligence Teach-In and the SRZ Cybersecurity: Obligations and Expectations for Investment Fund Managers Breakfast, and he has presented "Treatises and Complex Litigation" as the annual guest lecturer at a Yale Law School research class for the last six years.

Michael earned his J.D. from Yale Law School, where he was the John M. Olin Fellow of the Center for Studies in Law, Economics and Public Policy and the editor of the *Yale Journal on Regulation*. He earned his B.A., with distinction, from Yale University, where he won the American Jewish Congress Essay Prize for best paper on Jewish history or theology and was in Phi Alpha Theta, the national history honors society.

Information Security: Obligations and Expectations

I. Introduction

A. "Reasonable" Cybersecurity

Information security is not only a good idea; it's a legal obligation. There are federal and state laws that impose obligations on businesses, including investment advisers, to keep their data secure. Most of these laws can be summarized as follows: Take reasonable security measures. What are reasonable security measures? It may take the regulators and courts years to reach a definitive answer (if they ever do), but there are best practices that facilitate compliance.

B. Existing Rules

1. Investment advisers must maintain data security not only because they may be obligated to do so by contract (e.g., under contracts between the firm and investors or commercial vendors), to comply with fiduciary obligations, or for practical business reasons (e.g., to protect trade secrets), but also for compliance reasons — namely, the existence of federal and state statutes and regulations that require data security. There are two essential types of data security obligations: (1) the duty to protect information; and (2) the duty to disclose breaches.

   (a) The Duty to Protect: provide reasonable security for data, systems and communications.

   (b) The Duty to Disclose: disclose breaches to affected parties and regulators, and disclose material risks.

2. Right now, the applicable laws are mostly concerned with protecting the personally identifiable information of human beings (e.g., social security numbers or addresses) ("PII").

3. At present, 47 states (and Washington, D.C.; Puerto Rico; Guam; and the Virgin Islands) have data protection laws concerning protection of individuals' PII (all states other than Alabama, New Mexico and South Dakota). (The National Conference of State Legislatures provides a list of the relevant laws.)[1]

C. Sector-Specific Laws: the Gramm-Leach-Bliley Act

1. The two most significant existing federal regulations for investment advisers and investment companies focus on protecting customers' PII.

   (a) Section 30 of Regulation S-P: Requires brokers, dealers, investment companies and registered investment advisers to adopt written policies and procedures designed to protect "customer records and information."[2] The protections are expected to be "administrative, technical, and physical" and require board approval.

   (b) Regulation S-ID, the Identity Theft Red Flags Rules: Require covered entities to develop and implement a written program to "detect, prevent, and mitigate identity theft in connection with

[1] *See* http://www.ncsl.org/research/telecommunications-and-information-technology/security-breach-notification-laws.aspx.

[2] 17 C.F.R. § 248.30.

the opening of a covered account or any existing covered account."[3]

2. The Securities and Exchange Commission (the "SEC") has brought enforcement cases against firms for violating Regulation S-P by failing to follow or enforce cybersecurity policies and procedures.[4]

3. Regulations S-P and S-ID are also enforced against broker-dealers by the Financial Industry Regulatory Authority ("FINRA") in accordance with FINRA's supervision rules requiring that member firms comply with applicable securities laws and rules.[5] Entities not regulated by FINRA should look to FINRA's enforcement cases because they may be used as persuasive, non-binding authority.[6]

4. SEC staff expect registered investment advisers to adopt and maintain written information security policies (each a "WISP"). Question 2 of the SEC's Office of Compliance Inspections and Examinations ("OCIE") Risk Alert (described below) requires an investment adviser to provide a copy of its policy to OCIE.

II. The SEC's Risk Alert

A. The Sweep

1. In April 2014, the OCIE issued a Risk Alert announcing that it would be "conducting examinations of more than 50 registered broker-dealers and registered investment advisers, and that the exams will focus on areas related to cybersecurity."[7]

2. To help registrants and their compliance professionals prepare for these examinations, OCIE included an appendix to the Risk Alert containing a seven-page "sample" cybersecurity document request. The document request is the most substantive part of the Risk Alert and merits close reading. Taken together, the questions suggest that OCIE is building upon existing regulations that concern risks to customers' PII and will now also assess firms' vulnerability to cybersecurity risks in general, including "misappropriation of funds, securities, sensitive … Firm information, or damage to the Firm's network or data."

3. In other words, the data at issue is no longer just PII. It could be, for example, trading strategies or algorithms. The SEC is interested in all the risks that misuse of technology may pose to a firm's assets, including the firm's reputation.

4. Topics addressed in the Risk Alert include:

   (a) Cybersecurity governance;

   (b) Identification and assessment of cybersecurity risks;

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[3] 17 C.F.R. § 248.201(d)(1).

[4] *See, e.g.*, Exchange Act Release No. 58515, Admin. Proc. File No. 3-13181 (Sept. 11, 2008), *available at* https://www.sec.gov/litigation/admin/2008/34-58515.pdf; Exchange Act Release No. 64220, Admin. Proc. File No. 3-14328 (Apr. 7, 2011), *available at* https://www.sec.gov/litigation/admin/2011/34-64220.pdf; Exchange Act Release No. 60733, Admin. Proc. File No. 3-13631 (Sept. 29, 2009), *available at* http://www.sec.gov/litigation/admin/2009/34-60733.pdf.

[5] *See* NASD Rules 3010 and 3012, and FINRA has also brought enforcement cases.

[6] *See, e.g.*, FINRA Letter of Acceptance, Waiver and Consent No. 2009019893801 (Nov. 21, 2011); FINRA Letter of Acceptance, Waiver and Consent No. 2010022554701 (April 9, 2012); FINRA Letter of Acceptance, Waiver and Consent No. 2008015299801 (April 9, 2010). All of these letters of acceptance are available at http://disciplinaryactions.finra.org/.

[7] Securities and Exchange Commission, Office of Compliance Inspections and Examinations, Risk Alert: OCIE Cybersecurity Initiative (April 15, 2014) ("Risk Alert"), *available at* http://www.sec.gov/ocie/announcement/Cybersecurity+Risk+Alert++%2526+Appendix+-+4.15.14.pdf.

(c) Protection of networks and information;

(d) Risks associated with remote customer access and funds transfer requests;

(e) Risks associated with vendors and other third parties with access to the firm's networks, customer data or other sensitive information;

(f) Detection of unauthorized activity;

(g) Experiences with certain cybersecurity threats; and

(h) Cyber risk insurance.

The sample request is quite broad and covers a great deal of material in 28 multi-part questions. At the same time, some questions seek precise information on narrow issues, such as the particular dates since Jan. 1, 2013 of any security incidents, including "the service affected, and the nature and length of the impairment."[8]

5. A firm's WISP should address as many of the applicable issues raised by the Risk Alert as possible.

III. The NIST Framework: Why It Matters and What It Is

A. Why the NIST Framework Matters

The SEC's questions in the Risk Alert give hints about what "reasonable security measures" might be by guiding firms toward the adoption of a published standard such as the one published by the National Institute of Standards and Technology ("NIST"), discussed below.

1. The Risk Alert expressly states that some of the questions track information outlined in the "Framework for Improving Critical Infrastructure Cybersecurity," released on Feb. 12, 2014 by NIST.[9]

2. Moreover, one question in the appendix specifically asks the registrant to "identify any published cybersecurity risk management process standards that the entity has used to model its information security architecture and processes [on], such as those issued by NIST or the International Organization for Standardization (ISO)."

3. NIST is a part of the U.S. Commerce Department, and the Framework is the product of a collaboration between the government and the private sector. The Framework is designed to "provid[e] a consensus description of what's needed for a comprehensive cybersecurity program."[10] It compiles, and makes reference to, similar past frameworks that other organizations, such as COBIT and ISO, have developed.

4. Further, the SEC has pointed to the NIST Framework in places other than the Risk Alert. In a June 2014 speech, one of the SEC Commissioners, Luis Aguilar, suggested that the NIST framework may be a baseline for best practices by companies, including in assessing legal or regulatory exposure to

[8] Risk Alert, Appendix, Question 24, at 6.

[9] National Institute of Standards and Technology, Framework for Improving Critical Infrastructure Cybersecurity (Feb. 12, 2014) ("the Framework"), *available at* http://www.nist.gov/cyberframework/upload/cybersecurity-framework-021214-final.pdf.

[10] Statement by Under Secretary of Commerce for Standards and Technology and NIST Director Patrick Gallagher, *cited in* Press Release, NIST Releases Cybersecurity Framework Version 1.0 (Feb. 12, 2014), *available at* http://www.nist.gov/itl/csd/launch-cybersecurity-framework-021214.cfm.

cyber risks. "At a minimum," he stated, "boards should work with management to assess their corporate policies to ensure how they match-up to the Framework's guidelines — and whether more may be needed."[11]

5. A firm is not required to use the NIST Framework to develop its security plan, but the Framework has been highlighted by the SEC and thus it is not lightly ignored.

B. The Nature of the NIST Framework

1. The NIST Framework is a deliberately general document that describes a process to apply to risks. It does not prescribe particular tools or products, such as firewalls or encryption. The generality of the document is a little frustrating, but probably essential. It is designed to be flexible enough to accommodate technology and business change.

2. The Framework consists of three parts: the Framework Core, the Framework Profile and the Framework Implementation Tiers.

(a) "The Framework Core is a set of cybersecurity activities, outcomes, and informative references that are common across critical infrastructure sectors."[12] These activities are organized into five functions — Identify, Protect, Detect, Respond and Recover. "When considered together, these Functions provide a high-level, strategic view of the lifecycle of an organization's management of cybersecurity risk"[13] and allow an organization to learn from past security incidents.

(b) "The Profile can be characterized as the alignment of standards, guidelines, and practices to the Framework Core in a particular implementation scenario. Profiles can be used to identify opportunities for improving cybersecurity posture by comparing a 'Current' Profile (the 'as is' state) with a 'Target' Profile (the 'to be' state). … Profiles can be used to conduct self-assessments and communicate within an organization or between organizations."[14]

(i) For example, a Profile can aid communication with vendors and other third parties who have authorized access to a firm's systems or information. A firm with a Profile has something to show its vendor, making it easier to describe what needs to be protected, and what a vendor must do before it will be granted access. Similarly, a firm could request that the prospective vendor submit its own Profile.

(c) The Framework Implementation Tiers range from Partial (Tier 1) to Adaptive (Tier 4). They describe: (1) "an increasing degree of rigor and sophistication in cybersecurity risk management practices"; (2) the extent to which cybersecurity risk management is informed by business needs"; and (3) the extent to which cybersecurity risk management is "integrated into an organization's overall risk management practices."[15] In determining what Tier they desire, firms should determine which level meets the firm's goals and "is feasible to implement."[16]

[11] Luis Aguilar (SEC Commissioner), Boards of Directors, Corporate Governance and Cyber Risks: Sharpening the Focus, Cyber Risks and the Boardroom Conference, New York Stock Exchange (June 10, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370542057946.

[12] The Framework, at 1.

[13] *Id.* at 4.

[14] *Id.* at 5.

[15] *Id.* at 9.

[16] *Id.*

IV. Becoming Compliant: Where to Start

A. Firm-Level Risk Assessments

1. OCIE expects that firms will maintain a detailed inventory and understanding of their cyber infrastructure. This includes physical devices, the software platforms and applications used on the network, network resources, connections and "data flows (including locations where customer data is housed)."[17]

2. The SEC is concerned with firms' vulnerability to cybersecurity risks in general, including "misappropriation of funds, securities, … [and] Firm information[.]"[18] Managers should accordingly review existing related policies, such as controls on processing redemption requests and IT safeguards, in a cybersecurity context.

3. Every fund manager should be prepared to explain how it designed and maintains its infrastructure, its incident response plan and its training for employees. Third-party security firms can assist in this effort.

4. Consider doing a gap analysis. Discover where the gaps in the firm's security are and close them.

   (a) A gap analysis is an analysis of what you have done, where you are now, and where you want to go.

      (i) "What you have done" includes any previous security reviews or audits.

      (ii) "Where you are now" includes any existing personnel, policies, procedures and controls you currently have in place. A full risk assessment identifying all systems, all "treasure" (what you want to protect), all risks and all residual risks after the controls are applied.

      (iii) "Where you want to go" means identifying any regulatory compliance needs, selecting an appropriate framework (e.g., NIST; ISO 27001) and developing a roadmap for hiring, policy development, control implementation, ongoing risk assessment, etc.

   (b) The gap analysis should be done at the firm level, but also at lower levels within the firm. At the firm level, guidance is provided to the entire firm and is applicable to all types of information systems and mission objectives, and a standard risk threshold exists. Different groups at a fund manager will likely present different types of information security risks (e.g., investor relations and trading).

B. Cybersecurity Personnel

Many of OCIE's questions in the Risk Alert focus as much on the "who" as the "what." Firms should have well-defined roles and responsibilities for cybersecurity personnel, and to that end should designate a chief information security officer, or the functional equivalent — an employee in charge of information security as distinct from IT operations. Question 21 in particular asks for considerable detail regarding which specific persons (identified by title, department and job function) are responsible for tasks such as detecting malware, "maintaining baseline information about expected events on the Firm's network,"

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[17] Risk Alert, Question 24, at 6.

[18] Risk Alert, Question 24, at 7.

and "monitoring the activity of third party service providers with access to the Firm's network." Compliance personnel should be familiar with the division of labor in the technology department.

C. Records of Cybersecurity Incidents

1. Firms should maintain detailed records relating to cybersecurity incidents. This is one of the more significant parts of the Risk Alert. Financial firms of course have long-standing obligations to maintain accurate books and records, but such record-keeping is not traditionally associated with cybersecurity or even technology support departments. OCIE is not asking firms to catalogue tech support tickets; it is seeking granular detail on particular security incidents, both retrospectively and going forward. For example, Question 24 asks for details on many kinds of cybersecurity events, such as the detection of malware on a firm's devices, or the impairment of a "critical Firm web or network resource [due to] a software or hardware malfunction." This may require a considerable expansion of current record-keeping, and collaboration between cybersecurity and legal compliance personnel. The Risk Alert does not expressly address what makes a particular incident material, but Question 24 hints that the SEC will recognize materiality concerns in some way because it allows respondents to omit some incidents that: (1) resulted in losses of $5,000 or less; (2) did not result in "unauthorized access to customer information"; or (3) did not make a firm service unavailable for "more than 10 minutes."[19]

2. In designing their record-keeping system, cybersecurity personnel might also consider additional uses for the records beyond complying with OCIE's document requests. The records created in response to OCIE's request could also become a valuable tool for firms to use in their own internal investigations, or to assist firms if they become the victims of tortious or criminal conduct. For example, the malware used to misappropriate data can sit on a server for months before it is detected, and thus the investigation of a breach may be aided by examining seemingly unconnected events several months or even years prior. Valuable investigative resources such as log records (e.g., web server access logs and secure shell server logs) can be overwritten or deleted, so preserving the kind of information requested by OCIE in a readily accessible form may prove useful.

D. Disaster Recovery

Managers should review their existing disaster recovery plans to ensure that they are up-to-date with firm operations and that they take into account cybersecurity and identity theft prevention policies. Note that Regulation S-P requires a written business continuity plan.

V. Practical Cybersecurity: Human Resources Policies and Insider and Third-Party Risk

A. Human Resources

1. Almost every aspect of a firm's existence intersects with computers and digital data. Accordingly, cybersecurity is less a separate concern than a theme that should run through all of a firm's risk management policies. Personnel policies are no exception.

(a) Since the advent of the cellphone, employees have had firm information in the palms of their hands. As cellphones have become smartphones, the amount of firm information that employees have access to at all times has increased exponentially. As Bring-Your-Own-Device ("BYOD") practices have spread, the wall between personal and business use has grown thinner.

[19] Risk Alert, Question 24, at 6 ("If the response to any one item includes more than 10 incidents, the respondent may note the number of incidents and describe incidents that resulted in losses of more than $5,000, the unauthorized access to customer information, or the unavailability of a Firm service for more than 10 minutes.")

Now, many employees own the devices on which they work, and they engage in both business and personal activities on the same device.

(b) Technological change — in particular the BYOD trend — heightens employee security risks:

(i) Lost or Stolen Devices: Mobile devices are more likely than desktop computers to be lost or stolen.

(ii) Cloud-Based Storage*:* Firm data saved in "cloud" storage by employees may be unsecure and out of the firm's reach.

(iii) Wireless (In)security: Data traveling on unsecured wireless networks can easily be stolen.

(iv) Downloads/Uploads: Malware may cause damage to a firm's system and threaten its security.

(v) Friends and Family: Mobile devices may be accessed by friends or family.

2. Disgruntled/Disloyal/Terminated Employees

(a) Firm-owned devices, and the business data stored thereon, can readily be secured, studied and wiped by the firm. Most court decisions involving employee challenges to an employer's access to personal data based on privacy concerns have favored the employer and have turned on the fact that the employer owned the device or system on which the information was stored or transmitted. By contrast, a device owned by an employee that contains personal data may not be readily secured legally. Relevant federal statutes include the Electronic Communications Privacy Act ("ECPA") and the Computer Fraud and Abuse Act ("CFAA").

(i) ECPA: Title I prohibits wiretapping unless there is consent from one party; it is for a legitimate business reason; it is routinely conducted; and, in some federal appellate court circuits, the party is informed that he/she is being monitored. There are exemptions for publicly accessible radio communications, government officials and communication services providers. Title II (the Stored Communications Act ("SCA")), bans surreptitious access to stored communications like email, social media messages and text messages. The SCA makes it a crime to intentionally access without authorization or exceed an authorization to access stored communications. Therefore, employers may not access an employee's web-based personal email; nor can they access password-protected social media posts without consent.[20] If the communications pass through firm servers or are stored on firm equipment (e.g., hard drives), however, employers may access personal email and social media posts.[21]

(ii) CFAA: The CFAA prohibits employers from intentionally accessing a computer without authorization. Employees have sued their employers under the CFAA for accessing the employees' phones, devices or accounts without authorization.[22]

(iii) Eighteen states (New Hampshire, Rhode Island, New Jersey, Maryland, Michigan, Illinois, Wisconsin, Tennessee, Louisiana, Missouri, Oklahoma, New Mexico, Colorado, Utah, Nevada, California, Oregon and Washington) have passed so-called "anti-snooping" laws prohibiting

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[20] *See, e.g.*, *Pure Power Boot Camp v. Warrior Fitness Boot Camp*, 587 F. Supp. 2d 548 (S.D.N.Y. 2008).

[21] *See, e.g.*, *Front, Inc. v. Khalil*, 2013 N.Y. Misc. LEXIS 3157 (N.Y. Co. 2013).

[22] *See, e.g.*, *Rajaee v. Design Tech Homes, Ltd.,* 2014 U.S. Dist. LEXIS 159180 (S. D. Tex. 2014).

employers from demanding passwords to access personal email and social networking sites. There is no federal equivalent yet. New York has several bills pending on the same subject.

(b) To avoid running afoul of these statutory protections, and to protect firm information, firms should:

(i) Obtain advance authorization to access and wipe information stored on employee-owned mobile devices that contain firm information;

(ii) Consider using mobile management software to, among other things, create a "corporate sandbox" that segregates firm information from personal information (and consider that even though it may be technologically possible to access personal information on a dual-use device, there is a downside to doing so);

(iii) Clearly delineate where work cannot be done (e.g., prohibit firm work on personal email accounts); and

(iv) Craft policies that ensure that employees do not have an expectation of privacy with respect to firm information on their own devices or personal information transmitted using the firm's technology or stored on the firm's systems.

(c) Proprietary and Trade Secret Information

(i) A critical element of proof in a trade secret theft case is that the employer has taken "reasonable measures to protect" the information it claims was misappropriated.[23] The evidentiary burden is difficult to meet when the information walks out the door every day in employees' pockets.

(ii) Employees can misappropriate firm information in a variety of ways. For example, they may photograph documents or screens or surreptitiously record discussions, and because smartphones are ubiquitous, the theft may not be obvious. Or, employees may electronically transfer data, using email, internet-based storage or portable storage drives.

(iii) To protect firm information, in addition to traditional measures, such as confidentiality agreements and policies, firms should take technical precautions, such as restricting access to trade secret data (e.g., by using proprietary software source code for trading algorithms), disabling transmission of information to portable drives, encrypting information and compartmentalizing information (so that no single individual can misappropriate a particular trade secret).

(d) Employee Speech Protections

(i) Recently the National Labor Relations Board ("NLRB") has been pursuing employers, both unionized and not unionized, challenging overly broad policies that chill employee speech and terminations stemming from employee speech on social media sites.

(ii) Section 7 of the National Labor Relations Act of 1935 ("NLRA") gives employees the "right to self-organize, to form, join, or assist labor organizations ... and to engage in other

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[23] *See MidAmerica Prods., Inc. v. Derke*, 2013 N.Y. Misc. LEXIS 1211 (N.Y. Co. 2013) (holding that customer information sheets were not a trade secret because "plaintiffs did not take any reasonable measures to guard the secrecy" when anyone in the office with access to the computer had access to the data).

concerted activities … .” Concerted activity includes speech regarding discontent with an employee’s current employer, including complaints about wages or a tough boss.

(iii) The NLRB has concluded that a policy banning personal use of business devices chills concerted activity and, therefore, is too broad. The NLRB has also concluded that policies that prohibit employees from saying anything about their employers on social media sites are overly broad.[24] To comply with the NLRA, policies should permit non-excessive personal use of the firm’s systems and limit prohibitions with respect to social media.[25] Policies should, however, prohibit employees from using systems that an employer cannot access (such as personal web-based emails) for business.

(e) Training

Training employees is critical, because many security incidents are the result of employee error or misconduct. The consequences of comingling personal and business data and functions on one device are not intuitive to employees. Many problems are not caused by disgruntled employees acting intentionally. Rather, they are caused by innocent insiders. Training will go a long way toward mitigating the risk.

(f) Elements of a BYOD Policy

(i) Restrictions: A comprehensive BYOD policy should include provisions regarding password protection, encryption of firm data that is stored on the device, lock or wipe after a certain number of unsuccessful access attempts, restrictions on the source of apps (e.g., only Apple or Google), no friends or family access and no storage of corporate data on remote servers through consumer-grade “cloud” storage services. If a firm chooses to use cloud storage, it should carefully select an enterprise-grade provider that provides better encryption and the ability to monitor and wipe what an employee has stored. Employers should also require immediate reporting of lost or stolen devices, use of mobile management software with remote wiping capabilities and use of passwords with safeguards to prevent hacking and misuse of information on the device.

(ii) Monitoring: In addition, employers should alert employees that they have no privacy expectation in firm data on the phone or personal data transmitted using the firm’s software installed on the phone (e.g., firm email); firms should get consent to monitor data that is stored, sent from or received on the device; and firms should get consent to remotely wipe firm information if the device is lost or stolen and upon termination of employment.

(iii) Coordination with Other HR Policies: Employers should ensure that BYOD policies do not conflict with other HR policies and specify that any other policies such as EEO, anti-harassment, confidentiality and compliance policies apply to work done on the device.

(iv) Provisions Contemplating Termination of Employment: Security issues are most acute upon termination of employment. Remote-wiping capabilities are especially important in this circumstance. Employers should obtain prior permission to wipe the phone of firm information. Using a corporate cloud service and setting up a corporate “sandbox” for employees to use helps preserve the integrity of firm information, but will not capture all

[24] *See Durham School Servs., L.P.*, 360 N.L.R.B. 85 (2014) (a prohibition on sharing information “related to the company or any of its employees or customers” was overbroad and too vague under the NLRA).

[25] *See Landry’s Inc.*, No. 32-CA-118213 (N.L.R.B. A.L.J. June 26, 2014) (a policy that urged employees not to post about the company was found not to violate the NLRA because it was not an outright prohibition).

firm data if some continues to be stored on the device itself. Employers should therefore require employees to consent to an inspection of the device during and upon termination of employment.

(v) Compliance with Record-Keeping Obligations: Whether or not a firm has a record-keeping obligation depends on the content of the communication rather than the platform used to communicate. If text messages include communications that relate to recommendations or advice by a registered investment adviser, they are subject to the record-keeping obligations under Rule 204-2 of the Investment Advisers Act.[26] Employers should make sure that they have access to and maintain all information that is subject to record-keeping obligations. In addition, policies should allow for retrieval of employee-owned devices for compliance-related inquiries. It is good practice to maintain separate, work-specific, employer-controlled accounts for employees to use on sites such as LinkedIn if they use those platforms for communicating with clients.

B. Third-Party Risks: Vendor Management

Risks to investment advisers from third parties, and specifically vendors, are a major concern of the OCIE, according to the Risk Alert. Such third parties include fund administrators, prime brokers, consultants and commercial vendors. Questions 16 through 20 cover the firm's management of third-party vendors, addressing issues regarding cybersecurity risk assessment of vendors, training materials used for vendors, segregation of sensitive data from third-party access and security applied to control remote systems access by vendors.

1. The Diligence Process: Choosing a Vendor

(a) It is prudent to investigate a proposed vendor and its creditworthiness prior to entering into a contract, especially if the vendor is not a household name.

(b) Some vendors will not negotiate changes to their agreements. In this situation, discomfort with the vendor's contract provisions can be soothed somewhat if the investment adviser can get comfortable with the vendor's product and the vendor itself. The best source of this due-diligence information is other customers of the vendor. It is routine for vendors to offer customer references. Investment advisers should take advantage of these offers.

(c) Ask for and review the vendor's written information security program. It is standard practice for the vendor to attach its program as an exhibit to the vendor contract as a contractual commitment of the vendor.

(d) The vendor should advise what industry standards it follows (such as ISO or NIST).

(e) The vendor should identify any subcontractors that will have access to sensitive information and should provide diligence material for each subcontractor.

(f) Ask for and review the vendor's incident response plan.

(g) The vendor should agree to preserve information consistent with any instructions the firm provides, including any litigation and regulatory holds.

2. Contract Provisions

[26] OCIE, Investment Adviser Use of Social Media, National Examination Risk Alert (Jan. 4, 2012), at 2; *see* 17 C.F.R. § 275.204-2.

Question 17 of the Risk Alert addresses whether the firm incorporates data security requirements into its vendor contracts. Attached as Exhibit A is a fairly comprehensive set of data security-related contract provisions that an investment adviser can try to incorporate into its vendor contracts (and of which it should provide examples to OCIE in response to Question 17). These provisions apply to vendor-hosted software-as-a-service and cloud-based vendor arrangements.

C. Practical Recommendations

No firm's data will be totally secure, but practical steps can be taken to protect a firm against data breaches:

1. Employee Training: The most important defense against phishing attacks is to train employees not to interact with suspicious emails.

2. Passwords and RSA Security Codes: Restricting system access to users that belong is an obvious and reasonable requirement.

3. Email Filters: Spam filters are a significant block to phishing attacks and malware.

4. Limitation on Administrative Privileges: Limiting the number of employees with broad system access limits the damage an intruder can cause once the intruder successfully breaches the firm's security layers.

5. Technological Devices: Technological devices such as email sandboxes (which allow email to be checked for malware before they can do damage) and virtual air-gapping (allowing Internet access via a vendor's system without exposing the firm's devices) are expensive and may slow down systems, but they can provide effective security.

6. Limitation on Large Downloads: Restricting flash drive downloads by employees limits information lost through employees.

VI. Data Breaches

A. Incident Response Plan

1. Prepare for the possibility that the firm will be breached or suffer some other kind of violation of its security.

(a) Develop an incident response plan before a breach happens. This is better than assembling one after the problem happens at 8:00 p.m. on New Year's Eve.

(b) Don't just think of the dramatic stuff. A security incident could be a breach by an outside attacker, but it also includes more prosaic events such as the loss of laptops, mobile phones or RSA keys.

(c) Assemble a team that includes various parts of the firm such as:

(i) Tech security;

(ii) Tech operations;

(iii) PR;

(iv) Audit; and

(v) Legal.

Specify points of contact for each department and allocate responsibilities, and distribute the list in a way that it can be accessed in an emergency.

(d) Develop responses to the most likely attacks (e.g., phishing and insider threats).

(e) Test the response plan — regularly, not just when it is first developed.

(f) Update the plan regularly, and when a significant technology change event occurs — such as the switch to a new off-site data center, the implementation of a major new piece of software, etc. Also, re-evaluate the plan after each significant incident.

(g) One helpful resource is NIST's Computer Security Incident Handling Guide.[27]

B. Reporting

1. When to report a data breach (and what to report about it) is very fact specific. Factors that matter include the nature of the data (e.g., whether it was PII), the residence and number of individuals whose information has been compromised, and whether the data was encrypted.

2. Timing of the disclosure. State laws vary, but typically require that affected persons be notified of PII breaches without unreasonable delay. As discussed below, most states also typically allow for delay due to cooperation with law enforcement.

3. Form of the disclosure. Affected persons should typically be notified by either written notice, electronic notice, or, sometimes, substitute notice. Substitute notice typically consists of a combination of email notification, a message posted on the firm's website and publication in statewide media. Substitute notice is not permissible unless the breached form lacks sufficient contact information for the affected persons, or if the firm can show that notice will cost more than a certain amount (different for different states) or must be provided to a certain number of people (also different for different states). For example, substitute notice is allowed by Maine and New Hampshire if the cost exceeds $5,000 or the firm must notify more than 1,000 individuals, but other states have thresholds of $250,000 or 500,000 individuals.

4. There is oftentimes no obligation to report a security breach to the SEC or to prepare any particular document regarding the breach and how the firm addressed it. But an internal breach report, and related documentation, may be useful in demonstrating the firm's efforts to address information security concerns.

C. Attorney-Client Privilege and Incident Response

1. Try to protect your deliberations. It will make the substance and outcome of your third-party deliberations better.

2. Merely copying your lawyer on a communication doesn't make it privileged.

[27] *See* Paul Cichonski et al., Computer Security Incident Handling Guide, Special Publication 800-61, Revision 2 (August 2012), *available at* http://csrc.nist.gov/publications/nistpubs/800-61rev2/SP800-61rev2.pdf.

3. But if incident response or after-action reports are conducted at the direction of a lawyer, it is more likely that courts will find them to be privileged.

D. Evidence Collection

1. Document as much as possible — actions that are performed by IT, conversations with users and system owners regarding the incident, etc.

(a) The point is to know what happened when, and what the decision-making process was.

(i) This information may help a firm to improve its future responses.

(ii) This information may also help protect the firm from second-guessing by litigants. It allows the firm to show that the ultimate solution wasn't the only possible solution, and that the interim theories were reasonable.

2. "Preserve evidence from the incident. Make backups (preferably disk image backups, not file system backups) of affected systems. Make copies of log files that contain evidence related to the incident."[28]

3. To the extent possible, preserve evidence in a way that doesn't alert the suspected culprit. For example, think carefully about circulating a litigation hold. Who is in the circle of trust?

E. Communicating and Working with Law Enforcement

1. Under many state laws, a firm that is cooperating with a criminal investigation may delay its breach disclosure to affected individuals.[29]

2. Some things to consider:

(a) If a firm wants to pursue its own litigation, criminal litigation may take precedence. Civil litigation is often (but by no means invariably) stayed when there is a parallel criminal case.[30] So getting law enforcement involved usually means diminishing control.

(b) On the other hand, if the firm has had to disclose a breach to affected individuals, the firm may be contacted by the Secret Service or FBI anyway. By taking affirmative steps the firm might keep more control of the situation, or at least keep lines of communication with law enforcement open.

(c) Law enforcement has investigatory tools that private firms do not (e.g., search warrants and contacts in international law enforcement).

(d) When talking to investigators, a firm has to be accurate, of course. The firm may have to discuss aspects of a hack it has seen but doesn't understand.

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[28] *Id.*, Appendix G, at 68.

[29] *See, e.g.*, Cal. Civ. Code § 1798.82(c); Conn. Gen. Stat. Ann. § 36a-701b(d); Fla. Stat. Ann. § 817.5681(3); Mass. Gen. Laws Ann. Ch. 93H, § 4; N.Y. Gen. Bus. Law § 899-aa(4); and Tex. Bus. & Com. Code Ann. § 521.053(d).

[30] *See* Milton Pollack, *Parallel Civil and Criminal Proceedings*, 129 F.R.D. 201 (S.D.N.Y. 1989); *Parker v. Dawson*, No. 06-CV-6191 JFB WDW, 2007 WL 2462677 (E.D.N.Y. Aug. 27, 2007); *S.E.C. v. Boock*, No. 09 CIV. 8261 (DLC), 2010 WL 2398918 (S.D.N.Y. June 15, 2010); *but see S.E.C. v. Saad*, 384 F. Supp. 2d 692 (S.D.N.Y. 2005) (Rakoff, J.).

(e) Get outside counsel involved in dealings with law enforcement.

3. Personal relationships can matter in terms of responsiveness and communicating with law enforcement. This may also determine whether to call the FBI, Secret Service, or a particular U.S. Attorney's Office or state District Attorney's office to ask them to open an investigation.

4. What will law enforcement want?

   (a) Don't do something that tips off the attacker. That could lead to destruction of evidence, or the creation of new back doors allowing the attacker to come back later.

   (b) May want assistance with undercover operations.

   (c) Preserve Evidence: Don't turn off computers — that will result in loss of volatile memory. (It may be OK to disconnect from the Internet. Talk to the tech and security team, and ask law enforcement before you do it.)

VII. Insurance

The insurance markets now offer cyber risk coverage for data breaches. This coverage is available to investment advisers.

A. Crime Coverage

Many businesses have crime coverage that will cover theft of funds or tangible property through electronic or cyber fraud. Crime coverage, however, will typically not provide coverage for damages resulting from the loss of data, unauthorized disclosure of information or systems losses due to a virus or other electronic attack. These types of risks typically are covered only by a cybersecurity risk policy.

B. Third-Party and First-Party Liability

In today's market you can expect to find cyber coverage for third-party and first-party liability. Coverage should include protection against claims by customers or investors seeking damages due to disclosure of personal and financial data, allegations of a breach of duty due to the failure to prevent and detect a data breach, and the destruction of critical business records. First-party coverage should include the cost and expenses to investigate and respond to the cyber incident, the destruction of valuable data and software and business interruption.

C. The SEC's Risk Alert

Question Number 8 of the SEC's Risk Alert asks if the firm under review has in place a cyber risk insurance policy. If a firm answers "yes" to this question, it is likely that the SEC and FINRA will get more comfort from this than from other factors (and maybe more than is due). It may be assumed by the reviewer that the presence of insurance coverage means that a knowledgeable third party (the insurance carrier) has conducted a thorough investigation of the fitness of the firm's security infrastructure and policies prior to providing coverage. This may or may not be true in reality (depending on the size of the policy and the breadth of coverage), but the inference (or reality) of third-party due diligence could make obtaining an insurance policy a relatively cheap certification of regulatory compliance.

Exhibit A

[The following are suggested vendor contract provisions related to information security. "Customer" is the management company.]

I. General

Vendor has examined Customer's current computer networking platform and its hosting and data security requirements and confirms that the Vendor's Service will interact and operate with the Customer's platform and provide a secure hosting environment in accordance with the specifications and in accordance with industry standards for the protection of confidential information. Customer shall have the option to replace the Vendor with a third-party provider of its choosing, and Vendor shall undertake commercially reasonable efforts to transition Customer to the new provider as quickly, economically and efficiently as possible and will do so in a way that provides a seamless and secure transition with no business interruptions to Customer.

II. Security

A. Application Security

Vendor shall implement the following best practices with regard to development and deployment of the Vendor's Service.

Vendor shall maintain, at no expense to Customer, appropriate systems security for the Vendor's Service in accordance with commercially reasonable industry standards and practices designed to protect all data and information provided by or on behalf of Customer that is input into, displayed on or processed by the Vendor's Service and all output therefrom ("Customer Data") from theft, unauthorized disclosure and unauthorized access. Such systems security includes, among other things, the following practices and procedures with respect to the Vendor's Service: (1) implementation of application vulnerability tests and provision to Customer of evidence of tests and results; (2) all communications to web security layer transmitted using robust secure protocol; and (3) the following safeguards:

1. Authentication

   (a) All access is authenticated and communication secured using industry best practices.

   (b) Systems identity is tied to an individual user by the use of credentials and/or by second factor authentication.

   (c) Reasonable authentication controls that conform to industry recognized standards are provided.

2. Authorization

   (a) Ensure that only authorized users are allowed to perform actions within their privileged level.

   (b) Control access to protected resources based upon role or privilege level.

   (c) Prevent privileged escalation attacks.

3. Secure Coding Practices

(a) Developers should be trained on secure developing best practices.

(b) Applications should be written in a secure manner using a formal process that provides evidence that application security vulnerabilities are not present prior to moving into production and periodically thereafter, including after significant changes. At a minimum, application security vulnerabilities would include the SANS Top 20 and OWASP Top 10.

(c) These requirements should be validated by tools such as dynamic application scanning and/or static code analysis.

4. Password and Account Management

(a) Passwords should follow best practices, including:

(i) Encrypting passwords using "hashing" and "salting" techniques.[31]

(ii) Enforcing password complexity.

(iii) Limiting failed attempts before account lockout.

(iv) Not allowing clear passwords.

(v) Password reset does not send credentials.

(b) Where appropriate, Vendor shall securely log (with time and date) commands requiring additional privileges to enable a complete audit trail of activities.

B. Data Security

Vendor shall implement the following best practices:

1. Data at Rest

(a) Customer Data encrypted using industry best practices.

(b) Backups of Customer Data have the same controls as production data.

2. Data in Motion

(a) Customer Data ingested from client should be encrypted (e.g., SFTP, certificate based authentication).

(b) Customer Data sent over browser should use SSLv3 or better.

3. Multi-Tenancy

(a) In a multi-tenant environment, Vendor shall provide appropriate security controls and robust cryptographic methods to protect and isolate Customer Data from other tenants.

[31] "Hashing" a password converts it into a long hexadecimal number. "Salting" is the addition of random characters to the password before it is hashed. The idea is that this is difficult to decode, especially with added "salt." Thus, even if a password file itself is compromised, it still has a certain level of protection and individuals have some time to change their passwords before they are decoded.

4. Administrative Access and Environmental Segregation

   (a) Applying Principle of Lease Privilege: Proper controls should be in place to ensure that access is limited to administrators who must see Customer Data.

   (b) Where possible confidential data should be masked with one-way hashing algorithms.

   (c) Customer Data should not be replicated to non-production environments.

C. Threat Management

Vendor shall implement the following best practices:

1. Intrusion Detection

   Vendor shall implement and maintain an intrusion detection monitoring process at the network and/or host level to protect the Vendor's Service and to detect unwanted or hostile network traffic. Vendor shall update its intrusion detection software continuously, on a scheduled basis following the availability of updates by the software provider. Vendor shall implement measures to ensure that Vendor is alerted when the system or service detects unusual or malicious activity. Vendor shall notify Customer within five (5) days of any significant intrusion.

2. Penetration Tests

   As a way to validate vendor threat management capabilities, Customer has the right to perform, or to have a third party perform, independent intrusive application penetration tests on its segmented data and directories of the Vendor's Service infrastructure at Customer's own expense, no more than twice per year, and Vendor shall reasonably facilitate the same. In addition, Vendor shall conduct penetration tests at least once per year on its client-wide computing environment and will provide Customer with written copies of such penetration tests performed by Vendor or its subcontractors no more than thirty (30) days after Vendor receives the results or reports.

D. Infrastructure Security

Vendor shall configure the Infrastructure (e.g., servers and network devices) and platforms (e.g., OS and web servers) to be secure following these best practices:

1. Audit Logging

   (a) Vendor shall monitor and log all system access to the Vendor's Service to produce an audit trail that includes, but is not limited to, web server logs, application logs, system logs and network event logs.

   (b) The logs should be stored off-system to reduce risk or loss due to tampering.

2. Network Security

   (a) Vendor shall comply with industry standards, separating perimeter networks from endpoints hosted in the private network using industry standard firewalls. Vendor shall update its firewall software continuously, on a scheduled basis, following the availability of updates by the software provider.

(b) Vendor shall test its perimeter devices continuously on a scheduled basis, and, if deficiencies are discovered, Vendor shall promptly troubleshoot and remediate security deficiencies discovered as a result of such testing or as a result of logging access attempts, based upon the risk of the deficiency.

3. Vulnerability Management

In addition to the third-party vulnerability assessments described above, Vendor shall implement commercially reasonable processes designed to protect Customer Data from system vulnerabilities, including:

(a) Perimeter Scanning: Vendor shall perform perimeter scanning through the use of embedded adaptors within Vendor's infrastructure providing information to an external reporting tool. Vendor shall produce reports monthly and make them available to Customer on a monthly basis upon written request.

(b) Internal Infrastructure Scanning: Vendor shall perform internal infrastructure scanning through the use of embedded adaptors within Vendor's infrastructure providing information to an external reporting tool through a VISA-approved PCI scanning vendor. Vendor shall produce reports monthly and make them available to Customer on a monthly basis upon written request.

(c) Application Vulnerability Scanning: Vendor shall perform application vulnerability scanning on the Hosted Service before code is released into production. Vendor shall produce reports shortly thereafter and make them available to Customer following a written request.

(d) Malware Scanning: Vendor shall perform anti-malware scanning on all servers utilized in performing the Vendor's Service under a central management platform.

4. Secure Configuration

Vendor shall comply with industry standards for platform hardening and secure configuration in order to reduce attack surface. Hardening procedures should be enforced before system is put into production.

E. Security Procedures

Vendor shall implement the following best practices:

1. Incident Response

Vendor shall maintain security incident management policies and procedures, including detailed security incident escalation procedures. In the event of a breach of any of Vendor's security or confidentiality obligations hereunder, Vendor agrees to notify Customer by telephone and email of such an event within twenty-four (24) hours of discovery. Vendor shall be solely responsible for its subcontractors. Vendor will also promptly perform an investigation into the breach, take appropriate remedial measures and provide Customer with the name of a single Vendor security representative who can be reached with security questions or security concerns twenty-four (24) hours per day, seven (7) days per week, during the scope of Vendor's investigation.

2. Patch Management

Vendor shall use a patch management process and tool set to keep all servers up to date with appropriate security and feature patches.

3. Documented Remediation Process

Vendor shall use a documented remediation process designed to timely address all identified threats and vulnerabilities with respect to the Vendor's Service. High severity findings should be remediated within thirty (30) days or reported to Customer.

4. Employee Termination Procedures

Vendor shall promptly terminate all credentials and access to privileged password facilities of a Vendor employee in the event of termination of his or her employment.

F. Governance

Vendor shall implement the following best practices.

1. Security Policy

Vendor shall maintain, at no expense to Customer, an information security policy that is approved annually by Vendor and published and communicated to all Vendor employees and relevant third parties. Vendor shall maintain a dedicated security and compliance function to design, maintain and operate security in support of its "trust platform" in line with industry standards. This function shall focus on developing policies and procedures for system integrity, risk acceptance, risk analysis and assessment, risk evaluation, risk management and treatment, and statements of applicability. Vendor shall provide evidence of a security policy.

2. Security Training

Vendor shall ensure, at no expense to Customer, that all Vendor employees and managers complete relevant training required to operationalize the procedures and practices outlined herein, including security awareness training, on at least an annual basis. Vendor shall provide evidence of training when completed.

3. Security Reviews

Customer and Vendor shall meet at least once annually. Such meetings shall be attended by senior level management to discuss: (1) the effectiveness of the Vendor's Service's security platform; and (2) any updates, patches, fixes, innovations or other improvements made to electronic data security and cloud computing environments by other commercial providers or for other Vendor customers that Vendor or Customer believe will improve the effectiveness of the Vendor's Service's security platform for Customer.

4. Third-Party Audits and Compliance Standards

(a) Vendor shall provide Customer with a copy of any security audit (including SSAE 16, AICPA Service Organization Control Reports or independent audits) that is performed no more than thirty (30) days after Vendor receives the results or reports. Customer has the right to, or to engage a third party on its behalf to, visit Vendor's offices up to four (4) times per calendar year in order to conduct due diligence and auditing procedures on Vendor's business operations related to the Vendor's Service in terms of technical infrastructure, system interaction, organization, quality, quality control, personnel involved with services for Customer, and general resources in terms of skills and personnel.

(b) SSAE 16 Audit

If applicable, Vendor will furnish evidence of a successful SSAE-16 audit upon Customer request to the extent permitted by law and subject to applicable regulatory restrictions and confidentiality obligations. Vendor must verify that the audit certifies all infrastructure and applications that support and deliver services to Customer Data.

(c) ISO 27001 Audit

If applicable, Vendor will furnish evidence of a successful ISO 27001 audit upon Customer request to the extent permitted by law and subject to applicable regulatory restrictions and confidentiality obligations. Vendor must verify that the audit certifies all infrastructure and applications that support and deliver services to Customer Data.

(d) PCI-DSS Compliance

If applicable, Vendor shall maintain, at no expense to Customer, policies, practices and procedures sufficient to comply with the Payment Card Industry Data Security Standard, as the same may be amended from time to time, with respect to the Hosted Service.

(e) Vulnerability Assessments

At least annually and at no expense to Customer, Vendor shall conduct an application vulnerability assessment with respect to the handling of data relating to the Vendor's Service, which assessment will be performed by a qualified independent third party. Upon Customer's request, Vendor shall provide Customer with copies of documentation relevant to such assessment to the extent permitted by law and subject to applicable regulatory restrictions and confidentiality obligations.

G. Physical Security

Vendor shall implement the following best practices:

Vendor shall limit access to its facilities utilized in performing the Vendor's Service to employees and employee-accompanied visitors using commercially reasonable Internet industry standard physical security methods. At a minimum, such methods shall include visitor sign-ins, restricted access key cards or locks for employees; limited access to server rooms and archival backups; and burglar/intrusion alarm systems.

H. Disaster Recovery

Vendor shall implement the following best practices:

1. Vendor shall have a disaster recovery plan in place for the restoration of critical processes and operations of the Vendor's Service at the hosting location from which the Vendor's Service is provided. Vendor shall also have an annually tested business continuity plan in place to assist Vendor in reacting to a disaster in a planned and tested manner. Vendor shall provide Customer with a copy of its then-current plan promptly following Customer's written request for same. Such a plan must differentiate between a failure that is contained within the Vendor's System provider's

data center (“Type A Incident”) and a failure in which an entire Vendor’s System provider’s data center is not available (“Type B Incident”). Key features and goals of the plans shall include:

(a) Recovery Point Objective (RPO)

Backup state frequency up to one (1) hour of user data in a Type A Incident and up to twenty-four (24) hours in a Type B Incident.

(b) Recovery Time Objective (RTO)

(i) Recovery time objective is three (3) hours after a critical system malfunction is detected. Up to one (1) hour assigned for attempting to fix existing conditions without resorting to full disaster recovery procedure and two (2) additional hours for full disaster recovery.

(ii) Vendor shall provide notification to Customer for any disaster that causes the Hosted Service to be down and unavailable within thirty (30) minutes of such disaster. Within one (1) day after such disaster, Vendor will recover the Vendor’s Service and Customer Data.

(iii) If Vendor’s disaster recovery plan is invoked: (1) Vendor shall execute such plan and restore the Vendor’s Service to the service availability service level required herein; and (2) Customer shall be treated with at least equal priority as any other Vendor customer.

2. Backup Management

(a) Vendor shall perform full backups of the database(s) containing Customer Data no less than once per day without interruption of the Vendor’s Service. Vendor shall also provide off-site archival storage on no less than a weekly basis of all backups of the database(s) containing Customer Data on secure server(s) or other commercially acceptable secure media. Such data backups will be encrypted, sent off-site to a secure location each business day and stored/retained for seven (7) years.

(b) In order to recover from a Type B Incident, the required backed-up data is replicated over at least three geographically dispersed data centers at any point in time. Backup snapshots may be periodically sent to another data center. Data retention for a Type A Incident utilizes twenty-four (24) hourly snapshots, fourteen (14) daily snapshots and three (3) monthly snapshots. This backup policy is designed to allow for a partial restore of the system as well as a full system restore.

3. Right to Audit

Client has the right to, or to engage a third party on its behalf to, at its own expense, visit Vendor’s offices once per calendar year in order to conduct due diligence and auditing procedures on Vendor’s business operations related to the Vendor’s Service in terms of technical infrastructure, system interaction, organization, quality, quality control, personnel involved with services for Customers, and general resources in terms of skills and personnel.

Tax Considerations for 2015

24TH ANNUAL
PRIVATE INVESTMENT FUNDS SEMINAR
JANUARY 21, 2015

Schulte Roth & Zabel

Partner
New York Office
+1 212.756.2508
noah.beck@srz.com

Practices

Tax

Noah D. Beck

Noah's practice focuses on tax aspects of domestic and cross-border mergers and acquisitions, joint ventures, spin-offs, restructurings and workouts, and private equity fund formation issues. He has advised on complex transactions including the recent public acquisition of Safeway Inc. by Albertsons and a consortium led by Cerberus Capital Management LP; the acquisition by Cerberus of the automotive interiors business of Visteon Corporation; Tiptree Financial Inc.'s sale of subsidiary Philadelphia Financial Group Inc. to funds managed by the Tactical Opportunities Group of The Blackstone Group LP; and the agreement by Cerberus Capital Management, its affiliate The Traxis Group BV and Blue Bird Corporation to sell all of the outstanding capital stock of School Bus Holdings Inc., an indirect parent company of Blue Bird, to Hennessy Capital Acquisition Corp. Prior to joining SRZ, Noah practiced at Simpson Thacher & Bartlett LLP, where he represented private equity funds, including Blackstone and KKR, in a variety of transactional and fund-related matters.

A member of the Tax Section of the New York State Bar Association, Noah is recognized as a leading lawyer by *The Legal 500 United States* and as a Rising Star, from 2012 to 2014, by *New York Super Lawyers*. He is the co-author of "The Demise of CoCos and the Tax Consequences of Exchanging Convertible Debt" (Practicing Law Institute, Corporate Tax Practice Series).

Noah earned an LL.M. and a J.D., *cum laude*, from the New York University School of Law, where he was a Robert McKay Scholar and a staff editor for the *Annual Survey of American Law*. He holds a B.A., *cum laude*, from Duke University, where he made the Dean's List with Distinction.

Partner
New York Office
+1 212.756.2124
philippe.benedict@srz.com

Practices

Tax

Real Estate Capital Markets & REITs

Philippe Benedict

Philippe focuses his practice on the tax aspects of investment funds, mergers and acquisitions, international transactions, real estate transactions and financial instruments. He has advised on many major transactions involving sales or spinoffs of investment fund managers, including Senator Investment Group LP's sale of a minority stake to The Blackstone Group LP; Caxton Associates LP's sale of a minority percent interest to the Petershill II Fund affiliated with the Goldman Sachs Group Inc.; Credit Suisse's sale of Strategic Partners to The Blackstone Group LP; and Signet Capital Management's sale of its fund-of-funds business to investment management firm Morgan Creek Capital Management LLC. Philippe advises on the tax aspects of securitizations, including his recent representation of affiliates of Fortress Investment Group LLC and affiliates of Highbridge Capital Management in the securitization of their leveraged facilities. He has also advised multiple alternative asset managers on the formation and structuring of funds, including Mount Kellett Capital Management LP on the launch of a new fund; SG Capital Partners in the formation of a new fund; Gunnar Overstrom, formerly a partner at Maverick Capital Ltd., in the formation of Three Corner Global Investors LP; Junto Capital Management LP on the launch of Junto Capital Partners LP and Junto Offshore Fund Ltd.; Trian Fund Management LP on all aspects of launching new co-investment hedge funds; Incapture Investments LLC on the launch of a systemic trading fund that relies on proprietary technology called Rapture to trade in all markets; Sachem Head Capital Management LP with the launch of hedge funds and the establishment of long/short equity funds; and Capstone Investment Advisors LLC, MKP Capital Management LLC and Scopia Fund Management LLC in their respective sales of a passive minority interest to Neuberger Berman Group-managed private equity fund Dyal Capital Partners. Philippe's recent real estate transactions include advising the Related/Oxford joint venture developing Hudson Yards on closing nearly $1.4 billion in equity investments and debt financing for the center's first tower; advising Arel Capital in a number of equity investments, including operating multi-family properties with significant retail components and ground-up development projects for modern condominium buildings in Manhattan and Brooklyn; and advising Perella Weinberg Partners on the acquisition of 50-percent ownership of interests in two hotels and the structuring of a REIT joint venture with Loews Corporation.

Chambers USA, *The Legal 500 United States* and *Tax Directors Handbook* have recognized Philippe as a leading lawyer. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and also speaks at prominent industry events. In the past year, he presented "A New Paradigm: Customized Solutions for Investors" and "Management Company Structuring and Operations" at the SRZ 23rd Annual Private Investment Funds Seminar, and he participated in "FATCA Update for Investment Fund Managers," an SRZ webinar.

Philippe earned his LL.M. in taxation and his J.D. from New York University School of Law. While pursuing his J.D., he was the recipient of a Gruss Fellowship and served on the staff of the *Journal of International Law and Politics*. He obtained his B.S., *summa cum laude*, from Adelphi University.

Partner
New York Office
+1 212.756.2542
stephanie.breslow@srz.com

Practices

Investment Management
Energy
Financial Institutions
Hedge Funds
Private Equity

Stephanie R. Breslow

Stephanie is co-head of SRZ's Investment Management Group and a member of the firm's Executive Committee. Her practice includes investment management, partnerships and securities, with a focus on the formation of private equity funds (LBO, mezzanine, distressed, real estate, venture) and liquid-securities funds (hedge funds, hybrid funds) as well as providing regulatory advice to investment managers and broker-dealers. She also represents fund sponsors and institutional investors in connection with seed capital investments in fund managers and acquisitions of interests in investment management businesses, and she represents funds of funds and other institutional investors in connection with their investment activities.

Stephanie is chair of the Private Investment Funds Subcommittee of the International Bar Association, a founding member and former chair of the Private Investment Fund Forum, a member of the Advisory Board of Third Way Capital Markets Initiative, a founding member of the Wall Street Hedge Fund Forum and a former member of its Steering Committee, and a member of the Board of Trustees of 100 Women in Hedge Funds. She is listed in *Chambers USA*, *Chambers Global*, *The Legal 500 United States*, *Best Lawyers in America*, *America's Leading Lawyers*, *Who's Who Legal: The International Who's Who of Business Lawyers* (which ranked her one of the world's "Top Ten Private Equity Lawyers"), *Who's Who Legal: The International Who's Who of Private Funds Lawyers* (which placed her on its "Most Highly Regarded Individuals" list), *Expert Guide: Best of the Best USA* (Investment Funds), *Expert Guide to the World's Leading Investment Funds Lawyers*, *Expert Guide to the World's Leading Women in Business Law* (Investment Funds), *Expert Guide to the World's Leading Private Equity Lawyers* and *PLC Cross-border Private Equity Handbook*, among other leading directories. She was named "Private Funds Lawyer of the Year" at the Who's Who Legal Awards 2014 as well as a New York State Bar Association Empire State Counsel honoree in 2014. She was also named one of *The Hedge Fund Journal*'s 50 Leading Women in Hedge Funds and the *Euromoney Legal Media Group*'s "Best in Investment Funds" at the inaugural Americas Women in Business Law Awards. Additionally, Stephanie was recognized by the Girl Scouts of Greater New York as one of 2012's Women of Distinction. Stephanie is a much sought-after speaker on fund formation and operation and compliance issues, and she also regularly publishes books and articles on the latest trends in these areas. She recently contributed to the 2014 *Fund Formation and Incentives Report* (in association with Private Equity International) and co-authored *Private Equity Funds: Formation and Operation* (Practising Law Institute), the leading treatise on the subject. She also contributed a chapter on "Hedge Funds in Private Equity" for inclusion in *Private Equity 2004-2006* (PLC Cross-border Handbooks), contributed a chapter on "Advisers to Private Equity Funds — Practical Compliance Considerations" for *Mutual Funds and Exchange Traded Funds Regulation* (Practising Law Institute, Volume 2), and wrote *New York and Delaware Business Entities: Choice, Formation, Operation, Financing and Acquisitions* (West) and *New York Limited Liability Companies: A Guide to Law and Practice* (West).

Stephanie earned her J.D. from Columbia University School of Law, where she was a Harlan Fiske Stone Scholar, and her B.A., *cum laude*, from Harvard University.

Partner
London Office
+44 (0) 20 7081 8009
nick.fagge@srz.com

Practices

Tax

Investment Management

Private Equity

Nicholas Fagge

Nick principally advises investment management clients on the structuring of U.K. management companies, covering all relevant partnership and tax issues. He also advises more widely on U.K. and international tax issues relating to the taxation of private investment funds, their U.K. investors and managers.

Nick is a Chartered Tax Adviser and associate of the Chartered Institute of Taxation, the leading body in the United Kingdom for taxation professionals dealing with all aspects of taxation. He also is a member of the Tax Committee of the Alternative Investment Management Association. A frequent speaker and writer on U.K., EU and international tax issues for various publications and engagements, Nick particularly focuses his topics on how changes in tax codes and regulations affect hedge funds and their U.K. managers. In addition to authoring numerous SRZ alerts, he most recently participated in "FATCA Update for Investment Fund Managers," an SRZ webinar, and he presented "Management Company Structuring and Operations" at the firm's London Investment Management Hot Topics seminar.

Nick completed his legal training at the College of Law and graduated from Corpus Christi College at the University of Oxford.

Partner
New York Office
+1 212.756.2510
shlomo.twerski@srz.com

Practices

Tax

Energy

Real Estate Capital Markets & REITs

Shlomo C. Twerski

Shlomo focuses his practice on the tax aspects of onshore and offshore investment funds, registered investment companies and business development companies, private equity partnerships, real estate and corporate transactions, restructurings and workouts, securitizations, and existing and emerging financial instruments. He also provides ongoing tax advisory services to a number of hedge fund managers regarding fund structuring and formation, distressed debt investments and other complex transactions.

Recognized as a leader in his field by *Chambers USA*, *The Best Lawyers in America*, *The Legal 500 United States* and the *Tax Directors Handbook*, Shlomo is also a member of the Tax Section of the New York State Bar Association. He regularly speaks at industry conferences and events, and his most recent presentations include the SRZ webinar "FATCA Update for Investment Fund Managers" and "U.S. Tax" at the Bank of America Merrill Lynch COO/CFO Hedge Fund Symposium. He is also a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) as well as various SRZ alerts.

Shlomo earned his J.D. from Hofstra University School of Law, where he was an articles editor of the *Hofstra Law Review*.

Tax Considerations for 2015

I. U.S. FATCA and U.K. FATCA

A. As of Jan. 1, 2015, the U.S. Foreign Account Tax Compliance Act ("FATCA") is fully in effect: U.S. withholding agents making payments of U.S.-source FDAP income to non-U.S. entities generally will be required to withhold 30 percent under U.S. FATCA unless the withholding agents can reliably associate the payment with a valid tax form that certifies the FATCA-compliant status of the non-U.S. entity receiving the payment.

1. Non-U.S. funds that register with the Internal Revenue Service ("IRS") and provide their prime brokers and counterparties with a valid Form W-8 that includes the fund's U.S. FATCA-compliant status and Global Intermediary Identification Number ("GIIN") should not be subject to withholding under U.S. FATCA on their U.S.-source FDAP income.

2. Non-U.S. funds that are taxed as flow-through entities with direct outside investors should also currently maintain valid forms from each underlying investor in order to avoid unnecessary U.S. FATCA withholding by counterparties in respect of undocumented underlying investors.

B. All major jurisdictions in which funds generally are organized have signed Intergovernmental Agreements ("IGAs") with the United States under U.S. FATCA, but only a few of them have issued enabling legislation putting the terms of the IGA into effect. In addition, the United Kingdom has entered into IGAs with its Crown Dependencies and Overseas Territories (such as Jersey, Guernsey, the Cayman Islands and the British Virgin Islands) to implement U.K. FATCA.

The Cayman Islands has issued regulations and Guidance Notes (Version 2.0, Dec. 15, 2014) detailing a Cayman Islands investment fund's obligations under local law. Notably, Cayman Islands funds should be mindful of the upcoming registration with the Cayman Islands Tax Information Authority. The regulations have set an original deadline of March 31, 2015 for such registration, which is expected to be delayed until April 30, 2015 in order to give the Cayman Islands Tax Information Authority enough time to roll out its registration platform.

C. As of Jan. 1, 2015, all new investors (entities and individuals) must provide certifications as to their status under U.S. FATCA and U.K. FATCA. Non-U.S. investment funds should ensure that their subscription documents contain the certifications needed under U.S. FATCA and U.K. FATCA.

1. For U.S. FATCA, collection of IRS Forms W-8 and W-9 is sufficient in many instances. However, due to the implementation of U.S. FATCA through IGAs, investment funds located in Model 1 IGA countries should also include supplemental certifications in their subscription documents that solicit information required under the IGA but not contained on Forms W-8 and W-9.

2. For U.K. FATCA, investment funds should include certifications in their subscription documents to determine if an investor is considered a "reportable account" under these rules.

D. Transfers of interests in non-U.S. investment funds require due diligence of the transferee under U.S. FATCA and U.K. FATCA, similar to the due diligence required for general subscriptions. Funds should update their transfer procedures to make sure that transferee investors provide U.S. FATCA and U.K. FATCA certifications as part of the transfer process.

E. With respect to pre-July 1, 2014 individual investors, non-U.S. investment funds should obtain valid U.S. FATCA and U.K. FATCA certifications by June 30, 2015. The due diligence of pre-existing entity investors should be completed by June 30, 2016.

F. The first U.S. FATCA report by a non-U.S. investment fund concerning its "reportable accounts" is due during 2015 with respect to the 2014 calendar year. The first report under U.K. FATCA is not due until mid-year 2016, which will cover the 2014 and 2015 calendar years. Thereafter, reports are due on an annual basis for both U.S. FATCA and U.K. FATCA with respect to the prior year. The deadline for reporting in the Cayman Islands is May 31.

G. When launching new non-U.S. fund vehicles, investment managers should add to their checklist of pre-launch tasks the need to register the new fund vehicles with the IRS under U.S. FATCA.

H. The expanded affiliated group rules continue to be a problem that investment funds face. Investment funds should continue to monitor their ownership to avoid having a majority investor that creates an expanded affiliated group.

II. Withholding Taxes on Section 305(c) Deemed Dividends on Convertible Debt

A. In general, Section 305(a) provides that distributions of stock of a corporation to its shareholders are not taxable unless covered by one of the exceptions in Section 305(b). Distributions covered by one of the exceptions under Section 305(b) are treated as taxable distributions covered by Section 301.

B. Section 305(b)(2) provides that a stock distribution is treated as a taxable distribution under Section 301 if it results in the receipt of property (including cash) by some shareholders and an increase in the proportionate interests of other shareholders in the assets or earnings of the corporation.

C. Section 305(d) provides that owners of convertible securities are treated as shareholders for purposes of Section 305(b).

D. Section 305(c) treats an increase in the conversion ratio with respect to convertible debt as a distribution of stock that must be tested under Section 305(b) to determine if it is a taxable distribution.

E. Many convertible debt issuances in the capital markets contain conversion ratio adjustment provisions that provide for an increase in the conversion ratio in the event that the issuer increases the dividend with respect to the underlying common stock. These increases would be taxable under Section 305(b)(2) by virtue of Section 305(c), because the common shareholders would receive cash while the convertible debt holders would receive an increase in their proportionate interest in the assets and earnings of the company through the conversion ratio adjustment.

F. Despite disclosure with respect to the application of Section 305(c) to convertible debt contained in the prospectuses for convertible debt, as a practical matter, proper withholding was not done in many cases.

G. The IRS has become aware of this systemic failure to account for deemed dividends and has been approached by interest groups representing withholding agents and owners of convertible debts to attempt to resolve this issue.

H. Investment funds that own convertible debt (including prior owners that have liquidated their positions) need to consider the tax and financial reporting impacts of these contingent liabilities, including the corresponding impact on net asset value ("NAV").

I. Going forward, owners of convertible debt should specifically consider the potential impact of deemed dividends (including withholding tax with respect to non-U.S. persons) on their decision to own convertible debt and ensure that they are aware of any deemed dividends so that they can comply with any taxes with respect thereto. More withholding agents are expected to implement procedures to ensure that appropriate withholding is made in the future.

J. In December 2013, the U.S. Treasury Department ("Treasury") issued proposed regulations under Section 871(m), which extend the application of Section 871(m) to a broader group of equity-linked instruments ("ELIs"), including convertible debt. In Notice 2014-14, the IRS indicated that it intends to limit the application of Section 871(m) to convertible debt issued on or after 90 days after the date of publication of the final regulations. It is not entirely clear how the rules under Section 871(m) will interact with those under Section 305(c) with respect to deemed dividends under Section 305(c). The New York State Bar Association released a report raising these overlap issues, in addition to advocating that the rules under Section 871(m) not apply to typical convertible debt as this would represent a substantial departure from the historically accepted treatment of convertible debt.

III. Inversions

A. Notice 2014-52

1. In response to the recent wave of inversions, Treasury and the IRS announced in Notice 2014-52 their intent to issue regulations designed to limit the effectiveness of certain inversion transactions that they have determined to be inconsistent with policy goals underlying existing anti-inversion rules, including Section 7874 of the Internal Revenue Code (the "Code").

2. Certain of the proposed rules effectively prevent certain inversion transactions by causing them to fail the threshold tests in Section 7874 of the Code for what constitutes an inversion. Other proposed rules would greatly diminish the effectiveness of certain post-inversion tax-minimization strategies historically employed by inverted companies, particularly those that allow inverted companies to access "trapped" foreign cash.

(a) Rules That Impact Whether a Transaction Constitutes an Inversion

(i) Regulations under Sections 7874 and 367 expanded with regard to pre-inversion "skinny-down" distributions

(ii) Regulations under Section 7874 targeting so-called "cash-box" inversions

(iii) Regulations under Section 7874 targeting "spinversions"

(b) Rules Limiting Certain Post-Inversion Tax Strategies

(i) Regulations under Section 956 expanded to cover "hopscotch" transactions

(ii) Regulations under Section 7701(l) expanded to limit post-inversion de-controlling of controlled foreign corporations ("CFCs")

(iii) Regulations under Section 304 limiting transactions designed to remove untaxed foreign exploration and production ("E&P") while bypassing tax in the United States

3. The rules proposed under Notice 2014-52 are generally proposed to be effective with regard to transactions engaged in on or after Sept. 22, 2014 by companies that inverted on or after Sept. 22,

2014. The notable exception is the proposed expansion under Section 304, which would apply to any Section 304 transactions effective on or after Sept. 22, 2014.

B. Additional Proposals

1. Notice 2014-52 and subsequent statements from Treasury and the IRS indicate a clear intent to issue additional rules limiting the ability of inverted companies to enter into transactions that strip income out of the United States, including through intercompany debt. The scope and form of such rules is unknown at this time, though it is expected that any rules applying only to inverted companies would apply to companies that inverted on or after Sept. 22, 2014.

IV. LP Medicare

A. Medicare Taxes in General

1. Individuals who are not employees are subject to self-employment taxes on their net income from self-employment under Section 1401 of the Code. The Medicare portion of the tax mirrors the Medicare tax relating to employees and is 2.90 percent of the first $200,000 of self-employment income ($250,000 for a married couple filing jointly, and $125,000 for a married taxpayer filing separately) and 3.80 percent of any additional self-employment income.

2. Self-employment income subject to the tax includes, as a general matter, the portion of a partner's distributive share of the income and loss from any trade or business carried on by the partnership, whether or not the income is distributed.[1]

B. Limited Partner Exception[2]

1. "Limited partners" are not subject to self-employment taxes on their distributive share of a partnership's income. They are subject to such taxes on any guaranteed payments.

2. The term "limited partner" is not defined in Section 1402 of the Code. The exception was enacted in 1977.

3. The Joint Committee on Taxation has subsequently referred to state law for the determination of "limited partner" status.[3]

C. Proposed Regulations and Moratorium

1. In January 1997, Treasury issued proposed regulations to define a "limited partner" for self-employment tax purposes and excluded individuals who participate in the partnership's business for more than 500 hours during the applicable taxable year.[4]

2. Congress responded with a moratorium, prohibiting the issuance of any such regulations before July 1, 1998 or any such regulations effective prior to such date.[5] No regulations have subsequently been issued.

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[1] Code § 1402(a).

[2] Code § 1402(a)(13).

[3] *See, e.g.*, Options to Improve Tax Compliance and Reform Tax Expenditures (JCS-02-05) (Jan. 27, 2005), at 97.

[4] Proposed Regulations § 1.1402(a)-2(h)(2), REG-209824-96 (Jan. 13, 1997).

[5] Taxpayer Relief Act of 1997, Pub. L. 105-34, § 935 (Aug. 5, 1997).

D. Statutory Proposals: Congress has tried to enact legislation to eliminate the limited partner exception for limited partners who materially participate in a professional service business carried on by a partnership. For example, such a provision was included in earlier drafts of the American Jobs and Closing Tax Loopholes Act of 2010 and was passed by the House before the provision was removed from the text of the final legislation.

E. *Renkemeyer, Campbell and Weaver LLP v. Commissioner*, 136 T.C. 137 (2011)

1. In *Renkemeyer*, the Tax Court held that the service partners of a Kansas limited liability partnership were subject to self-employment taxes on their distributive share of the entity's income.

2. In reaching its conclusion, the Tax Court first analyzed whether the LLP's members were limited partners under Kansas state law. The Kansas LLP law arose out of the Kansas general partnership law and not a limited partnership statute, and so the Tax Court found that state law was not determinative in this case.

3. The Tax Court also looked to the legislative history for guidance. It noted that the statutory exception was intended to apply to passive investors.

F. Chief Counsel Advice 201436049

1. On May 20, 2014, the Office of Associate Chief Counsel for the IRS advised that the members of an investment management firm structured as a limited liability company were not limited partners within the meaning of the statutory exception. Of particular note, the members were actively engaged in the company's trade or business and also received W-2s from the management company reporting wages.

2. The Chief Counsel Advice is limited to the specific facts of the taxpayers involved and cannot be used as precedent. As with *Renkemeyer*, the entity involved was not a limited partnership under state law, and so the members technically were not "limited partners" of such a limited partnership.

G. Where Are We Now?

1. It appears that a limited partner of a state law limited partnership should still benefit from the statutory exception in the absence of legislative changes or new regulations.

2. Both the Tax Court and the IRS have shown themselves to be reluctant to extend the statute's protection to anyone not in a state law limited partnership, especially where the individual provides full-time services to the partnership's trade or business.

V. United Kingdom's Taxation of Carried Interest and "Disguised Fee Income"

The U.K. government has issued draft legislation to change the way in which fund managers are taxed on amounts that they receive for the provision of investment management services as part of arrangements that include partnerships. The new rules are intended to have an effect on all relevant amounts received by fund managers on or after April 6, 2015.

The announcement of the proposed new measures described them only as intended to prevent fund managers from attempting to obtain more favorable capital gains treatment on their management fee income by taking such income in the form of a partnership profit share. However, the draft legislation is much broader, and the new rules, as currently drafted, potentially have a significant impact on fund managers receiving incentive allocations or carried interest from funds structured as partnerships.

The new measures are currently set out in draft legislation and are likely to be amended before the effective date in light of comments received from investment management industry bodies and other interested parties. However, fund managers should be aware that there will be changes in this area and that their ability to obtain capital gains treatment on carried interest or other incentive allocations may be restricted in the future.

A. The Proposed Measures

Under current law, fee income received by fund managers from the provision of investment management services is generally treated as trading income, subject to income tax (45 percent) and national insurance contributions (2 percent). However, where a fund manager receives a profit allocation from a fund structured as a partnership (including by way of a carried interest), that profit allocation retains its underlying character in the hands of the fund manager and is taxed accordingly. Where the profit allocation is an allocation of capital gains of the partnership fund, the fund manager is subject to capital gains tax (28-percent rate).

The new measures in the draft legislation set out that where an individual provides investment management services with respect to a fund and there is a partnership involved in the fund arrangements, then any amount arising directly or indirectly to the individual from the fund (which could be by way of profit allocation, loan, advance, dividend or in any other form) that is "untaxed" is treated as a "disguised fee." An amount is "untaxed" for these purposes in every case other than where the individual is subject to tax on the amount as employment income or trading income.

Where an individual receives such "disguised fees," the individual will be subject to income tax and national insurance contributions on the "disguised fees" as if the individual were carrying on a trade and the disguised fees were the profits of that trade. Where the investment management services are to any extent performed in the United Kingdom, the deemed trade that gives rise to the "disguised fees" is treated as carried on wholly in the United Kingdom.

There are only two exceptions under which "untaxed" amounts received by an individual are not treated as "disguised fees." First, amounts will not be "disguised fees" if they fall within a new statutory definition of "carried interest." Where an individual receives an amount from a fund paid out of profits after investors have received back all or substantially all of their investment together with a preferred return at least equal to compound interest of 6 percent on their investment (either on a "fund as a whole" or a "deal by deal" model), the amounts received will meet the statutory definition of "carried interest" and will be excluded from the scope of "disguised fees." Secondly, amounts that arise to an individual by way of repayment of an investment made by the individual, or which constitute a commercial rate of return on an investment made by the individual, will not be "disguised fees."

B. Some Implications

The restrictive definition of "carried interest" used in the draft legislation — which requires that all investors receive back their invested capital and at least a 6-percent compound interest preferred return before any carried interest is payable to the managers — would mean that in most cases individuals performing investment management services in the United Kingdom and receiving compensation in the form of incentive allocations or other participation in the profits of the fund would be subject to income tax and national insurance contributions.

Where the investment management services that give rise to the "disguised fees" are to any extent performed in the United Kingdom, the "disguised fees" are treated as profits of a trade carried on wholly in the United Kingdom. In this case, the "disguised fees" would be treated as United Kingdom-source trading income of the individual manager, so that the remittance basis of taxation would not be available regarding this income to an individual manager who was non-U.K. domiciled. A non-U.K. domiciled investment manager in receipt of "disguised fees" from investment management services performed to any extent in the United Kingdom would be subject to U.K. income tax and national insurance contributions on an "arising basis."

It is also possible to read the draft legislation as suggesting that where a non-U.K. resident individual with no connection to the United Kingdom receives an incentive allocation or other fund participation which is generated to any extent from investment management services carried on in the United Kingdom (for example, by a subsidiary or affiliated U.K. management entity), that allocation or participation will be treated, for U.K. tax purposes, as profits of a trade carried on in the United Kingdom so that the non-U.K. resident individual would be subject to U.K. income tax on those deemed U.K. trading profits. Although the effects of this might be mitigated to some extent by an available double tax treaty, there remains the possibility of increased and/or double taxation.

C. Future Developments

It is clear that further discussions will need to take place with Her Majesty's Revenue & Customs ("HMRC"), the U.K. tax authority, to determine the boundaries of the proposed new rules, eliminate or alleviate any unintended consequences of the way in which the proposed new rules are now drafted, and clarify the interaction of the proposed new rules with existing legislation. It is hoped that revised draft legislation will remove anomalies and narrow the scope of the provisions, so as to move closer to the U.K. government's expressed intent in introducing the new rules.

VI. OECD Base Erosion and Profit Shifting (BEPS) Project: Action Point 6 — Preventing Treaty Abuse

On Nov. 21, 2014, the Organisation for Economic Co-operation and Development ("OECD") published a Public Discussion Draft titled "Follow Up Work on BEPS Action 6: Preventing Treaty Abuse" (the "Discussion Draft"). The Discussion Draft builds on the proposals outlined in the OECD's Sept. 16, 2014 Report on Action 6 (the "September Report") for changes to the OECD's Model Tax Convention and related Commentary to deal with the issue of "treaty abuse" or "treaty shopping." The Discussion Draft acknowledges that further work is required to determine how the proposed treaty abuse measures outlined in the September Report should apply to funds and collective investment vehicles. However, the Discussion Draft still does not provide detailed proposals or substantive discussion and remains essentially a request for public comment and evidence in this area.

A. The September Report

The initial focus of the OECD's BEPS Project was seemingly on the prevention of perceived treaty abuse by multinational groups. The September Report identified two possible approaches:

1. The inclusion in the OECD Model Tax Convention of a "limitation of benefits" ("LOB") rule aimed at identifying cases where income arises to an entity in a treaty jurisdiction but is ultimately received by persons outside that jurisdiction; or

2. The inclusion of a Principal Purpose Test ("PPT"), which denies treaty benefits where it is reasonable to conclude that obtaining the treaty benefit was one of the principal purposes of the arrangement or transaction under consideration.

OECD member states will have flexibility as to whether to adopt either or both of the proposed approaches into their bilateral tax treaties. It is possible that some OECD member states might choose to adopt both recommendations, including both an LOB and a PPT.

It is difficult to draw any definitive conclusions as to the potential application and impact of a PPT, given that it becomes almost inevitably a subjective test. However, it is clear that, where a PPT is adopted, taxpayers will need to give careful consideration in structuring their arrangements to whether a revenue authority or court might conclude that the obtaining of treaty benefits was one of the principal purposes of the way in which their arrangements have been structured.

The proposed LOB clause is more formulaic. If a tax treaty were to include an LOB, treaty benefits would only be available to an entity resident in the treaty jurisdiction if the entity was in one or more of the following categories:

1. A "qualifying person" (broadly, a publicly traded entity or an entity that meets certain ownership or base erosion tests);

2. Engaged in the active conduct of a trade or business;

3. Owned as to at least 95 percent by "equivalent beneficiaries" and meeting certain "base erosion" tests (so that treaty benefits remain available where the economic benefit arises to persons who would have been entitled to treaty benefits if they had received the income directly); or

4. A person who does not fall into any one of the preceding three categories but obtains a clearance from the relevant tax authority that the LOB should not apply (which is intended to be granted only where it is not a principal purpose of the entity to obtain tax benefits under the treaty).

The effects on funds and collective investment vehicles include the following:

1. It has become commonplace for funds to rely on claims under double tax treaties to reduce or eliminate withholding taxes on dividend or interest income arising on the assets in which they invest. This may be because the fund itself is an entity located in a treaty jurisdiction or, more commonly, the fund may establish trading subsidiaries in treaty jurisdictions to hold relevant assets and claim double tax treaty benefits. An LOB clause as included in the first Action Point 6 proposals would have denied treaty benefits in either case.

2. The September Report proposed a number of different approaches that could be adopted by treaty states to address the particular position of funds:

   (a) Treaty states could take no special measures to address the position of funds and have the LOB apply to them in full (which would in practice deny treaty benefits to most funds);

   (b) Treaty states could adopt deeming measures that would have the effect of automatically disapplying the LOB in the case of funds (for example, by deeming funds to be individuals for treaty purposes);

   (c) Treaty states could expand the definition of "qualified person" to include funds within its scope. It is, however, likely that treaty states would not do this on an unrestricted basis, but would instead seek to impose conditions around the kinds of fund that would come within the expanded definition of qualified person (for example, by reference to the locations of the fund's investor base or whether the fund was held by a widely diversified group of investors); or

   (d) Treaty states could rely upon the discretion permitted to tax authorities in the LOB to grant treaty benefits to funds on a discretionary basis in each particular case.

3. These various approaches highlight a number of significant issues that would arise for funds in determining the availability of treaty benefits.

   (a) The proposals give a wide discretion to treaty states to adopt different approaches in dealing with the application of an LOB to funds and even potentially a discretion to apply an LOB on a fund-by-fund basis. This wide range of possible approaches may give rise to a lack of certainty for funds and a difficulty in achieving consistency across jurisdictions. A fund or trading subsidiary located in a particular jurisdiction may be entitled to treaty benefits with respect to income received from some jurisdictions, but it may be denied treaty benefits with respect to income received from other jurisdictions.

   (b) Depending on the approach that treaty states adopt to funds, funds may have to closely analyze the identities and jurisdictions of their investor basis (and possibly divulge that information to a taxing authority) in order to determine and evidence the fund's entitlement to treaty benefits. In some cases, this may impose a substantial and disproportionate administrative and monitoring burden.

   (c) The various approaches focus on the status and nature of the fund itself. The question of whether treaty benefits should be available to trading subsidiaries of funds, special purpose vehicles or other intermediate entities does not seem to have been considered.

B. The Discussion Draft

1. The Discussion Draft (Nov. 21, 2014) acknowledges some of these issues for funds but does not propose or discuss detailed solutions.

2. For example, the Discussion Draft notes that the Action Point 6 Working Group is considering the degree of discretion that may be afforded to treaty states and examining whether it might be possible to develop a single preferred approach to the position of funds. However, the Working Group wants to ensure that any solutions that may be developed for funds address the issues in a way that does not create treaty-shopping opportunities. Given the wide diversity of funds that exist and that seek treaty benefits (including a wide diversity of types of entity, investment portfolio and investor base), it seems unlikely that any kind of "one-size-fits-all" solution could be effective.

3. The Discussion Draft also acknowledges the existence of trading subsidiaries and intermediate entities and invites comments as to how treaty benefits could be afforded to such entities without creating treaty-shopping concerns. It still seems likely that any possible solution would involve a look-through to the ultimate investors in the fund to determine the grant of treaty benefits.

4. Finally, the Discussion Draft suggests the inclusion of guidance (presumably in the Commentary to the relevant provision of a revised Model Tax Convention) identifying the factors that tax authorities should take into account when considering whether to make a discretionary grant of treaty benefits where other conditions of an LOB are not met. Consistent with the current approach of the Commentary, this could include illustrative examples and would be intended to give greater clarity as to when a discretionary grant is likely to be made. Stakeholders are invited to submit examples and relevant factors for inclusion. Whilst such guidance might be useful, it seems unlikely that a discretionary process involving tax authorities could ever be a complete solution to the problem for funds and others seeking treaty benefits.

5. The Discussion Draft is useful as an indication of the Working Group's direction of travel, although it is clear that much work remains to be done before a revised version of the Model Tax Convention and Commentary can be produced (slated for September 2015) and potentially adopted in whole or

part by treaty states. Much of the Discussion Draft is a request for views, evidence and examples from stakeholders. Given the importance of the issues to the funds industry, and the lack of clarity as to how some of the proposed measures may apply to funds, this is an invitation that a number may wish to take up.

C. Future Implementation

It is important to recognize that changes to the OECD Model Tax Convention and its related Commentary do not have any effect in and of themselves. Any changes will have legal effect only where OECD Member States choose to adopt these changes (in whole or in part) into their own bilateral double tax treaties with one another. Even where there is a willingness or desire on the part of OECD Member States to adopt the new measures, it is likely that the negotiation and implementation of amendments to bilateral double tax treaties will take some time. The actual effect of the proposed changes may not be felt for at least two or three years.

VII. Certain Tax Considerations for MLP Investments

A. Direct Investments

1. Offshore Funds: U.S. Trade or Business

(a) To the extent a master limited partnership ("MLP") is engaged in a U.S. trade or business, an offshore fund that holds interests in such MLP will be deemed to be engaged in such U.S. trade or business, and income and gain passed through from the MLP would be subject to U.S. income and branch profits tax.

(b) Rev. Rul. 91-32: Non-U.S. partners' gain from disposition of interest in a partnership engaged in a U.S. trade or business is treated as effectively connected income.

(c) Owning more than 5 percent of an MLP can also result in Foreign Investment in Real Property Tax Act ("FIRPTA") gain if the MLP owns U.S. real property interests.

2. Onshore Funds: There are state and local tax filing obligations for investors in onshore funds due to business operations of MLPs in those states and localities.

B. Alternative: Investing in MLP Through Swap

1. Stay at or below 5 percent to avoid FIRPTA issue

2. Avoid "crossing in"/"crossing out"

3. Avoid bearing counterparty hedging expenses

4. No voting rights

C. Issues for U.S. Taxable Investors

1. The preamble to the proposed Treasury regulations calls for a "reasonable tax accounting method" for total return swaps.

(a) "Wait and see method" deemed to be not a "reasonable tax accounting method"

(b) Some practitioners require total return swaps to be marked to market annually

(c) Mark to market results in ordinary income or ordinary expense

(d) If fund is not "trader," swap expenses are subject to significant deductibility limitations

(e) "Bullet swap" alternative

D. Not Subject to Mark to Market

E. Capital Gain/Capital Loss Under Section 1234A

1. Application of Section 1260

(a) If a long-term capital gain is recognized on an MLP swap, the gain is converted to ordinary income, except to the extent that any long-term capital gain the fund would have realized if it had directly invested in the MLP.

(b) A nondeductible interest charge may also be imposed on income tax liability attributable to the portion of a gain treated as ordinary income under Section 1260.

(c) Section 1260 is not applicable to short-term gains from swaps not exceeding one year; swaps can be renewed for successive one-year terms.

(d) If wash sale rules disallow a loss deduction on the swap (do wash sale rules apply to MLP positions?), attention must be given to the long-term holding period of a successor position.

ERISA: From No Plan Assets to Managing Plan Assets

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Schulte Roth & Zabel

Partner
New York Office
+1 212.756.2141
david.cohen@srz.com

Practices

Employment &
Employee Benefits

Hedge Funds

Private Equity

Regulatory & Compliance

Trading Agreements

David M. Cohen

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 SRZ, David 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 in *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. He is also a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). David recently presented "What You Need to Know When ERISA Plans Come Knocking" at the SRZ London Breakfast Briefing and "Current Fiduciary Issues" at the Practising Law Institute Pension Plan Investments 2014: Current Perspectives conference.

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

Jennifer Dunn

Partner
New York Office
+1 212.756.2009
jennifer.dunn@srz.com

Practices

Investment Management
Hedge Funds
Private Equity

Jennifer advises hedge funds, private equity funds (including mezzanine and distressed funds), hybrid funds, funds of funds and investment advisers in connection with their structuring, formation and ongoing operational needs, general securities law matters, and regulatory and compliance issues. Her experience includes structuring and negotiating seed and strategic investments, advising investment managers regarding the structure and sale of their investment management businesses and the structure of their compensation arrangements, and representing investment managers in connection with managed accounts and single-investor funds.

Recognized by *The Legal 500 United States* and the *Expert Guide to the World's Leading Women in Business Law* (Investment Funds) and as an IFLR 1000 Rising Star (Investment Funds), Jennifer recently co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and presented at conferences sponsored by the New York City Bar Association, 100 Women in Hedge Funds, KPMG and Bank of America Merrill Lynch. She also presented "Marketing Opportunities and Challenges" at the SRZ 23rd Annual Private Investment Funds Seminar and participated in the "Allocation of Investment Opportunities Workshop" at an SRZ Investment Management Hot Topics seminar.

Jennifer earned her J.D. from Columbia University Law School, where she was a Harlan Fiske Stone Scholar, and her B.A., *cum laude*, from the University of Pennsylvania.

Partner
New York Office
+1 212.756.2567
steven.fredman@srz.com

Practices

Investment Management
Hedge Funds
Private Equity
Regulatory & Compliance
Securities & Capital Markets

Steven J. Fredman

Steve is co-head of SRZ's Investment Management Group. He concentrates his practice in the areas of investment funds (domestic and offshore), investment advisers and broker-dealers, the acquisition and related financing of investment management firms, and securities regulation. Steve structures and organizes private investment partnerships and offshore funds, including general equity, arbitrage, global investment, private equity, distressed company, small cap and funds of funds, and he counsels clients on issues relating to partnership law, new product development and other matters. He also structures and organizes investment advisers and broker-dealers, handles the registration of commodity pool operators and commodity trading advisers, and provides ongoing advice to investment advisers on securities laws, rules, regulations and information. He represents clients in connection with the acquisition and sale of investment management firms or their assets as well.

Steve is recognized by many ranking publications, including *Chambers Global*, *Chambers USA*, *The Legal 500 United States*, *Expert Guide: Best of the Best USA* (Investment Funds), *Expert Guide to the World's Leading Investment Funds Lawyers*, *Expert Guide to the World's Leading Private Equity Lawyers*, *International Who's Who of Private Funds Lawyers* and *The Best Lawyers in America*. A past member of the American Bar Association's Committee on Partnership and the New York City Bar Association's Committee on Art Law, Steve is a frequent speaker and writer in his areas of expertise. He most recently presented at the Goldman Sachs Seventeenth Annual Hedge Fund Conference, and he discussed "Distressed Investments: Structured Products" at the SRZ 23rd Annual Private Investment Funds Seminar. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and "Asset Manager M&A Deals," an SRZ white paper.

Steve holds a J.D. from Georgetown University Law Center, where he was an editor of *Law and Policy in International Business*, and a B.A. from Columbia University, where he was Phi Beta Kappa.

Partner
New York Office
+1 212.756.2529
ian.levin@srz.com

Practices

Employment &
Employee Benefits

Mergers & Acquisitions

Executive Compensation

Ian L. Levin

Ian's practice concentrates on executive compensation and employee benefits, with a focus on the employee benefit aspects of mergers and acquisitions and issues arising from the investment of pension plan assets. He represents both executives and companies with respect to the negotiation and drafting of executive employment agreements and advises as to the design and establishment of virtually all types of employee benefit arrangements ranging from cash incentive, equity, deferred compensation and change-in-control arrangements to broad-based retirement and welfare plans. He also advises clients on fiduciary and plan asset requirements of ERISA, including the structure and offering of various securities and securities products; the formation and ongoing compliance of private equity and hedge funds; the administration, management and investment of employee benefit plans; and compliance with ERISA's various prohibited transaction rules and exemptions.

Ian has been recognized as a leading employment and employee benefits attorney by *The Legal 500 United States*, which noted that he "operates at a very high level across many areas, but brings a particularly unique set of skills to ERISA Title I matters in his representation of private investment funds." He also serves as an adjunct professor at New York Law School. Ian has written articles for *The Metropolitan Corporate Counsel* about ERISA and incentive-based compensation regulations, and his recent speaking engagements include addressing several New York City Bar Association conferences.

Ian received his LL.M. from New York University School of Law, his J.D. from Emory University School of Law and his B.A. from Union College.

Partner
New York Office
+1 212.756.2048
ronald.richman@srz.com

Practices

Employment & Employee Benefits

Mergers & Acquisitions

Regulatory & Compliance

Insurance

Executive Compensation

Ronald E. Richman

Ron is co-head of SRZ's Employment & Employee Benefits Group and a member of the firm's Executive Committee. His practice concentrates on the litigation of employment and employee benefits cases in federal and state courts throughout the United States involving trade secrets, non-competition, non-solicit, and breach of confidentiality and breach of loyalty issues. Ron defends employee benefit plans, fiduciaries, and employers in class actions and in cases brought by individual plaintiffs. He represents employee benefit plans before the U.S. Department of Labor, the Pension Benefit Guaranty Corporation and the Internal Revenue Service in connection with novel issues of law concerning plan mergers, terminations, spin-offs, fiduciary duties and prohibited transactions, and various aspects of withdrawal liability and mass withdrawal liability. He also represents employers (particularly hedge and private equity funds), employees and partners with respect to executive compensation and partnership issues.

Recognized by *New York Super Lawyers* and *The Best Lawyers in America* as a leading labor and employment litigation attorney, Ron is a Fellow of the American College of Employee Benefits Counsel and a member of the CPR Employment Dispute Committee of the CPR Institute for Dispute Resolution. He is a former board member for the Lawyers Alliance for New York and a former adjunct professor in the New York University School of Continuing Education's Certified Employee Benefits Specialist Program. Ron frequently speaks and writes on employee benefits and employment topics of interest to the human resources community. He most recently presented "Understanding Pension Plan Liabilities" at the SRZ 3rd Annual Distressed Investing Conference, and he participated in an SRZ Employment & Employee Benefits Luncheon for Investment Managers. He also recently published "ERISA Presumption of Prudence in 'Stock Drop' Cases Rejected" in the *New York Law Journal*.

Ron received his J.D. from Columbia University School of Law, where he was a Harlan Fiske Stone Scholar and the recipient of the Emil Schlesinger Labor Law Prize, and his B.S. from the Industrial and Labor Relations School at Cornell University.

ERISA: From No Plan Assets to Managing Plan Assets

Introduction

The Employee Retirement Income Security Act of 1974 ("ERISA") imposes significant responsibilities (so-called "fiduciary responsibilities") on persons who manage or provide services to employee benefit plans, directly or through so-called plan asset look-through vehicles, and it imposes important restrictions on transactions involving employee benefit plans (or involving the investment of the assets of such plans). Additional responsibilities and restrictions are imposed under the Internal Revenue Code of 1986 (the "Code"). This outline summarizes the most important of these rules and restrictions applicable to managers of hedge funds in circumstances in which investment in the fund by employee benefit plans causes the hedge fund to be a "plan asset look-through vehicle."

ERISA operates by: (1) prohibiting broad categories of transactions between a plan and the people who manage or provide services to the plans; (2) providing statutory exemptions from all or part of the prohibitions for specific kinds of transactions; and (3) permitting the Department of Labor ("DOL") to grant individual or industry-wide exemptions ("class exemptions") from all or part of the prohibitions for specific kinds of transactions. Therefore, analyzing whether a particular transaction is permissible is usually a two-step process: First, does the transaction or service fall within the broad prohibitions? If so, then second, is any exemption available to permit the transaction or service? To the extent that an exemption is available, the hedge fund manager must understand and strictly comply with the conditions set forth in the exemption. Failure to do so may render the exemption meaningless.

This outline is organized as follows:

Section I contains a discussion of the terms used in ERISA and summarizes the broad prohibitions of ERISA.

Section II discusses the circumstances in which the investment by employee benefit plans in a hedge fund will cause the fund to be a plan asset look-through vehicle that is subject to ERISA, and the consequences to the fund's investment manager if the fund attains plan asset look-through status.

Section III discusses the consequences to an ERISA-covered plan of investing in a plan asset look-through hedge fund.

Section IV discusses a specific class exemption (the so-called "QPAM Exemption") issued by the DOL that permits certain categories of transactions and services in the event that a hedge fund attains plan asset look-through status.

Section V discusses a specific statutory exemption that permits certain categories of transactions and services in the event that a hedge fund attains plan asset look-through status.

Section VI discusses special prohibited transaction concerns that arise in managing a plan asset look-through hedge fund and how to handle those concerns.

Section VII discusses increasing ERISA capacity while trying to avoid plan asset look-through status, also known as "the hard wired feeder concept."

I. General Application of the Fiduciary Provisions

A. Coverage

1. ERISA

The fiduciary responsibility and prohibited transaction provisions of Title I of ERISA, which impose responsibilities on plan fiduciaries and which regulate plan dealings with providers of services and other parties in interest, apply generally to "employee benefit plans," whether or not such plans are "qualified plans" under the Code.[1] However, a DOL regulation provides that the term "employee benefit plan" does *not* include: (1) an individual retirement account, annuity or bond created by an individual employee, to which his employer does not contribute;[2] (2) a plan which covers only the sole owner of a business (incorporated or unincorporated) and/or his spouse (a "one-man" plan);[3] or (3) a plan which covers only partners and their spouses (a "partner-only" plan).[4]

NOTE: Although IRAs, one-man plans and partner-only plans are not covered by ERISA's fiduciary responsibility rules, they *are* subject to restrictions imposed by the Code, as discussed below.

ERISA also excludes from its fiduciary responsibility rules those plans maintained by governmental bodies, certain plans maintained by churches and certain plans maintained by private employers primarily for the purposes of providing deferred compensation for a select group of management or highly compensated employees. However, plans maintained by tax-exempt organizations *other* than governmental bodies and churches *are* subject to ERISA's fiduciary responsibility provisions,[5] and governmental plans may be subject to ERISA-like fiduciary responsibility rules imposed under state law.

2. Internal Revenue Code

The provisions of the Code regulating transactions involving employee benefit plans apply to individual retirement accounts, annuities or bonds, and so-called "qualified plans" (including one-man plans and partner-only plans). Although the prohibited transaction provisions of the Code generally do not apply to non-qualified employee benefit plans, they do continue to apply to a plan that was once qualified but later became disqualified.[6]

NOTE: It is important to keep in mind that, since IRAs, one-man plans and partner-only plans are subject to the Code, the prohibited transaction rules imposed by the Code apply to these accounts and plans even though they are exempt from the ERISA fiduciary responsibility rules. The fiduciary obligations imposed solely by ERISA, which do *not* apply, are summarized in part D of Section I. The prohibited transaction rules, which are imposed both by ERISA and by the Code, and which *do* apply to IRAs, one-man plans and partner-only plans, are summarized in part E of Section I.

B. Definition of Fiduciary

ERISA and the Code regulate the activities of "fiduciaries." A person is a fiduciary with respect to a plan asset look-through hedge fund to the extent he or it:

[1] ERISA § 401(a); 3(3).

[2] Labor Reg. § 2510.3-2(d).

[3] Labor Reg. § 2510.3-3(b).

[4] Labor Reg. § 2510.3-3(b).

[5] DOL News Release (Jan. 12, 1987).

[6] Code § 4975(e)(1).

1. Exercises any discretionary authority or control with respect to the management of a fund or the management or disposition of the fund's assets;

2. Renders investment advice to the fund for a fee or compensation, direct or indirect, with respect to any moneys or property of the fund or has any authority or responsibility to do so; or

3. Has any discretionary authority or discretionary responsibility in administering the fund.[7]

This statutory test is a purely functional test. Thus, the fiduciary of a plan asset look-through hedge fund will be the entity that calls the investment shots for the fund. Depending on the structure of the fund, this may not be the general partner of a partnership, the managing member of an LLC or the board of directors of an offshore corporation if such person or entity does not perform any of the functions set forth in the statute and quoted above.

C. Definition of Party in Interest

ERISA and the Code also restrict transactions involving a plan and a "party in interest." The Code does not use the term "party in interest" but refers instead to a "disqualified person." The definition of a "disqualified person," though not identical to that of "party in interest," is sufficiently similar so that, for simplicity, the term "party in interest" will be deemed to include a "disqualified person" for purposes of this outline. A "party in interest" is defined to include:

1. Any fiduciary (including by definition a trustee);

2. Any person providing services to a plan;

3. An employer whose employees are covered by the plan;

4. A union or other employee organization whose members are covered by the plan;

5. An owner of a 50-percent or more interest in an entity described in (3) or (4);

6. A relative of an individual described in (1), (2), (3) or (5). "Relative" includes a spouse, ancestor, lineal descendant or spouse of a lineal descendant;[8]

7. An entity 50 percent or more of which is controlled, directly or indirectly, by individuals or entities described in (1), (2), (3), (4) or (5);

8. An employee, officer, director or a person directly or indirectly controlling 10 percent or more of an individual or entity described in (2), (3), (4), (5) or (7); or

9. A person who is a 10 percent or more partner or joint venturer in an individual or entity described in (2), (3), (4), (5) or (7).[9]

(The percentages in (7), (8) and (9) may be, but have not been, lowered by regulation.)

D. General Duties of a Fiduciary

[7] ERISA § 3(21)(A); Code § 4975(e)(3).

[8] ERISA § 3(15); Code § 4975(e)(6).

[9] ERISA § 3(14); Code § 4975(e)(2); Advisory Opinion 75-147.

Under ERISA, a fiduciary's general obligations with respect to a plan asset look-through hedge fund are, briefly, the following:

1. He must discharge his duties solely in the interest of participants and beneficiaries of the investing ERISA-covered employee benefit plans for the exclusive purpose of providing benefits under and defraying reasonable administrative costs of such plans.[10]

2. He must act with the care, skill, prudence and diligence under the prevailing circumstances that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and like aims.[11]

3. He must diversify plan investments so as to minimize the risk of large losses (with certain very limited exceptions).[12]

4. He must discharge his duties in accordance with the documents governing the investing plans to the extent that such documents are consistent with ERISA.[13]

5. Except as authorized by regulation, he may not maintain title to assets of the fund outside the jurisdiction of the district courts of the United States.[14] The DOL issued a regulation that allows certain persons to maintain assets outside the United States under limited circumstances.[15] Under this regulation, a fiduciary may purchase securities issued by a foreign corporation or governmental entity, or whose principal trading market is outside of the United States, if the fiduciary is a corporation or partnership organized under United States or state law that has its principal place of business in the United States, provided that the fiduciary is a registered investment adviser (or a bank or insurance company) with $50,000,000 under management and either: (1) over $750,000 in shareholders' or partners' equity; or (2) all of its liabilities are assumed or guaranteed by a bank, insurance company, another investment adviser with over $750,000 in shareholders' or partners' equity, or a registered broker or dealer with a net worth of over $750,000.

6. He may not permit the fund to acquire or hold employer securities or employer real property of the investing plans in excess of certain specified limitations.[16]

Under applicable DOL regulations, a fiduciary is considered to satisfy the requirement that he act with the care, skill, prudence and diligence of a prudent man with respect to his investment duties if, with regard to a particular investment or investment course of action, he gives appropriate consideration of the facts and circumstances which, given the scope of his investment duties, he knows or should know are relevant to a particular investment or investment course of action. Thus, under the regulation, the fiduciary should consider the role that the particular investment or investment course of action plays in the fund's overall investment portfolio. The fiduciary should determine whether the particular investment or investment course of action is reasonably designed, as part of the fund's investment portfolio, to further the purpose of the fund given the risk of loss and opportunity for gain (or other

[10] ERISA § 404(a)(1)(A); Code § 401(a).

[11] ERISA § 404(a)(1)(B). This is sometimes referred to as the prudent expert standard. It is a higher standard than the common law fiduciary standard of a general partner to a partnership.

[12] ERISA § 404(a)(1)(C).

[13] ERISA § 404(a)(1)(D).

[14] ERISA § 404(b).

[15] Labor Reg. § 2550.404b-l.

[16] ERISA § 406(a)(2).

return) associated with the investment. Among the factors that a fiduciary should consider are the composition of the fund's investment portfolio and its diversity or lack thereof, the liquidity, rate of return and cash flow needs of the fund and the projected return from the fund's investments relative to other types of investments.

E. Prohibited Transactions

Under ERISA, a fiduciary may not engage in a prohibited transaction with a plan asset look-through hedge fund nor cause the fund to engage in a prohibited transaction with a party in interest. The penalties imposed on fiduciaries and on parties in interest for violations of these rules are discussed in detail in Appendix A. Except as otherwise indicated below, these rules are imposed both by ERISA and by the Code.

1. Prohibited transactions involving fiduciary self-dealing:

(a) Dealing with the assets of the plan in the fiduciary's own interest or for his own account (e.g., effecting a securities transaction through a broker-dealer that is an affiliate of the plan asset look-through hedge fund manager or purchasing a security with fund assets for the purpose of maintaining the price of the security for the benefit of such a broker-dealer or its other customers).[17]

(b) Acting on behalf of a party whose interests are adverse to the interests of the plan in any transactions involving the plan (e.g., the manager of a plan asset look-through hedge fund crosses the fund's securities trades with another hedge fund managed by the same manager).[18] (ERISA only.)

(c) Receiving any consideration for its own account from any party dealing with the plan in connection with a transaction involving the plan's assets (e.g., the manager of a plan asset look-through hedge fund receives a fee or other thing of value from an unaffiliated broker in return for the manager selecting that broker to execute trades for the fund).[19]

These prohibited transaction rules are intended to prevent the fiduciary from engaging in any acts of self-dealing or in transactions where the fiduciary has, or may have, a conflict of interest.

2. Prohibited transactions between a party in interest (including any fiduciary) and a plan asset look-through hedge fund:

(a) Sale, exchange or lease of property.[20]

(b) Loans and other extensions of credit, including margin loans and short sales. (However, see the exemption for certain margin loans and short sales discussed below in Section IV of this outline.)[21]

(c) Furnishing of goods, services or facilities.[22]

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[17] ERISA § 406(b)(1); Code § 4975(c)(1)(E).

[18] ERISA § 406(b)(2).

[19] ERISA § 406(b)(3); Code § 4975(c)(1)(F). A violation of this section may give rise to criminal penalties. 18 U.S.C. § 1954.

[20] ERISA § 406(a)(1)(A); Code § 4975(c)(1)(A).

[21] ERISA § 406(a)(1)(B); Code § 4975(c)(1)(B).

(d) Transfers to, or use by a party in interest of, any fund assets.[23]

(e) Subject to certain exceptions, acquisition by a party in interest, on behalf of the fund, of any employer security or employer real property.[24] (ERISA only.)

F. Liability for Breach of Co-Fiduciary

In addition to any liability that a fiduciary may have for his own breaches of fiduciary duty, he is liable for the breach of another fiduciary of the same plan asset look-through hedge fund if:

1. He knowingly participates in or undertakes to conceal a breach of fiduciary duty which he knows to be a breach;

2. He enabled such fiduciary to commit the breach by not discharging his own fiduciary duties properly; or

3. He is aware that the breach has occurred, unless he takes reasonable steps to remedy the breach.[25]

Accordingly, if one plan fiduciary has knowledge of another plan fiduciary's breach of fiduciary responsibility, he has an affirmative duty to make reasonable efforts to remedy the breach. Failure to do so will expose the fiduciary to potential liability for the acts of the offending fiduciary. The DOL regulations provide that mere resignation is not sufficient to discharge the fiduciary's positive duty to make reasonable efforts to remedy a breach.[26]

II. Determining If a Hedge Fund Holds Plan Assets

In 1986, the DOL promulgated a regulation (commonly referred to as the "Plan Asset Regulation")[27] to set forth the circumstances under which the assets of an entity in which a "benefit plan investor" invests will be treated as "plan assets" of such investor (and the entity will thus be treated as a plan asset look-through entity). In August 2006, the Pension Protection Act enacted new rules (Section 3(42) of ERISA) for determining when an entity in which a benefit plan investor invests will be treated as a "plan asset vehicle." These rules supersede, in part, the Plan Asset Regulation.

Generally, under the Plan Asset Regulation (as modified by Section 3(42) of ERISA), when a benefit plan investor purchases an equity interest of an entity which is neither a publicly offered security, nor a security issued by an investment company registered under the Investment Company Act of 1940, the benefit plan investor's assets will include only its equity interest in the entity. However, if benefit plan investors own 25 percent or more of any class of the equity interests in the entity, that entity will be a plan asset look-through entity. As a result, the benefit plan investor's assets will include not only its equity interest in the entity, but also an undivided interest in each of the underlying assets of the entity. Further, any entity providing services to the entity will be deemed to be providing services to each of the investors that is subject to

[22] ERISA § 406(a)(1)(C); Code § 4975(c)(1)(C).

[23] ERISA § 406(a)(1)(D); Code § 4975(c)(1)(D). This prohibition would bar the investment manager of a plan asset look-through hedge fund from receiving any soft dollars from the broker-dealers through which the investment manager executes the fund's trades. However, in Technical Release 86-1, the DOL recognized that Section 28(e) of the Securities Exchange Act of 1934 was passed after ERISA and thus preempts ERISA's ban on the receipt of soft dollars. This preemption only applies to "soft dollars" that fall completely within the scope of Section 28(e). Thus, a manager's receipt of non-28(e) soft dollars (such as rent subsidies, free trips, apartment rentals, etc.) would be prohibited.

[24] ERISA § 406(a)(1)(E).

[25] ERISA § 405(a).

[26] Labor Reg. § 2509.75-5 FR-10.

[27] Labor Reg. § 2510.3-101.

ERISA and/or the prohibited transaction provisions of the Code, causing the service provider to be a party in interest to each such investing plan. Similarly, the investment manager of the entity will be deemed to be providing investment management services to each of the investors that is subject to ERISA and/or the prohibited transaction provisions of the Code. Accordingly, the investment manager of a plan asset look-through entity will be a fiduciary to each such investing plan and thus subject to ERISA's fiduciary responsibility provisions discussed in Section I of this outline.

Under Section 3(42) of ERISA, the determination of whether an entity is a plan asset vehicle is made immediately after the most recent acquisition of any equity interest in the entity. Section 3(42) of ERISA further provides that this determination must be made by disregarding the value of any equity interests held by a person (other than a benefit plan investor) who has discretionary authority or control with respect to the assets of the entity or any person who provides investment advice for a fee (direct or indirect) with respect to such assets, or any affiliate of such a person.

Neither Section 3(42) of ERISA nor the Plan Asset Regulation addresses the treatment of a redemption of an equity interest or an intra-family transfer; the term "acquisition" is undefined. In an advisory opinion letter (Advisory Opinion 89-05A) dated April 5, 1989, the DOL indicated that, in its view, the redemption of a partner's equity investment in a partnership would constitute an acquisition, triggering a test of the level of benefit plan investor participation in the entity because the redemption would result in an increase in the interests of the remaining partners. The DOL also stated that, in its view, intra-family transfers of equity interests in a partnership, whether by devise or inheritance, also would trigger the benefit plan investor level of participation test.

Section 3(42) of ERISA defines the term "benefit plan investor" to include: (1) any employee benefit plan, as defined in Section 3(3) of ERISA, that is subject to the provisions of Title I of ERISA (e.g., U.S. private pension and health and welfare plans); (2) a plan that is subject to the prohibited transaction provisions of Section 4975 of the Code (e.g., ERISA-covered employee benefit plans, individual retirement accounts and Keogh plans); and (3) any entity whose assets are treated as "plan assets" by reason of an employee benefit plan's investment in the entity, but only in the proportion that is equal to benefit plan investor ownership of the entity. Appendix B provides a list of common types of plans and entities that are considered benefit plan investors.

The Plan Asset Regulation provides that an "affiliate" of a person includes any person, directly or indirectly, through one or more intermediaries, controlling or controlled by, or under common control with, the person. For purposes of this definition, "control" with respect to a person other than an individual means the power to exercise a controlling influence over the management or policies of such person.

The Plan Asset Regulation sets forth three special exceptions under which benefit plan investors will not be deemed to have an interest in the underlying assets of an entity, regardless of the amount of equity in the entity that is held by benefit plan investors. First, if the security is a publicly offered security; second, if the entity is an operating company; and third, if the entity is an investment company registered under the Investment Company Act of 1940.

III. Consequences to an ERISA-Covered Plan of Investing in a Plan Asset Look-Through Hedge Fund

A. Trustees May Be Relieved of Their Duty to Manage Plan Assets

ERISA provides that the trustees of a plan are vested with the exclusive authority and discretion to manage the assets of the plan.[28] The trustees must fulfil this responsibility in accordance with the

[28] ERISA § 403(a)(1).

fiduciary responsibility provisions of ERISA discussed in part D of Section I of this outline. Thus, regardless of their financial education or sophistication, the trustees of the plan will be held to an extremely high standard of behavior. Congress recognized that this was somewhat unfair and thus relieved the trustees of their responsibility for day-to-day management of the plan's assets as long as the authority to manage and control the assets of the plan has been delegated to an investment manager.[29]

ERISA provides that if an investment manager has been appointed, the trustees will not be liable for the acts or omissions of the investment manager, nor will they be obligated to invest or otherwise manage the assets entrusted to the investment manager.[30] This major relief was enacted to encourage professional plan management. However, the relief is only available if the entity that is managing plan assets meets the definition of an investment manager set forth in Section 3(38) of ERISA. ERISA defines an investment manager to include a bank, an insurance company and, most significantly, a registered investment adviser.[31] Thus, hiring an unregistered adviser provides no relief for the plan trustees. In fact, the opposite is true. The trustees will retain full liability for the acts or omissions of the unregistered adviser as if they were the acts or omissions of the trustees themselves. It is for this reason that the investment manager of a plan asset look-through hedge fund must be registered as an investment adviser unless the manager is either a bank or an insurance company. Without that, the trustees of each benefit plan investor that is an ERISA-covered plan will be responsible for the individual decisions of the plan asset look-through hedge fund manager as if they themselves made those decisions.

B. Special Reporting Requirements

In general, each benefit plan investor that is covered by ERISA or the prohibited transaction provisions of the Code is required to file an annual report (Form 5500) with the DOL and the IRS. One item required by the annual report is a list of all the assets of the plan, including the fair market value of each asset. Therefore, each plan is required to include information regarding each asset held by a plan asset look-through hedge fund. However, as an alternative, each such plan may include on its annual report solely the value of its interest in the hedge fund, provided that the hedge fund files certain information with the DOL regarding the hedge fund's investments and expenses for the year. Many plans prefer to rely upon this alternative, and the fund should furnish timely valuation information to each such plan investor.

As a separate matter, beginning in 2009, the DOL began to require a plan to report certain direct and indirect compensation paid by the plan in connection with its investments. A plan is expected to request this information from the various investment managers and investment vehicles in which the plan invests. This information is filed on Schedule C to the plan's Form 5500. In connection with a plan asset look-through hedge fund, all of the compensation that the plan is required to report would be indirect compensation unless the plan paid a placement agent directly in connection with its investment in the hedge fund. Indirect compensation includes the management and incentive fees paid by the hedge fund, brokerage amounts in excess of pure execution fees, entertainment received by the hedge fund manager from its service providers, and any other fees paid to the hedge fund manager by third parties in connection with the investment of the hedge fund's assets (for example, if an entity in which the hedge fund invests then pays consulting fees to the hedge fund manager or an affiliate because of the hedge fund's investment in that entity). Plans request this compensation information in many different formats, and we suggest that the investment manager of a plan asset look-through hedge fund develop

[29] ERISA § 403(a)(2).

[30] ERISA § 404(d)(1).

[31] ERISA § 3(38).

its own model response rather than attempting to complete the various forms it receives from the ERISA-covered investors.

C. Bonding Requirement

To protect employee benefit plans against loss as a result of fiduciary misconduct, ERISA requires that certain plan fiduciaries be bonded in an amount equal to the lesser of 10 percent of the funds handled by such fiduciaries or $500,000.[32] The Pension Protection Act of 2006 raised this number to $1 million if a plan holds securities of its plan sponsor. However, it is unclear whether every fiduciary handling a plan's assets needs to maintain the $1 million (rather than $500,000) coverage, or only those who invest in employer securities. A letter was filed with the DOL on this issue that took the position that if a fiduciary does not invest in employer securities, it should be allowed to purchase the lower bond, regardless of whether other investment managers for the plan have purchased the plan sponsor's securities. If the DOL's response is that every manager of a plan holding employer securities will have to purchase a $1 million bond, then the investment manager of a plan asset look-through hedge fund would purchase the bigger bond as it is highly unlikely that the investment manager would keep tabs on the plan's other holdings.

Regardless of the answer to the question regarding the amount of the ERISA Section 412 bond, the investment manager of a plan asset look-through hedge fund must obtain such a bond, which names the client plan as the insured. In the alternative, the investment manager may provide by contract that each ERISA-covered investing plan will cover the investment manager of the fund on an agent's rider to the plan's fidelity bond. This complies with the provisions of Section 412 of ERISA, but larger plans often push back on this requirement and may require the manager to agree to obtain the bond in a side letter.

IV. Class Exemption from the Prohibited Transaction Rules of ERISA for Qualified Professional Asset Managers

In 1984, in recognition of the fact that the definition of the term "party in interest" was so broad that it caused many beneficial and appropriately priced transactions to become prohibited, the DOL granted extensive relief to professional asset managers in their dealings with "remote" parties in interest with respect to their plan clients. PTCE 84-14 (the "QPAM Exemption")[33] provides that a plan that is managed by a qualified professional asset manager ("QPAM") may enter into a transaction described in Section 406(a) of ERISA (such as a loan, lease, provision of services, etc. between a plan and a party in interest) which would otherwise be prohibited if, at the time of the transaction: (1) neither the party in interest nor any of its affiliates has the power to hire or fire the QPAM or to negotiate the terms of the QPAM's management agreement (effectively excluding transactions with the employer sponsoring the plan and its affiliates); (2) it is not a party in interest with respect to a plan or plans of the same employer whose assets constitute 20 percent or more of the QPAM's assets under management;[34] and (3) the party in interest is not the QPAM itself or any of its affiliates. In this scenario, the transaction will not constitute a prohibited transaction as long as the QPAM alone negotiated the terms of the transaction (i.e., the QPAM must have discretionary control over the assets involved in the transaction, and no plan sponsor veto is allowed) and the terms of the transaction were arm's-length terms.

Part VI of the exemption defines a QPAM to include a bank, S&L, insurance company or, most importantly, a registered investment adviser with $85 million under management as of the last day of its most recent fiscal

[32] ERISA § 412.

[33] 49 Fed. Reg. 9494 (March 13, 1984).

[34] In the plan asset look-through entity context, each underlying client of the entity would be measured separately, rather than counting the entity itself as one client of the investment manager.

year and shareholder's or partner's equity (determined under U.S. Generally Accepted Accounting Principles) of at least $1 million. The $1 million determination is made based on the investment adviser's most recent balance sheet prepared within the last two years preceding the transaction for which QPAM relief is required. However, for convenience, this determination is typically based on the adviser's balance sheet as of the last day of its most recent fiscal year. If an investment adviser fails the net worth test, it may still be a QPAM if the investment adviser and its affiliates together have shareholder's or partner's equity in excess of $1 million and certain affiliate(s) unconditionally guarantee to pay all of the investment adviser's liabilities, including any liabilities that may arise if the investment adviser violates any of its fiduciary obligations to the plan or violates any of the prohibited transaction rules.

The QPAM Exemption provides extensive relief for an investment manager of a plan asset look-through hedge fund, particularly if its investment strategy involves the acquisition of securities on margin, short sale transactions, or entering into swaps. In all of these cases, the transactions give rise to extensions of credit between the plan and the broker-dealer executing the transaction (and are thus prohibited under Section 406(a)(1)(B) of ERISA).[35] The QPAM Exemption allows the QPAM freely to enter into transactions involving the extension of margin credit and to pay interest on any margin debt created in short selling without the need to keep a list of all broker-dealers providing services to the plan.[36] In addition, in connection with a short sale program managed by a QPAM, the plan may borrow the stock (typically from a broker-dealer) to cover the short sale without the need to examine whether the lender is a party in interest. As discussed above, the only limitations in both cases are that the party extending credit cannot be the QPAM or an affiliate of the QPAM, nor can the party possess the power to hire or fire the QPAM.

Another example of the relief provided by the QPAM Exemption is that it allows the investment manager of a plan asset look-through hedge fund to enter into principal trades with broker-dealers that provide execution services to one or more of the fund's benefit plan investors. Because the broker-dealer is a service provider to each such plan, the trade would violate the prohibition of Section 406(a)(1)(A) of ERISA that bars a sale or exchange of property between a plan and a party in interest. The QPAM Exemption permits the transaction to occur, again assuming that the broker-dealer is neither the QPAM nor an affiliate of the QPAM, nor does it possess the power to hire or fire the QPAM. As another example of the usefulness of the QPAM Exemption, it has become common for a hedge fund of funds to borrow from a bank on a short-term basis to fund investments and redemptions. Just as the QPAM Exemption permits extensions of credit in connection with trading on margin and short sales, so it permits extensions of credit in such situations, even if the bank is otherwise a party in interest to a benefit plan investor in the plan asset look-through hedge fund of funds.

On Aug. 23, 2005, the DOL adopted significant changes to the QPAM Exemption.[37] The revised exemption narrows the definition of who is an affiliate of the entity that has the power to hire and fire the QPAM. Moreover, the revised exemption completely removes the prohibition against the QPAM dealing with a party in interest that has the power to hire and fire the QPAM if the QPAM is managing a plan asset look-through pooled investment vehicle in which at least two unrelated ERISA-covered plans invest. The only exception to this liberalization arises if the counterparty to a transaction had the power to cause a plan to invest in the plan asset look-through pooled investment vehicle and that plan holds 10 percent or more of the equity in the pooled investment vehicle. The DOL has opined that if the ABC plan invests in a plan asset look-through

[35] By executing the securities transactions of a plan asset look-through hedge fund, the broker-dealer becomes a party in interest (as a service provider) to each benefit plan investor in the hedge fund. Because the broker-dealer is a service provider, the extension of credit violates Section 406(a)(1)(B) of ERISA.

[36] While providing exemptive relief from the prohibition against extensions of credit, the purchase of securities on margin and the existence of margin debt in short-sale transactions may cause income derived from these investments to be deemed to be "debt financed income" subject to the unrelated business income tax under Sections 512 and 514 of the Code. Accordingly, an investment adviser should seek assurance from the investing plan that no governing plan documents specifically prohibit investments that could subject the plan to the unrelated business income tax.

[37] 70 Fed. Reg. 49305 (Aug. 23, 2005).

hedge fund through several funds of funds, or through a combination of a direct investment and an indirect investment through a fund of funds, ABC plan's direct and indirect investments in the underlying hedge fund are not aggregated for purposes of determining whether ABC plan owns 10 percent or more of the equity in the underlying plan asset look-through hedge fund.

There are three types of transactions specifically enumerated in the QPAM Exemption for which the QPAM Exemption does not provide relief. For a plan asset look-through hedge fund, the most important of these transactions is securities lending. If the borrower of the securities is a party in interest with respect to any benefit plan investor in a plan asset look-through hedge fund, the loan of securities will violate Section 406(a)(1)(b) of ERISA. Although the QPAM Exemption does not provide relief for such transactions, a separate class exemption, Prohibited Transaction Exemption 2006-16[38] for securities lending, and the statutory exemption for dealings with "remote" parties in interest set forth in Section 408(b)(17) of ERISA (discussed in Section V of this outline), provide sufficient relief to allow the investment manager of a plan asset look-through hedge fund to engage in securities lending on behalf of the fund. Although not mentioned in the QPAM Exemption, in the preamble to Prohibited Transaction Exemption 2006-16, the DOL raised a question as to whether repurchase agreements were not structurally the same as securities loans.[39] Although not providing a definitive answer, the DOL's discussion of this issue has led a number of investment managers of plan asset look-through hedge funds and their counterparties to conclude that the QPAM Exemption may not permit repurchase agreements between the fund and the counterparty. Instead, the parties to the transaction will often rely on the statutory exemption for dealings with "remote" parties in interest set forth in Section 408(b)(17) of ERISA (discussed in Section V of this outline).

V. General Exemption for Transactions with Service Providers

As part of the Pension Protection Act of 2006, Congress recognized that the prohibited transaction rules were in need of modernization, particularly in light of consolidation in the financial services industry and the very broad definition of the term "party in interest." This broad definition has had the effect of preventing many otherwise beneficial transactions between plans and parties in interest to such plans that have no particular influence over the investment decisions of a plan fiduciary. Accordingly, the Pension Protection Act added Section 408(b)(17) of ERISA,[40] a new statutory exemption that permits a fiduciary with respect to a plan to cause the plan to enter into an otherwise prohibited: (1) sale, exchange or lease of property; (2) loans including a margin loan; or (3) transfer to, or use by a party in interest of, any plan assets, with a party in interest. Section 408(b)(17) of ERISA sets forth two conditions to the very broad relief provided thereunder. First, the party in interest dealing with the plan cannot be a fiduciary with respect to the investment of the plan assets involved in the transaction. Second, the plan must receive no less, nor pay no more, than adequate consideration with respect to the transaction.

In the case of a security traded on a national exchange, Section 408(b)(17) of ERISA defines adequate consideration as the price on the exchange taking into account factors such as size of the transaction and marketability of the security. In the case of a security that is not traded on a national exchange, Section 408(b)(17) of ERISA defines adequate consideration as a price not less favorable than the offering price for the security as established by the current bid and ask quotes of a party independent of the issuer and the party in interest to the transaction, again taking into account factors such as size of the transaction and marketability of the security. In the case of an asset other than a security for which there is a generally recognized market, Section 408(b)(17) of ERISA defines adequate consideration as the fair market value of the asset as determined in good faith by a fiduciary or fiduciaries in accordance with DOL regulations.

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[38] 71 Fed. Reg. 63786 (Oct. 21, 2006).

[39] 71 Fed. Reg. 63786, 63792 (Oct. 21, 2006).

[40] ERISA § 408(b)(17) and parallel Code § 4975(d)(20).

In the context of a plan asset look-through hedge fund, Section 408(b)(17) of ERISA would permit the investment manager of the fund to enter into transactions with a "party in interest" to a benefit plan investor in the hedge fund as long as the counterparty were not acting in a fiduciary capacity with respect to the particular transaction. Thus, in a typical counterparty transaction relying on the relief provided in Section 408(b)(17) of ERISA, there will be a representation in the documents evidencing the transaction that the counterparty is not a fiduciary to the plan asset look-through hedge fund and its benefit plan investors because the counterparty is not providing the investment manager with advice with respect to the transaction that is being relied upon by the investment manager in consummating the transaction. In theory, the relief provided by Section 408(b)(17) of ERISA should replace the need for the investment manager of a plan asset look-through hedge fund to be a QPAM (but not a registered investment adviser) because it provides very broad relief for the transactions exempted under the QPAM Exemption. However, because this section of ERISA is so new and the DOL has issued no regulations thereunder, most counterparties continue to insist on QPAM representations before they will enter into transactions with a plan asset look-through hedge fund.

VI. Special Prohibited Transaction Concerns That Arise in Managing a Plan Asset Look-Through Hedge Fund

A. Payment of Performance-Based Compensation (Incentive Allocation/Fees)

As a fiduciary, the investment manager of a plan asset look-through hedge fund is generally not permitted to deal with the assets in his own interest, or act on behalf of a party whose interests are adverse to those of the fund. Thus, the investment manager may not cause the fund to pay a performance-based fee (i.e., an incentive allocation or fee) in circumstances in which the investment manager can impact the amount of its fees by its own actions. However, according to applicable DOL advisory opinions,[41] an investment manager may receive performance-based compensation (i.e., receive an incentive fee or allocation) in the following factual situation:

1. The investment manager is registered under the Investment Advisers Act of 1940;

2. The decision to retain the investment manager and to pay the incentive fee is made by each fiduciary of each benefit plan investor, and such fiduciary must be independent of the investment manager;

3. Each benefit plan investor has total assets of at least $50 million;

4. No more than 10 percent of each benefit plan investor's total assets are placed in the fund (i.e., under the control of the investment manager);

5. The investment manager generally invests the fund's assets in securities for which market quotations are readily available, and if market quotations are not readily available (e.g., illiquid securities that are not regularly traded), the securities are valued by a qualified party who is independent of the investment manager and who is selected by the benefit plan investors;

6. The investment manager's services may be terminated on reasonably short notice under the circumstances;

7. The incentive fee arrangement complies with the terms and conditions of Securities and Exchange Commission Rule 205-3 governing performance-based compensation;

[41] *See* Adv. Op. 86-20A (BDN Advisers Inc.), Adv. Op. 86-21A (Batterymarch Financial Management) and Adv. Op. 89-31A (Alliance Capital Management LP).

8. The total fees paid to the investment manager do not exceed reasonable compensation for services performed by the investment manager;

9. Securities purchased or sold by the investment manager on behalf of the fund are not securities for which the investment manager (or an affiliate) is a market-maker;

10. The incentive fee is determined based on annual performance, taking into account both realized and unrealized gains and losses, and where the investment manager's services are terminated on a date other than an anniversary date, net profit is determined for the period from the commencement of the preceding full year through the termination date; and

11. Each benefit plan investor's plan fiduciary represents that it fully understands the formula for calculating the incentive fee and the risks associated with such an arrangement.

While the relevance of each of the above facts is open to discussion, two are clearly fundamental. First, the ability of the investment manager to control the amount of its compensation by assigning its own values to the hedge fund's assets could give rise to an act of self-dealing prohibited by Section 406(b)(1) of ERISA. Of course, this would also be true even if the manager is compensated purely on the basis of assets under management. However, the DOL has chosen to focus on manager valuation of the assets only in connection with the payment of performance-based compensation. In order to avoid prohibited transaction issues, the investment manager of a plan asset look-through hedge fund must not set its compensation by setting the value of the fund's securities. That does not necessarily require the fund to hire an independent valuator to determine the value of all of the assets, or even of the non-liquid securities. However, the manager must set forth in advance and in a fully disclosed manner to the benefit plan investors how pricing will be determined from (and by) external sources. The subscription agreement will then serve as the consent of the benefit plan investors to the stated valuation methodology.

Second, the incentive fee must be determined based on performance that takes into account both realized and unrealized gains and losses. In the view of the DOL, taking an incentive allocation on realized gains without taking into account unrealized gains and losses clouds the investment judgment of the investment manager, such that he no longer acts in the sole interest of the benefit plan investors, and gives rise to an act of self-dealing. In the DOL's view, paying on realized gains only provides the investment manager with an incentive to: (1) sell the winners and hold onto the losers; and (2) sell the winners early, in each case in order to generate current fees at the expense of the needs of the ERISA investors.

It should be noted that the factual statement set forth in the advisory opinions that the performance fee is to be measured over a one-year period merely reflects the state of Securities Exchange Commission Rule 205-3 at the time the DOL issued its advisory opinions. This one-year requirement has no independent existence under ERISA, nor is it linked to any of the prohibited transaction provisions of the statute. Similarly, neither the requirement that a plan investing in an entity that will pay performance-based compensation have assets of at least $50 million, nor the requirement that the plan have no more than 10 percent of its assets managed by a manager receiving performance-based compensation, have any independent existence under ERISA, nor are they linked to any of the prohibited transaction provisions of the statute. They are merely facts regurgitated by the DOL from the submissions received from the parties requesting the advisory opinions. However, it is clear that the independent plan fiduciary making the decision to invest in the hedge fund must have the sophistication necessary to make a meaningful determination that the investment is in the best interests of the plan he represents.

B. Employer Securities

ERISA restricts the ability of a benefit plan investor to hold securities issued by the sponsoring employer (or any affiliate of the sponsoring employer) of any benefit plan investor ("employer securities").[42] Accordingly, the investment manager of a plan asset look-through hedge fund may desire to restrict the acquisition of employer securities. Thus, if, for example, the XYZ Pension Plan is an investor in a plan asset look-through hedge fund, the investment manager of the fund should consider restricting the purchase of XYZ stock or debt. In the absence of a self-imposed prohibition, a plan asset look-through hedge fund could acquire "qualifying employer securities"[43] if the value of the qualifying employer securities (when combined with "qualifying employer real property") held by the benefit plan investor does not exceed 10 percent of the value of the benefit plan investor's assets. Each benefit plan investor is considered to have a proportionate interest in each asset of the hedge fund. Thus, if the XYZ Pension Plan's assets equal $100 million, the plan invests 8 percent of its assets directly in XYZ stock and acquires 5 percent of the hedge fund, a violation of ERISA would occur if the hedge fund acquires more than $40 million of XYZ stock because the XYZ Pension Plan will be deemed to have invested 10 percent of its assets in the XYZ stock (i.e., 8 percent directly and 2 percent indirectly through its investment in the hedge fund).

Unless a plan asset look-through hedge fund is willing to monitor its compliance with the ERISA employer security holding limitations every time it purchases employer securities, either: (1) the hedge fund should not invest in employer securities; or (2) the hedge fund's subscription agreement should provide for an acknowledgement by the fiduciary of the benefit plan investor that the investment manager is not taking on responsibility for monitoring compliance with the plan's ERISA restrictions imposed on the acquisition and holding of employer securities, and acknowledging that this is the responsibility of the subscribing fiduciary. The investment manager may also wish to include an indemnity with respect to this acknowledgement from the fiduciary acting on behalf of the benefit plan investor.

C. Investments in Other Entities

If a hedge fund is a plan asset look-through fund of funds, the investment manager will need to determine whether the underlying hedge funds in which it wishes to invest will permit investments from a plan asset look-through entity. If benefit plan investors own 25 percent or more of any class of equity interests in an underlying fund that accepts investments from such a plan asset look-through fund of funds, then such underlying hedge fund would be a plan asset look-through hedge fund subject to all of the rules discussed in this outline. Further, in such a situation, the investment manager of the fund of funds steps into the shoes of the plan trustees with respect to its responsibility to invest the assets of the hedge fund of funds. Thus, if the manager of the underlying hedge fund was not a registered investment adviser, the manager of the investing plan asset look-through hedge fund of funds would be liable for each of the investment decisions of the manager of the underlying plan asset look-through hedge fund.

On the other hand, just as a trustee sheds its responsibilities for the day-to-day investment of plan assets by hiring a registered investment adviser to manage the plan assets, so the investment manager of a plan asset look-through hedge fund of funds can shed its investment responsibilities for the

[42] ERISA §§ 406(a)(1)(E), 406(a)(2), 407(a).

[43] A "qualifying employer security" includes both stock and marketable obligations of the benefit plan investor's sponsoring employer, provided that no more than 25 percent of the outstanding stock or marketable obligations at the time of acquisition is held by the benefit plan investor, at least 50 percent of the outstanding stock or marketable obligations is held by persons independent of the sponsoring employer, and, in the case of marketable obligations, immediately following the acquisition, no more than 25 percent of the benefit plan investor's assets are invested in marketable obligations of the sponsoring employer.

investment of the assets in an underlying plan asset look-through underlying fund. In order to shed these responsibilities, the investment manager of a plan asset look-through hedge fund of funds should be appointed by the ERISA plans investing in the hedge fund of funds as a "named fiduciary" (within the meaning of Section 402 of ERISA) of each of such ERISA plans, for the limited purpose of investing in underlying plan asset look-through hedge funds. Of course, the investment manager of any underlying plan asset look-through hedge fund must also be a registered investment adviser, or the delegation will be ineffective. (See the discussion in part A of Section III of this outline.)

VII. Increasing ERISA Capacity While Trying to Avoid Plan Asset Look-Through Status: "The Hard Wired Feeder Concept"

ERISA-covered pension plan investors are a growing source of assets flowing into hedge funds. While many corporations have frozen their traditional defined benefit pension plans (i.e., no new benefits are accruing under the plan), those plans still have billions of investible assets, and investment time horizons of 20 to 40 years. Further, many of these plans are underfunded as a result of the recession of 2008 and the resulting low interest rates. Thus, internal corporate pension plan managers are seeking to invest more assets in alternative vehicles in the hopes of obtaining higher investment returns than those available from traditional asset classes, such as fixed income. At the same time, some hedge funds are facing redemptions from non-pension investors rebalancing portfolios or still addressing liquidity needs, while their pension investors have often remained invested in such funds. The convergence of these two factors is leading some hedge funds to approach the 25-percent limitation on benefit plan investors' investment in the fund. Accordingly, many managers are looking for ways in which to increase ERISA capacity without subjecting their hedge fund to the fiduciary responsibility provisions of ERISA.

A common approach to providing expanded ERISA capacity while at the same time avoiding subjecting the hedge fund and its manager to the fiduciary responsibility provisions of ERISA involves restructuring an existing master-feeder structure, or establishing a new master-feeder structure in place of existing arrangements. In this scenario, each feeder into the master fund is "hard wired" into the master fund. Thus, all of the investible assets of each of the feeder funds are invested in the master fund, which makes all of the investments. None of the feeders make their own investments. The feeder funds may maintain a minimal amount of cash to pay expenses, but in many cases the feeder funds do not even do that. Rather, a feeder fund will receive distributions from the master fund every time it has an expense to pay (which typically is not that often given the minimal role played by the feeder funds). The offering memorandum for the feeder funds will often refer to them as mere conduits into the master fund and will specifically state that the feeder funds are not making their own independent investments.

The "hard wired" master-feeder structure assumes that there is only one class of equity interests at the master fund (although sometimes there is a second class that holds the investments by the manager or its affiliates). After restructuring or establishing a "hard wired" master-feeder structure, an offshore feeder fund will often have one or more classes of equity interests exceeding the 25-percent limitation on investment by benefit plan investors. However, the master fund, where the capital from all of the feeder funds is aggregated, will be under 25 percent plan assets. Thus, even though the offshore feeder fund is a benefit plan investor, only a portion of its investment in the master fund is counted as benefit plan investor capital. At the onshore feeder fund, little if any investment will have come from benefit plan investors. Thus, no part of the onshore feeder fund's investment in the master mund is counted as benefit plan investor capital. When properly structured, the non-benefit plan investor capital from the offshore and onshore feeder funds will exceed 75 percent of the capital in the only class of shares of the master fund, and thus neither the master fund nor its investment manager are subject to ERISA.

The position taken at the offshore feeder fund is that while the offshore feeder fund is a plan asset look-through vehicle, the "manager" of the offshore feeder fund is not acting as an ERISA fiduciary when it invests the assets from the offshore feeder fund into the master fund. Further, there is nothing other than ministerial actions for the "manager" of the offshore feeder fund to undertake in connection with the management of the offshore feeder fund. Thus, in our view, the "manager" of the offshore feeder fund is not acting as an ERISA fiduciary of the investing benefit plan investors for any reason. Accordingly, there is no need to appoint the "manager" of the offshore feeder fund as an "investment manager" within the meaning of Section 3(38) of ERISA with respect to the ERISA plans investing in the offshore feeder fund. Although this position has been endorsed by many practitioners, there is no authority on point, and we are aware of no "hard wired" master-feeder fund structure that provides for the investing benefit plan investors to appoint the "manager" of the offshore feeder fund as their "investment manager" within the meaning of Section 3(38) of ERISA.

The principal downside to the "hard wired" master-feeder structure is that it eliminates the flexibility to invest at the feeder fund level. Thus, this structure will not be appropriate for all investment strategies given the tax and regulatory issues connected with certain investments (e.g., ECI and FIRPTA). Among the items that need to be considered and actions that need to be taken to convert an already existing master-feeder structure into a "hard wired" master-feeder structure are the following:

A. Review the hedge fund's current investment program to determine if all of the investments can be made at the master fund level.

B. Review the hedge fund's existing and prior investments to determine if all are or were at the master fund level, or if some are or were at the feeder fund level.

C. If there are or were feeder fund level investments, determine if all those investments could have been made at the master fund level (or can be transferred to the master fund in the case of existing feeder fund investments).

D. Determine if the hard wiring of the feeder funds constitutes a material change in the investment program.

E. If hard wiring gives rise to a material change in the investment program, determine if investor consent, or redemption right, will be necessary.

F. Review the master fund to determine how many classes of shares exist at the master fund, and if there are multiple classes at the master fund level, determine if they can be merged.

G. Contact the ERISA investors to inform them of the proposed hard wiring and discuss any issues they may have with such a structure.

H. Review the offering memorandum for each of the feeder funds and determine the revisions necessary to reflect the hard wiring and the position that the "manager" of the offshore feeder fund is not acting as an ERISA fiduciary to the ERISA investors by investing the assets of the offshore feeder fund into the master fund.

I. Revise the investment management agreements for the feeder funds to reflect the hard wiring, stripping the agreements of all language that suggests discretionary investing at the feeder fund level.

J. Revise the limited partnership agreement of the onshore feeder fund to reflect the hard wiring, stripping the agreements of all language that suggests discretionary investing at the onshore feeder fund level.

K. Send a letter to the ERISA investors in the offshore feeder fund stating that the investment manager is not acting as an ERISA fiduciary in investing the assets of the offshore feeder fund into the master fund and obtain consent to the statement that the fiduciaries of the ERISA investors will never assert a position to the contrary.

L. Amend subscription agreements to include the statement that the investment manager is not acting as an ERISA fiduciary in investing the assets of the offshore feeder fund into the master fund and obtain consent to the statement that the fiduciaries of the ERISA investors will never assert a position to the contrary.

M. Address the need for the offshore feeder fund to obtain an ERISA fidelity bond covering each of the ERISA investors or provide for the ERISA investors to cover the "manager" of the feeder fund on an agent's rider to the ERISA investor's own fidelity bond.

As a general rule, we have found little or no resistance to the conversion of an existing master-feeder structure into a hard wired master-feeder structure and allowing the offshore feeder fund to exceed the 25-percent limit as long as the master fund is kept under 25 percent plan assets. However, there are two issues that do arise from ERISA investors. First, certain funds of funds that are benefit plan investors have promised their ERISA investors that the fund of funds would not invest in a plan asset fund. Many of those funds of funds have accepted that investing in a "hard wired" master-feeder structure in which the master fund is not a plan asset vehicle complies with the fund of funds' promise to its ERISA investors, though not all. In those situations where a fund of funds that is a benefit plan investor is not willing to invest in a "hard wired" offshore feeder fund that is over 25 percent plan assets, we recommend that an ERISA-only offshore feeder fund be set up to accommodate the existing ERISA investors that are willing to make the switch as well as for new ERISA investors. Those ERISA investors that state that they may not invest in a plan asset vehicle would remain in the original offshore feeder fund, which continues to be below the 25-percent ERISA threshold and thus is not a plan asset vehicle. A second issue that arises from ERISA investors involves the fidelity bond mandated by ERISA for anyone who "handles" pension money. Whether the "manager" of the offshore feeder fund needs to obtain the fidelity bond and who pays for the bond are the subject of negotiation. ERISA would permit the ERISA investor to cover the "manager" of the offshore feeder fund as an agent on the ERISA investor's own fidelity bond, but plans and funds of funds that are themselves benefit plan investors are sometimes resistant to doing this. If the "manager" of the offshore feeder fund agrees to obtain the fidelity bond, ERISA would permit the offshore feeder fund to pay the premium, but here, too, resistance is sometimes encountered from ERISA plans and other benefit plan investors.

Appendix A

Consequences of Violating the Fiduciary and Prohibited Transaction Provisions of ERISA

I. ERISA

A fiduciary that breaches any of the standards of fiduciary conduct imposed by ERISA is personally liable to make good to the plan any losses to the plan resulting from the breach and to restore to the plan any profits of the fiduciary arising from the fiduciary's use of plan assets. Making good the plan's losses requires that the breaching fiduciary both restore any investment losses and provide to the plan an amount equal to the income the plan would have earned had there been no fiduciary breach. That amount is typically determined based on the rate of return on the other assets of the plan and by determining how the assets committed as a result of the breach would otherwise have been invested. The fiduciary may also be removed by a court for violation of his fiduciary responsibilities and may be subject to any other relief that the court deems appropriate.[44]

NOTE: In order for a fiduciary to incur any liability under ERISA with respect to a prohibited transaction, he must have known or should have known that the transaction was in one of the prohibited categories described in part E(2) of Section I of this outline.[45] Therefore, transactions with a party in interest where the fiduciary does not know that such party is a party in interest will not subject the fiduciary to liability unless its lack of knowledge was due to its failure to discharge its fiduciary obligations in a prudent manner. For example, a purchase from or sale of a plan asset to a party in interest will not be a prohibited transaction if the transaction is an ordinary "blind" purchase or sale of securities through an exchange where neither buyer nor seller (nor the agent of either) knows the identity of the other party involved.[46]

Section 502(1) of ERISA requires the DOL to impose a civil penalty against a fiduciary who commits a fiduciary breach (including a prohibited transaction) equal to 20 percent of the amount recovered by the DOL pursuant to a settlement agreement with the DOL or pursuant to a court order in a judicial proceeding instituted by the DOL. Section 502(1) requires that a similar penalty be assessed against any non-fiduciary who knowingly participates in such a breach. The DOL has the authority to waive or reduce the penalty if the DOL determines that the fiduciary or non-fiduciary acted in good faith or if imposing the penalty would cause a severe financial hardship.

II. Internal Revenue Code

A. Tax Imposed

The Code imposes a tax on a disqualified person who participates in a prohibited transaction. The initial tax is 15 percent of the greater of the fair market value of the consideration given or the fair market value of the consideration received in the transaction.[47] However, if the prohibited transaction involves the receipt of excess compensation for the performance of services, the initial tax is 15 percent of the excess compensation. The tax is payable for every year beginning with the year in which the transaction occurs and ending with the year in which occurs the earlier of:

1. The mailing date of a notice of deficiency (90-day letter) to the taxpayer; or

2. The date on which the initial excise tax is assessed; or

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[44] ERISA § 409(a).

[45] ERISA § 406.

[46] Conf. Rept. 93-1280, 1974-3 C.B. 415, 468.

[47] Code § 4975(a) and (f)(4).

3. The "correction date," i.e., the date the transaction is undone to the extent possible, and in any case, the date on which the plan is placed in a financial position not worse than it would have been if the party in interest were acting under the highest fiduciary standards.[48]

If the correction date does not occur prior to 90 days after the mailing of a notice of deficiency (unless: (1) the taxpayer challenges the tax in the Tax Court; or (2) the IRS extends the permissible period in which the transaction may be corrected), there is an additional tax of 100 percent of the consideration given or received or the consideration in excess of reasonable compensation, whichever is applicable,[49] and the amount on which the tax is based may be increased.[50] Section 4975(d)(23) of the Code together with Section 4975(f)(11) of the Code provide an exemption from the prohibited transaction excise tax if a disqualified person enters into a prohibited transaction with the plan as long as he did not know (or should not reasonably have known) that the transaction was a prohibited transaction and if the prohibited transaction is corrected during a correction period. The statute defines the correction period as a 14-day period that begins on the date that the disqualified person discovers, or reasonably should have discovered, that the particular transaction was a prohibited transaction. Correction is defined as undoing the transaction to the extent possible and in any case making good to the plan any losses it suffered as a result of the prohibited transaction, and restoring to the plan any profits made by the disqualified person through the use of the plan's assets.[51]

B. Liability for the Tax

The tax is imposed on any party in interest who participates in the transaction (other than a fiduciary acting only as such). Generally, the tax is imposed without regard to whether or not the party in interest was aware that he was participating in a prohibited transaction.[52] If more than one person is liable for the tax, the tax is the joint and several liability of all such persons.[53] However, if a plan fiduciary participates in a prohibited transaction solely in his capacity as a fiduciary, he is not liable for the tax.[54] In addition, engaging in a prohibited transaction generally will not result in disqualification of a plan.

In the case of a non-qualified plan (i.e., a plan not covered by the prohibited transaction provision of the Code), the DOL can impose a penalty on a party in interest with respect to prohibited transactions similar to the tax described above, and Section 408(b)(20) provides an exemption from the tax if the prohibited transaction is corrected that parallels the provisions discussed above in connection with Sections 4975(d)(20) and 4975(f)(11) of the Code.[55]

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[48] Code § 4975(a), (f)(2) and (f)(5).

[49] Code § 4975(b) and (f)(6).

[50] Code § 4975(f)(4)(B).

[51] Code § 4975(d)(31) and (f)(11).

[52] Code § 4975(a) and (b).

[53] Code § 4975(f)(1).

[54] Code § 4975(a) and (b).

[55] ERISA §§ 502(i) and 408(b)(20).

Appendix B

Benefit Plan Investors

A. U.S. private pension plans

B. U.S. private 401(k)/profit sharing plans

C. U.S. private health and welfare plans (medical plans, life insurance plans, vacation plans, etc.)

D. Keogh plans

E. Church plans that have elected to be covered by Title I of ERISA

F. Certain life insurance company general and separate accounts

G. Individual retirement accounts (traditional, Roth, SEP-IRAs, SIMPLE IRAs, etc.)

H. Group trusts qualified under Revenue Ruling 81-100

I. Entities that are treated under ERISA as holding plan assets (e.g., a fund of funds)

Estate Planning, Charitable Giving and Other Considerations

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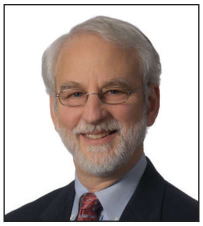

Partner
New York Office
+1 212.756.2317
kim.baptiste@srz.com

Practices

Individual Client Services

Nonprofit

Kim E. Baptiste

Kim focuses his practice in the areas of estate planning, trusts, charitable foundations, tax planning and estate administration. A Fellow of the American College of Trust and Estate Counsel and a former member of its Business Planning Committee, Kim is also a former member of the New York State Bar Association and a past member of the NYSBA Tax Section's Executive Committee and a past co-chair of the Committee on Taxation of Trusts and Estates. He serves as an adjunct professor in the Graduate Tax Program of the NYU School of Law.

Kim has been selected for inclusion by *New York Super Lawyers*, which lists the top five percent of attorneys by state and practice area as selected by their peers. He presented "Understanding Grantor Trusts" at the NYU Income Taxation of Trusts & Estates II conference and "Structuring and Restructuring Your Management Company" at a past SRZ Annual Private Investment Funds Seminar, and he also publishes in the areas of will drafting and estate administration.

After receiving his undergraduate degree from Yale University, Kim obtained a J.D. from Boston University School of Law, where he served as note and case editor on the *Boston University Law Review*, and an LL.M. in Taxation from New York University School of Law.

Partner
New York Office
+1 212.756.2348
susan.frunzi@srz.com

Practices

Individual Client Services
Education Law
Nonprofit

Susan C. Frunzi

Sue concentrates her practice on providing high-net-worth individuals with services in the areas of estate planning, estate administration, charitable giving and organizations, family law and litigation. She creates sophisticated plans for her estate-planning clients, including considerations involving possible incapacity or institutionalization, and she coordinates inter vivos and testamentary gift-giving with income, gift and estate tax laws. Sue also oversees all aspects of the administration of small and large estates, including representing clients in Internal Revenue Service estate tax audits. She develops and implements charitable giving plans, negotiates contributions to charitable organizations and oversees the administration of U.S. and foreign tax-exempt organizations. In the family law area, she negotiates and prepares cohabitation, prenuptial, postnuptial and separation agreements and counsels married couples on income, gift and estate tax planning issues. Sue also represents clients in tax court proceedings and in family law litigation, trust and estate disputes, and other matters.

Recognized as a leading lawyer by *The Best Lawyers in America* and as one of the "Top Women Attorneys" in the New York Metro Area by *New York Super Lawyers*, Sue is a Fellow of the American College of Trust and Estate Counsel. She is also a member of the New York City Bar Association, a former member of its Trusts, Estates & Surrogate's Courts Committee, and a member of the New York State Bar Association. She is a board member of The JPB Foundation, a member of the Museum of Modern Art's Planned Giving Advisory Committee, a member of The Rockefeller University's Committee on Trust and Estate Gift Plans, a former David Rockefeller Fellow of the New York City Partnership and Chamber of Commerce, and a former member of the board of directors of the Center for Children and Families Inc. Sue is also a co-author of Westlaw's *Trusts and Estates Practice in New York* and she presented "Management Company Structuring and Operations" at the SRZ 23rd Annual Private Investment Funds Seminar.

Sue obtained her J.D. from Columbia Law School, where she was editor of the *Columbia Law Review* and a Harlan Fiske Stone Scholar. She graduated *summa cum laude* and Phi Beta Kappa with a B.A. from Tufts University.

Partner
New York Office
+1 212.756.2201
daniel.hunter@srz.com

Practices

Investment Management
Hedge Funds
Private Equity
Regulatory & Compliance

Daniel F. Hunter

Dan concentrates his practice on the design, structure and regulation of alternative investment products, including hedge funds, hybrid opportunity funds and private equity funds. Among the various investment advisers he represents are some of the larger and more well-known fixed income, bank loan and distressed debt managers. Dan also provides day-to-day regulatory, operational, mergers and acquisitions and restructuring advice to his fund clients, and advises funds regarding the receipt or allocation of seed capital.

Dan has been recognized in *The Legal 500 United States* in the Investment Fund Formation and Management and Private Equity Funds categories. A sought-after speaker, he recently presented "AIFMD: Practical Implications for U.S. Managers" at the KB Associates Global Fund Distribution: New Opportunities, New Challenges conference and "Global Regulatory Issues" at the IIR 3rd Annual InvestorOps conference. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), and he served as a guest lecturer at the New York University School of Continuing and Professional Studies, where he taught "Introduction to Hedge Funds."

Dan received his J.D. from the University of Michigan Law School, where he was articles editor of the *University of Michigan Journal of Law Reform*, and his A.B., *cum laude* and with high honors in history, from the University of Michigan.

Partner
New York Office
+1 212.756.2329
catherine.schmidt@srz.com

Practices

Individual Client Services

Catherine Grevers Schmidt

Catherine focuses her practice on complex estate and tax planning for high-net-worth individuals and families, entrepreneurs and real estate owners, and on planning for the generation-skipping transfer tax. Through the use of sophisticated techniques such as qualified personal residence trusts, grantor retained annuity trusts, dynasty trusts, intentionally defective grantor trusts and limited liability companies, among others, as well as traditional wills and revocable trusts, she assists clients in minimizing the impact of estate and gift taxes on their estate plans, and in transferring family wealth to their children and grandchildren. She also has considerable experience in the administration of large estates and trusts, advising clients on private foundation matters and representing clients in contested estate and gift tax audits. In addition to numerous audits settled at the initial and appeals levels, she has also represented clients before the U.S. Tax Court, achieving favorable settlement results and trial victories.

Catherine has been recognized by *The Best Lawyers in America* in Trusts and Estates and in *Super Lawyers* in the area of Estate Planning and Probate. She has received Martindale-Hubbell's highest peer-reviewed "AV Preeminent" rating for excellence in the law and ethical conduct and is included on several local and national lists of preeminent women attorneys by such publications as LexisNexis, *Avenue Magazine* and Martindale-Hubbell. She is a former member of the Trusts, Estates and Surrogate's Court Committee of the New York City Bar Association, and she also served as chair of the Subcommittee on Portability. Catherine is also a former member of the Committee on Estate Planning of the New York State Bar Association. She writes about estate and gift tax topics and is a frequent speaker for programs sponsored by, among others, the Estate Planning Council of New York, the New York State Bar Association, New York University School of Continuing Legal Education and the New York State Society of Certified Public Accountants. She is often cited in publications including *Forbes*, *Kiplinger's*, *New York Daily News* and *The Wall Street Journal* with respect to legal issues in trusts and estates and is also a regular contributor to the *New York Daily News* "Money Pros" column.

Catherine earned her J.D., *magna cum laude*, from New York University School of Law, where she served on the *New York University Law Review* and was Order of the Coif. She received her Ed.M. from Harvard University and her B.S., *cum laude*, from Georgetown University, where she was a member of Psi Chi.

Estate Planning, Charitable Giving and Other Considerations

I. Overview of Transfer Tax System

A. Federal Tax Regime

1. Tax Rate: The federal gift tax rate and estate tax rate are each currently 40 percent.

2. Exemption from Tax: Currently, no federal gift or estate tax will be imposed on: (1) an outright transfer to a spouse or a charity;[1] (2) certain transfers in trust for a spouse's benefit;[2] (3) gifts of $14,000 per person per year (with an additional $14,000 per person per year exempt with a spouse's consent);[3] (4) medical and tuition payments on another's behalf made directly to the provider of services;[4] and (5) additional cumulative transfers to others, by lifetime gift or at death, of $5,430,000 (indexed annually for inflation).[5] Any unused portion of this $5,430,000 exemption can be used by a surviving spouse (in addition to the surviving spouse's own $5,430,000 exemption).

3. Generation-Skipping Transfer Tax: Additionally, subject to limited exceptions, a Generation-Skipping Transfer ("GST") tax currently applies to transfers to or in trust for grandchildren and more remote descendants or for other persons who are more than 37½ years younger than the transferor. The GST tax rate is currently 40 percent. Currently, no GST tax will be imposed on: (1) some, but not all, gifts of $14,000 per person per year (with an additional $14,000 per person per year exempt with a spouse's consent); (2) medical and tuition payments on another's behalf made directly to the institution or provider of services; and (3) additional cumulative transfers of $5,430,000 (indexed annually for inflation). Unlike the exemption from estate and gift tax, the unused portion of a person's $5,430,000 exemption from GST tax cannot be used by a surviving spouse.[6]

B. New York Tax Regime

1. New York Estate Tax Rate: New York State imposes an estate tax on certain property transfers at death. Among other exclusions, certain transfers to a spouse and transfers of real property and tangible personal property not located in New York are not subject to New York estate tax. Transfers subject to tax are taxed at a marginal rate that reaches 16 percent (but tax paid is deductible against federal estate tax).

2. No New York Gift Tax: Currently, there is no New York gift tax, but the donor must survive at least three years from the date of the gift, or the amount of the gift will be subject to New York estate tax (if certain exclusions do not apply).

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[1] *See* Internal Revenue Code (the "Code") §§ 2522, 2523, 2055 and 2056.

[2] *See* Code §§ 2523 and 2056.

[3] *See* Code §§ 2503(b) and 2513.

[4] *See* Code § 2503(e).

[5] *See* Code § 2010(c).

[6] *See generally* Code §§ 2601-2664.

3. New York Exemption from Estate Tax: New York State assesses its estate tax on estates with a taxable value in excess of $2,062,500. On April 1, 2015, this "threshold" amount will increase to $3,125,000, and it will further increase incrementally until Jan. 1, 2019, at which time the New York exemption is scheduled to equal the then-applicable federal exemption.

4. No New York GST Tax: New York state has repealed its GST tax.

C. Connecticut Tax Regime

1. Connecticut Gift and Estate Tax Rate: Connecticut imposes a gift tax on certain lifetime property transfers and an estate tax on such transfers at death. Among other exclusions, certain transfers to a spouse and transfers of real property and tangible personal property not located in Connecticut are not subject to Connecticut transfer tax. Transfers subject to tax are taxed at a marginal rate that reaches 12 percent (but tax paid is deductible against federal estate tax). Connecticut is the only state in the United States that currently imposes a gift tax.

2. Connecticut Exemption from Gift and Estate Tax: The first $2,000,000 of cumulative transfers, by lifetime gift or at death, that would otherwise be subject to Connecticut gift or estate tax is exempt from Connecticut gift and estate taxes.

3. No Connecticut GST Tax: Connecticut does not have a GST tax.

II. Estate Planning Techniques for Fund Managers

A. Transfer of Interest in Incentive Allocation

1. Estate Planning Goal: Given the high gift and estate tax rates noted above, the goal of any estate planning strategy is to remove assets from the fund manager's taxable estate by transferring assets, the appreciation on them and the income produced by them to trusts for members of the manager's family. Ordinarily the assets with the greatest growth potential in a hedge or private equity fund are interests in the entities that receive the funds' incentive allocation. Typically, these include an interest in the LLC that serves as the general partner of the domestic fund and a limited partnership interest in the management company that receives the management fee and in some fund structures the offshore incentive fee. Transferring such interests early in a fund's existence when their value is presumably low allows the manager to remove from his or her estate at little or no gift tax cost a valuable asset as well as the potentially significant growth on it.

2. Need for a Vertical Slice: If a manager makes a gift of a portion of his or her incentive allocation or any other profit participation, federal gift tax law requires the manager to also make a gift of the same percentage of his or her investment capital in the fund. This is known as a "vertical slice."[7] Thus, if the manager transfers 20 percent of the general partner entity that receives the incentive allocation from the domestic fund, the manager must also give away the same 20 percent of his or her investment capital in the fund. But, as discussed below, virtually all of such investment capital will be returned to the manager through the annuity payments.

B. GRATs: There are several means of transferring assets from a manager's taxable estate. First, if the value of the gift (including the portion of the incentive allocation and investment capital being transferred) is less than $5,430,000 (or $10,860,000 if the manager is married), the manager can just make a gift of the interest to a trust for his or her children or his or her spouse and children. The spouse can only be a

[7] *See* Code § 2702.

permissible beneficiary if the spouse's $5,430,000 exemption is not also being used for the gift. However, this is not without risk, because if the IRS ultimately determines in a gift tax audit that the transferred interest was worth more than $5,430,000, the manager will owe federal gift tax. If valuation is an issue, or if the manager prefers to preserve his or her estate tax exclusion for another use, the safer course for transferring fund interests may be to transfer them to a grantor retained annuity trust ("GRAT").

1. Summary of GRAT: A GRAT is an irrevocable trust that pays the grantor, the creator of the trust (in this case, the manager), either: (1) a fixed annual dollar amount (i.e., the annuity) for a specified number of years; or (2) an escalating annuity that increases by up to 20 percent each year during the specified annuity term. The annuity is typically expressed as a percentage of the value of the property transferred to the GRAT (i.e., the incentive allocation and investment capital). For gift tax purposes, the manager is treated as making a taxable gift of the difference between the value of the property the manager contributed to the GRAT and the present value of the annuity interest the manager retained. At the end of the annuity term, if any property remains in the GRAT after the final annuity is paid, such property will be removed from the manager's taxable estate and will pass to a trust for his or her children (or spouse and children) free of gift and estate tax.

2. No Gift Tax on Contribution to GRAT: It is possible to "zero out" a GRAT for gift tax purposes, so that no gift tax is payable on formation of the GRAT. For purposes of valuing the remainder interest for gift tax purposes, the IRS assumes that the assets in the GRAT will generate income and appreciation combined at a prescribed rate that is published monthly (sometimes referred to as the "benchmark rate"). The benchmark rate in January 2015 is 2.2 percent.[8] By tailoring the size of the annuity and the length of the GRAT term, the GRAT can be structured so that all of the property initially transferred to the GRAT as well as all of the assumed income and appreciation (equal to the applicable benchmark rate) will be returned to the manager through the annuity payments, and the remainder interest of the GRAT will be valued at zero for gift tax purposes.

3. Example of Zeroed-Out GRAT: Consider the following example. In 2015, at a time when the benchmark rate is 2.2 percent, a manager contributes fund interests with a fair market value of $5,000,000 to a GRAT with a term of five years. Assume that the assets produce a 5-percent annual return and appreciate by 10 percent annually. In addition, assume that the GRAT is drafted to provide that the annuity payments escalate by 20 percent each year. The manager will pay no gift tax upon funding the GRAT (or at a later date). In the first year of the GRAT's term, the required annuity will be approximately 14.5 percent of the fair market value of the initial contribution, which is approximately $725,000. This amount will increase by 20 percent each year during the five-year GRAT term, so that the last payment will be approximately 30 percent of the fair market value of the initial contribution, which is approximately $1,500,000. Under this scenario, the total amount paid to the manager over the five-year GRAT term will be $5,376,796, which is the initial $5,000,000 contributed plus the amount generated by a $5,000,000 asset that is assumed to grow at a 2.2-percent interest rate and makes escalating annuity payments each year. In essence, a GRAT operates like a fully amortized loan over the annuity term with a 2.2-percent coupon. This means that the manager will receive back from the GRAT the full value of what he or she contributed to the GRAT (i.e., the incentive allocation and investment capital) plus interest at 2.2 percent. Because the manager receives back the full value of what he or she contributed to the GRAT, the manager is not treated as having made a taxable gift.

   The value of the GRAT's remainder (i.e., the balance remaining after $5,376,796 is distributed to the manager over a five-year period) is expected to be $3,245,400 under the income and appreciation

[8] *See* Code § 7520.

assumptions in the example stated above. This amount will pass free of transfer tax to the GRAT's remainder beneficiaries. The remainder beneficiaries could be the manager's children or trusts for their benefit or a trust for the manager's spouse and children over which the Trustee has the discretion to pay any part or all of the trust income or principal to any one or more of the trust beneficiaries. Generally, while the manager's children are young, this means that no distributions are made. Rather, the trust just continues to grow as distributions from the fund's incentive allocation are made to it. Although the annuity term has ended, the remainder trust continues as a partner in the fund. However, it no longer has any obligation to pay anything to the manager. Thus, if the GRAT initially had a 20-percent interest in the fund, the remainder trust will as well, meaning that each year it will be entitled to 20 percent of the fund's incentive allocation.

4. Income Tax Benefit: A GRAT also provides a significant income tax benefit in that it is a grantor trust, which means that the manager will pay the income tax on any income earned by the trust during the annuity period.[9] By paying this tax, the manager is essentially making an additional tax-free gift of the amount of the tax. In addition, the remainder trusts for the manager's children (or spouse and children) can be structured as a grantor trust so that the manager can continue to pay any income tax on any income earned by the trust.

5. GRATs and GST Tax: For the above reasons, GRATs are well-suited for conferring transfer tax benefits in planning for a manager's children or other chosen beneficiaries. However, GRATs are not ideal candidates for passing assets below the manager's children's generational level because the manager's exemption from GST tax cannot be allocated to the GRAT until the end of the GRAT term, at which time the GRAT may hold significant assets. As a result, a greater amount of the manager's GST exemption would need to be applied to the GRAT at that time relative to what would have been needed to be applied to a different type of trust created by the manager on the same date that the GRAT was created.

6. No Gift Tax on GRAT's Appreciation: The estate planning benefit of a GRAT will be achieved if the assets in the GRAT generate income and appreciation that exceeds the benchmark rate. If that is the case, there will be property remaining in the GRAT at the end of the annuity term and, as described above, such property will pass to the GRAT's remainder beneficiaries free of gift and estate tax, outright or in trust.

7. Valuation: An appraisal of the fair market value of the assets contributed to the GRAT as of the date of such contribution must be obtained. The lower the value of the contributed assets, the lower the annuity payments to the manager that will be required to zero out the GRAT, and the greater the likelihood that some assets will remain to pass to the remainder beneficiaries at the end of the GRAT term. The valuation of the assets contributed must be performed by a professional appraiser who will consider a number for factors, such as assets under management and projected returns (based upon the manager's past performance, current market conditions, the business model, etc.). The appraiser will then prepare a discounted cash flow analysis to determine the value of the fund interests transferred to the GRAT, subject to significant discounts for lack of control and lack of marketability. It is preferable for the valuation (and funding of the GRAT) to occur as early in the life of the fund as possible before there is substantial positive investment performance. However, GRATs also can be used successfully for an established fund as long as it is likely to generate an annual return that exceeds 2.2 percent (or other monthly IRS benchmark).

8. No Estate Tax on GRAT's Appreciation If the Manager Survives the GRAT Term: At the conclusion of the GRAT's term, the GRAT's remaining assets will pass to the GRAT's remainder beneficiary, which,

[9] *See generally* Code §§ 671-679.

as noted above, frequently is a successor trust for the manager's children (or spouse and children). Provided that the manager survives the GRAT's term, these assets will no longer be includable in the manager's estate (i.e., no estate tax will be due on these assets), and the successor trust will not be required to pay the manager an annuity payment. (If the manager does not survive the GRAT term, included in the manager's estate will be the lesser of: (1) the amount of assets held by the GRAT necessary to produce the outstanding annuity payments; and (2) the full amount of the assets remaining in the GRAT.)

9. Upside but No Downside: A transfer tax benefit will result if: (1) the GRAT generates income and appreciation above the benchmark rate; and (2) the manager survives the GRAT term. Namely, the income and appreciation on the GRAT's assets above the benchmark rate will have been transferred from the manger's estate free of estate and gift tax. As mentioned above, if the manager does not survive the term, some portion of the assets in the GRAT may be included in his or her estate. If the assets do not generate income and appreciation above the benchmark rate, nothing will be left in the GRAT for the remainder beneficiaries. In either event, however, the manager will be no worse off from a transfer tax perspective than if the manager had never created the GRAT.

10. Payment of the Annuity: One critical requirement of a GRAT is that the annuity must be paid each year within 105 days after the anniversary of the date the GRAT was created.[10] If the annuity is not paid in a timely manner, the GRAT will not be a valid trust and all of the property contributed to the GRAT will be considered a taxable gift as of the date of the creation. The annuity can be paid in several different ways. It cannot, however, be paid by having the GRAT give the manager a promissory note.

11. The simplest way of paying the annuity is for the GRAT to pay it with the cash it receives from its portion of the incentive allocation. Assuming the fund is doing well, there should be ample revenue to meet the GRAT's annuity obligations. A second way to pay the annuity is for the GRAT to transfer funds from its capital account in the domestic fund to the manager's capital account. The GRAT's capital account will consist of the original capital the manager transferred to the GRAT as part of the vertical slice plus the earnings it has received as a result of the fund's performance. Thus, when the annuity is due, a book entry is made from one capital account to the other. In this way, the manager will essentially receive back all of the capital he or she initially contributed to the GRAT with an interest factor of 2.2 percent. The last means of paying the annuity is to borrow the amount needed from a source other than the manager, such as another family member or trust.

C. Installment Sales

1. Generally Used by Managers with Illiquid Investments: Since a GRAT requires annuity payments, illiquid investments generally are not the best assets to be contributed to a GRAT. Alternatively, a technique known as an "installment sale" may be utilized in many situations.

2. Summary of Installment Sale: In an installment sale, the manager will create an irrevocable grantor trust (often, a "dynasty trust") and sell investment assets to the trust in exchange for a promissory note given by the trust to the manager. The trust is structured so that, for income tax purposes, it is not a separate entity from the manager. Therefore, the manager is treated as if he or she sold the assets to him- or herself, so the sale is not deemed to be a realization event and no capital gains tax is due upon the sale. The manager generally must also make a taxable gift of cash or another asset (that serves as seed money) to the grantor trust so that the transaction will have economic

[10] *See* Reg. § 25.2702-3(b)(4).

substance. Typically, the taxable gift need not exceed 10 to 15 percent of the value of the property sold to the trust. Appreciation and income on the investment assets after the sale will be used to pay interest as well as a balloon principal payment at the end of the note's term. The interest rate on the note would be low in the current economic climate. Currently, the IRS requires that the interest rate equal or exceed 0.41 percent for a term of not more than three years, 1.75 percent for a term of three to nine years and 2.67 percent for a term of more than nine years.[11] Again, because the trust is not separate from the manager for income tax purposes, the manager is treated as paying interest to him- or herself, so no income tax is due on the interest payments. Any remaining income and appreciation after payment of interest and the balloon principal payment will be transferred to the trust free of transfer tax.

3. Dynasty Trust: An installment sale can be made to any grantor trust, though it is most often made to a so-called "dynasty trust" in order to build up assets for multiple generations (rather than just a donor's children). A dynasty trust is typically structured as a multi-generational discretionary trust for the manager's descendants (or spouse and descendants). At inception, exemption from GST is allocated to the dynasty trust in order to avoid transfer tax at each generation. Generally, a dynasty trust is not used as a remainderman to a GRAT for the reasons discussed above. The dynasty trust may last the longest permissible period under law, which, depending on the law of the state that governs the trust, could be approximately 100 years (as in New York, for example) or in perpetuity (as in Delaware, for example). The trustees can have complete discretion to distribute as much or as little of the trust income and principal to any one or more of the beneficiaries in whatever shares they choose. The manager's children can have full access to the trust property, subject to the trustee's discretion, but the typical intention is to build the trust assets for lower generations. Any trust property not distributed will accumulate and grow for future generations. Obviously, if such growth continues for a long period without ever being subject to a wealth transfer tax, even at very conservative growth rates, the trust assets can grow substantially over time. The trust is structured as a grantor trust, so the manager (not the trust) pays the income taxes on the trust's income during the manager's lifetime. (As a result, the trust is undiminished by such taxes without any additional gift being made.) If the manager's spouse is in fact named as a discretionary beneficiary of the trust, the manager will retain de facto access to the trust property so long as he or she remains married and the spouse is living. If the manager ever wanted to reclaim some portion of the trust property, whether because he or she needed the money or felt that the children did not need it, the trustees, if they deemed it advisable, could make a discretionary distribution to the manager's spouse (or a loan to him or her). Such a distribution would diminish the estate-planning benefit of the trust and should be considered carefully. It would also be possible for the trustees to terminate the trust at any time by making a discretionary distribution to the children or other beneficiaries if the manager decided that the trust was no longer necessary or desirable.

D. Low-Interest Loans

1. Many of the strategies referenced in this outline can confer a sizable estate planning benefit in part due to the low interest rates required by the IRS on certain transfers. A manager can take advantage of current market conditions by making a large loan, payable by annual interest payments and a principal balloon payment at the end of the loan's term, to a child (or a child's trust) or other persons (or their trusts). The borrowed assets would then be invested by the borrower (or by the manager on his or her behalf), who would strive to earn an investment return that exceeds the interest rate on the loan.

[11] *See* Code § 7520.

2. As with notes used in installment sales, the IRS currently requires that the interest rate on personal loans equals or exceeds 0.41 percent for a term of three years or less, 1.75 percent for a term of three to nine years and 2.67 percent for a term of more than nine years. Two estate planning benefits can be realized if the contemplated transaction is successful (i.e., if the return on the investment exceeds the applicable interest rate). First, in many instances, income can be shifted to a person in a lower marginal income tax bracket than the manager — this may result in significant net income tax savings for the manager's family. Second, any return on the investment above the applicable interest rate will be includible in the estate of the borrower (or in a trust not includible in anyone's estate for at least a few generations) and not in the estate of the manager. As a result, the manager will have transferred the net return from his or her estate to a member of a lower generation (or a trust) without paying any gift tax on the transfer.

E. Drafting the Management Company Partnership Agreement

1. The partnership agreement that governs the management company should provide that transfers by operation of law, such as in death or divorce, are explicitly limited to economic transfers and do not pass on rights to participate in decision-making to ex-spouses or estates (except, in the latter case, where specifically discussed and agreed to). Furthermore, each of the management company agreements and affiliated agreements (e.g., the limited liability company agreements of each general partner) should be drafted to ensure that transfers by operation of law do not inadvertently transfer certain voting rights to ex-spouses or estates.

2. In general, the relevant agreements should permit transfers of certain interests to trusts (or other estate-planning vehicles) only if the transferor is to retain decision-making authority over the transferred interests. Such provisions on the transferor's retention of authority, however, must take into account certain IRS rules that govern the legal requirements that must be met when determining whether a gift is complete for federal gift tax purposes.

3. Important rights and remedies, such as the rights to removal and transfer, should be drafted to apply equally to the individual partner in the management company as well as to any trust created for his or her benefit. Each of the management company agreements (and affiliated agreements) should require that, to the extent it is practical to do so, contributions to and withdrawals from the management company (or the general partner, as the case may be) occur pro rata with respect to the investor and any trust created for his or her benefit that holds such investor's investment. If not, adverse consequences could result (e.g., an individual could hold a smaller interest in the investment than does the individual's trust, or the investment manager could seek to remove the individual from the fund but lack the authority to remove such individual's trusts, which is not the intended result in most cases).

4. At the time a management company and related entities are being formed, it is often prudent to have a spouse sign a written agreement whereby the spouse consents to the provisions on involuntary transfers referenced above.

F. Admission of Trusts to Management

1. Any issuance of a security by the management company (or any parent company) to a trust will be a private placement and must meet the "accredited investor" test in Regulation D of the Securities Act of 1933 ("1933 Act"). Any trust must meet each of the following tests to be an "accredited investor":

(a) Total assets in excess of $5,000,000;

(b) Not formed specifically to purchase the securities; and

(c) Must be directed by a *sophisticated person* (i.e., a person who has sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of the prospective investment in the management company).

Alternatively, a trust of any size may be an accredited investor under Rule 501(a)(1) so long as a bank, insurance company, registered investment company, business development company or small business investment company is serving as a trustee and/or has authority to make investment decisions on behalf of the trust. The SEC has determined that while a trust standing alone may not be an accredited investor under Rule 501(a)(1) of Regulation D, if a bank is its trustee and makes the investment on its behalf, the trust will be accredited by virtue of the bank's status as an accredited investor under Rule 501(a)(1).

Additionally, Rule 501(a)(8) of Regulation D provides that an entity in which all of the equity owners are accredited investors is an accredited investor. However, in the case of an irrevocable trust, the trust beneficiaries are not considered to be "equity owners," and it is not the case that if all of the trust beneficiaries are accredited investors the trust is an accredited investor. The result is different in the case of a revocable trust where the trust is established by the grantor during his or her lifetime; the trust may be amended or revoked by the grantor during such time period and all the tax benefits of investments made by the trust pass through to the grantor. In that case, the grantor is considered the "equity owner," and if the grantor is an accredited investor under Rule 501(a)(5) or Rule 501(a)(6) (i.e., he or she meets the net worth or income tests), the revocable trust is an accredited investor.

2. It is also possible for an existing partner in the management company to give an interest to a trust. Gifts are not subject to the 1933 Act because they are not transfers for value.

3. The Investment Company Act of 1940 ("1940 Act") will not apply to the admission of the trust because the management company is not an investment company for purposes of the 1940 Act and therefore the trust does not need to be a "qualified purchaser" or meet the "knowledgeable employee" tests.

4. However, the 1940 Act *will apply* when admitting the trust to the manager's affiliated general partners because the trust will almost always want to invest in the underlying fund and, assuming the underlying fund is a 3(c)(7) fund (as opposed to a 3(c)(1) fund), the trust will need to meet the "qualified purchaser" test of the 1940 Act. Any trust must meet each of the following tests to be a considered a "qualified purchaser":

   (a) Family-Owned Companies with at Least $5,000,000 in Investments: Section 2(a)(51)(A)(ii) of the 1940 Act provides that any company that owns not less than $5,000,000 in investments and is owned directly or indirectly by two or more persons of a certain family relationship (or estates, organizations or trusts established by or for the benefit of such persons) is a qualified purchaser. As it is used in Section 2(a)(51)(A)(ii), "company" is defined in Section 2(a)(8) of the 1940 Act to include a trust. The 1940 Act does not define who the "owners" of a company are; however, the SEC has stated that the beneficiaries of certain family trusts could be considered the "owners" for purposes of Section 2(a)(51)(A)(ii) when those beneficiaries are the only persons holding economic interests in the trusts. In the case of a trust, all the beneficiaries of the trust must be comprised of siblings, a spouse (including former spouses), direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, other charitable organizations, or trusts established by or for the benefit of such persons. Further, there must be at least two natural persons who are beneficiaries of the trust.

(b) Trusts in Which the Trustee and Each Settlor Are Qualified Purchasers: Section 2(a)(51)(A)(iii) of the 1940 Act defines a trust as a qualified purchaser if: (1) the trustee or other person authorized to make decisions with respect to the trust and (2) each settlor or other person who has contributed assets to the trust is a qualified purchaser. To determine who must be a qualified purchaser, the SEC looks at the trustee (or other authorized person such as an investment advisor) who is responsible for making the investment decision and therefore responsible for assessing the risks associated with the investment. If the trust has more than one trustee, the SEC only requires that the trustee responsible for making the investment decision be a qualified purchaser.

(c) Employees of the Management Company Who Meet the "Knowledgeable Employee Test" (Rule 3c-5 Under the 1940 Act): Any such employee may also invest in 3(c)(7) funds through a trust so long as such employee is responsible for the trust's investment decision-making and its source of funds.

III. Charitable Planning Techniques

A. Public Charities

1. Summary: A public charity is a tax-exempt trust or corporation that is established exclusively for charitable, educational, scientific or religious purposes and that is financially supported by more than a small number of donors (and/or meets certain other technical requirements).

2. Income Tax Deductions: A manager will receive an immediate income tax deduction for contributions to a public charity. Contributions of cash to a public charity entitle a manager to an income tax deduction that is limited to 50 percent of the manager's adjusted gross income ("AGI") for the year of the contributions. Any appreciated securities and many other kinds of assets transferred to a public charity will also entitle the manager to an immediate income tax deduction, but the deduction will be limited to 30 percent of the manager's AGI for the year of the contributions. (Any excess contribution deductions above these AGI caps can be carried forward for use in the succeeding five years.)

B. Private Foundations

1. Summary: A private foundation is a tax-exempt trust or corporation established for one or more of the same purposes that public charities are established. However, a private foundation does not undertake certain actions that a public charity can undertake and is typically funded by one person or a small number of donors. Typically, a private foundation makes grants to other charitable organizations. A private foundation must distribute at least 5 percent of the average value of its assets annually. Through a private foundation, a manager can accomplish a variety of charitable goals, including obtaining an immediate tax deduction (regardless of the date when the foundation's funds are ultimately distributed to public charities), maintaining investment control over donated assets, teaching children philanthropy and money management (through their positions on the board of directors or as informed advisers to the foundation), assuring the manager's charitable vision will be realized and perpetuating the manager's name in connection with charitable works.

2. Income Tax Deductions: However, the income tax deductions afforded for gifts to private foundations are less favorable than the deductions afforded for gifts to public charities. The income tax deduction for cash contributions to a private foundation is limited to 30 percent of the manager's AGI for the year of the contributions, and such limitation for transfers of appreciated stock traded on a recognized securities exchange to a private foundation is limited to 20 percent of the manager's AGI for the year of the contributions. In addition, if contributions are made to a private foundation of assets other than cash and marketable securities, the donor's income tax deduction is limited to his or her basis in the asset contributed. Depending on the circumstances, this can be a significant detriment to contributing an interest in an investment fund to a private foundation.

3. Contributing a Fund Interest to a Private Foundation: If a manager wishes to transfer to a private foundation an interest in the incentive allocation in a hedge fund or private equity fund, numerous issues arise in addition to the basis limitation on income tax deductibility. First, there may be concerns about the risks and lack of diversification presented by this "investment." Second, because the foundation is an owner of the fund, the IRS and the Attorney General of the state in which the foundation is created will have the right to examine whether or not the foundation received its fair share of the incentive allocation. This can lead to unwanted scrutiny, even when everything is done "by the book."

4. Investing Private Foundation Assets in the Management Company: Many managers want their private foundations to invest all or a significant portion of the foundation's assets in the management company. There are serious concerns with any such investment. For example, the Attorney General of the state in which the private foundation is organized can apply its broad authority over charitable organizations to review the books and records of the management company and possibly its affiliates, which could, as above, bring an unwanted level of additional scrutiny on the manager's business. Also, the manager will not have the same arm's-length relationship with the private foundation as he or she will with other partners, and the private foundation may not agree to the fiduciary duty standard provided for in the management company agreement (which is typically set as low as is permitted under Delaware law).

C. Donor-Advised Funds

1. Summary: Because private foundations require certain annual distributions and have ongoing costs of operation (legal, accounting and administrative fees, annual tax forms, etc.), the manager may prefer to make charitable gifts through a donor-advised fund ("DAF"). A gift to a DAF permits a manager to take an immediate tax deduction and to "recommend" the identity of grant recipients at a later date. DAFs invest donated assets and make grants to charities from a manager's individual account based largely on the manager's recommendations. DAF fees are usually lower than the costs of operating a private foundation, and typically a manager's name can be used in connection with gifts made from a DAF. Of note is that contributions to a DAF are irrevocable and the DAF has final discretion to decide where to donate (though in practice, the donor's wishes are usually followed) and how to invest the DAF assets. (Many DAFs do not like to hold (or allow) interests in illiquid assets.)

2. Income Tax Deductions: The same income tax deduction limitations as apply to public charities apply to DAFs. Therefore, in certain situations, a contribution to a DAF can provide an income tax deduction to a manager that would not be conferred upon the manager if he or she made the same contribution to a private foundation.

D. Charitable Lead Annuity Trusts

1. Summary: A charitable lead annuity trust ("CLAT") annually pays a fixed amount to a designated charity for a number of years, with the remainder directed to noncharitable beneficiaries, typically the manager's children (outright or in further trust). A taxable gift is made to the remaindermen when the CLAT is created. The amount of the gift equals the value of the property transferred minus the present value of the annuity interest to be paid to the charity. If the value of the annuity interest equals the value of the property transferred to the CLAT, the CLAT is "zeroed-out" and no taxable gift is made. Any assets that remain at the end of the charitable annuity term will pass to the remaindermen free of transfer tax. If the return on the assets in a zeroed-out CLAT exceeds the IRS's assumed rate of return for the month in which the CLAT is funded or either of the two previous months if lower (the rate is 2.2 percent in January 2015, was 2.0 percent in December 2014 and was 2.2 percent in November 2014), the difference between the assumed and actual rates of return will pass to the remaindermen free of transfer tax. The CLAT can be structured as either a grantor trust or a nongrantor trust. If the CLAT is structured as a nongrantor trust, the manager will not receive an income tax deduction when the trust is created, but the trust can deduct the portions of its income paid to charity, and the trust's net income is taxable to the trust. If the CLAT is structured as a grantor trust, the manager is entitled to an income tax deduction when the trust is created, and the CLAT's income is taxable to the manager. Generally speaking, during the term of the CLAT the manager will recapture some or all of the income claimed as an up-front deduction. Thus, the selection of grantor versus nongrantor trust status is often an income timing issue.

2. Advantageous to Use with Low Interest Rates: As will be seen below, CLATs are most advantageous when the IRS benchmark rate is low. An example of a "zero-ed out" CLAT is as follows: A manager contributes $1,000,000 to a CLAT with a term of 10 years in 2015 when the assumed rate of return is 2.2 percent. Assume further that annually, until the CLAT's term ends, the CLAT's assets yield a 10-percent return, and an annuity payment in the amount of 11.25 percent of the CLAT's initial fair market value (i.e., $112,500) is made to a charity designated by the manager at the time the CLAT is created. The CLAT is structured as a grantor trust. Upon the CLAT's creation, the manager is entitled to an immediate charitable deduction of $1,000,000, which is the present value of the stream of annuity payments projected to grow at the IRS benchmark rate. The manager would pay all income taxes owed by the trust since the trust is a grantor trust. The value of the CLAT's remainder (i.e., the balance remaining after the annuity payments are made to the charity) is $800,782. This amount will pass free of transfer tax to the CLAT's remainder beneficiaries.

   Now consider if interest rates rose and the benchmark rate were increased to 6.2 percent and the annuity to 13.715 percent. The charity would receive higher annuity payments — $137,150 annually — and the CLAT's remainder beneficiaries would receive a significantly lower remainder — $407,924 — than they would each receive in the prior example. The manager will receive a charitable deduction of $999,933, which is almost the same as the manager would receive in the prior example. The reason that the charity receives more (and the remainder beneficiaries less) when interest rates are higher is because when the CLAT is projected to grow at a higher rate, the annuity payments to "zero out" the CLAT must increase (leaving a lower remainder).

E. Charitable Remainder Trusts

1. Summary: A charitable remainder trust ("CRT") allows a manager to provide income for a period of time to any person designated by the manager, with the remaining trust assets passing to charity once such period elapses. There are two types of CRTs: a charitable remainder annuity trust ("CRAT") and a charitable remainder unitrust ("CRUT"). If a manager makes a transfer to a CRT during the manager's lifetime, the manager will receive an income tax charitable deduction based on the present value of the remainder interest that will ultimately pass to charity. Of note, a CRT can be funded with appreciated assets to bypass (or, at a minimum, defer) capital gains taxes upon the sale

of the contributed assets. With a CRAT, the income beneficiary will receive a predictable stream of payments during the trust term. The income payments are fixed at the inception of the trust and do not fluctuate based on the performance of the trust assets. With a CRUT, the income beneficiary receives a fixed percentage of the fair market value of the trust assets as revalued annually. The income payment will increase or decrease each year based on the performance of the CRUT's assets. A CRT must make a minimum annual distribution of at least 5 percent (but no more than 50 percent) of the fair market value of the trust assets for either the lifetime of an individual or individuals or a term not to exceed 20 years.

2. Advantageous to Use with High Interest Rates: An example of a CRAT is as follows: Assume in 2015 at a time when the assumed rate of return is 2.2 percent that a manager contributes $5,000,000 of appreciated securities (with a basis of $1,000,000) to a CRAT with a term of 10 years, retains the right to receive annuity payments for the duration of the CRAT's term equal to 5 percent of the initial fair market value of the CRAT (i.e., $250,000) and the CRAT yields an annual return of 5 percent. The CRAT will sell the securities in part to have funds available to pay to the manager as annuity payments. The present value of the stream of annuity payments projected to grow at a rate of 2.2 percent (the IRS benchmark rate) is $2,222,325. The manager is entitled to an immediate charitable deduction of $2,777,675 (i.e., $5,000,000 minus $2,222,325). Under the assumed rate of return in this example, the value of the CRAT's remainder (i.e., the balance remaining after the 10 annuity payments are distributed to the manager over the CRAT's term) is $5,000,000; essentially, in this example, the manager retained all of the CRAT's income and appreciation, and the initial funding of the CRAT passed to charity. Of significance, neither the manager nor the CRAT paid any capital gains tax on the $4,000,000 in profit realized by the CRAT upon the sale of the appreciated securities, although some part or all of the gain could be taxed as the CRAT annuity payments are made.

   It is important to note that while the above transaction was advantageous to the manager in that the manager received an immediate charitable deduction and may avoid or reduce his or her capital gains tax on the securities, it would be more advantageous if the IRS benchmark rate were higher. Consider if interest rates rose and the benchmark rate were increased to 6.2 percent and all other assumptions remained the same. The manager would receive the same potential capital gains tax benefit and would still receive annuity payments of $250,000 each year, and the charity would still receive $5,000,000 at the end of the CRAT term. However, since the present value of the stream of annuity payments would be projected to grow at 6.2 percent, not 2.2 percent, the present value of the stream of payments would only be $1,822,700. In turn, the manager would receive a higher charitable deduction than when the benchmark rate was only 2.2 percent; the manager's charitable deduction would be $3,177,300 (i.e., $5,000,000 minus $1,822,700). The reason that the manager's charitable deduction increases when interest rates are higher is because when the CRAT is projected to grow at a higher rate, the anticipated remainder to be paid to charity at the CRAT's termination is higher.

F. Charitable Gift Agreements

1. Naming Opportunities: Many managers wish to share their financial success through large gifts to public charities such as colleges, hospitals and museums. Often, in exchange, the manager receives a naming opportunity — of a scholarship, a building, a program or a similar project or structure. A manager's income tax deduction for the charitable gift is not reduced or jeopardized by reason of such naming.

2. Use a Written Gift Agreement: These kinds of charitable gifts or pledges are typically (and should always be) memorialized in a written agreement between the manager and the charity in order to

be sure that both parties are legally bound to carry out their mutual promises. Important provisions of such an agreement include: (1) a statement of whether the naming will remain in perpetuity; (2) consequences of default by the charity (e.g., if the donor's name is removed in violation of the agreement's provisions); and (3) the ability of the donor to enforce the contract. In many states, only the Attorney General of the state in which the charity is located can enforce the gift agreement against the charity unless the agreement states otherwise, so it is crucial for the agreement to expressly state that the charity agrees that the donor also has the right to enforce the terms of the gift agreement in case the donor ever needs to enforce the agreement or seek its interpretation by a court.

IV. Marital Considerations

A. Prior to Marriage

1. Marital Rights: Spouses (or, in some states, non-marital partners) can have rights to certain business and other property rights if a couple separates or divorces. In many instances, these rights extend to income earned on and the appreciation of assets held prior to marriage. This can be a significant risk to investment fund managers who come into a marriage or relationship with an existing fund interest that is likely to grow and evolve over the course of a marriage. It can also impact other owners of the fund, as well as major investors who may worry about a spouse's claims to, or interference in, a fund if the marital relationship falters.

2. State Law Varies: The law can vary significantly (based upon where the spouses live) as to what rights a spouse might have in an asset that is owned prior to marriage. For example, in New York, property that was owned prior to marriage is typically protected from a spouse's claims, but income and appreciation on such property during the marriage can be subject to a spouse's claims if and to the extent that such income and appreciation are generated as a result of the efforts of either spouse (rather than the efforts of others or market forces). In other states, however, including Connecticut, all property owned by each spouse at the time of a divorce is potentially subject to the other spouse's claims — even if it was owned prior to marriage — though the timing and circumstances of ownership are factors to be considered.

3. Prenuptial Agreement: Thus, even prior to marriage (or, in some instances, cohabitation), it is important to consider the benefits of a prenuptial agreement that would prevent a spouse from ever obtaining an interest in the fund that could harm the governance and ongoing viability of the fund. Such an agreement typically would also restrict a spouse's economic rights in the fund (often in exchange for some other economic benefit).

B. During Marriage

1. Postnuptial Agreement: Married couples who have not entered into a prenuptial agreement can enter into a "postnuptial" agreement. A postnuptial agreement typically covers the same economic issues as are addressed in a prenuptial agreement, though these issues may be sensitive and difficult to raise and address during the marriage.

2. Risk of Diminution of Control for Manager: In the case of a fund manager who does not have a prenuptial agreement or a postnuptial agreement, it can be even more important than in other situations that the governing documents of the fund preclude an involuntary transfer of an interest in the general partner and the management company to a spouse (or other person). This type of provision is beneficial for certain other reasons as well. Many courts honor these types of provisions

so long as they meet certain requirements, including that they are not entered into to defraud a spouse or in contemplation of divorce.

C. Upon a Separation or Divorce

1. If Marital Agreement Governs: A well-drafted prenuptial or postnuptial agreement should protect the manager and the fund from a former spouse's claims to a direct and ongoing interest in the fund, even if the former spouse has certain economic rights that are satisfied with respect to the fund's ongoing performance.

2. If Marital Agreement Does Not Govern: If spouses have not entered into a prenuptial or postnuptial agreement, the law will determine how the spouses' property is to be divided, with the controlling law generally to be the law of the state in which they reside. In many (but not all) instances of divorce, courts tend not to award a non-owner spouse a direct ongoing interest in a business venture if ownership of the interest includes the right to participate in control of the business.

3. Potential Regulatory Disclosure Obligations Post-Divorce: A divorce between a partner in the management company and his or her spouse may need to be disclosed on the management company's Form ADV. For example, in certain instances, Form ADV can require disclosure of the divorced spouse's economic ownership in the management company, which of course could raise privacy and other concerns for the relevant parties.

Marketing Challenges: U.S. and EU Considerations

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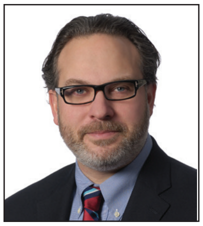


Special Counsel
New York Office
+1 212.756.2072
brad.caswell@srz.com

Practices

Investment Management

Hedge Funds

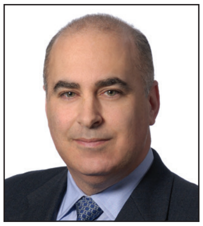
Regulatory & Compliance

Brad L. Caswell

Brad focuses his practice on counseling hedge and private equity funds on operational, regulatory and compliance matters. He provides guidance to clients on a broad range of issues, including those related to the U.S. Investment Advisers Act, other federal, state and self-regulatory organization requirements and securities trading rules in the United States. Brad also provides guidance to clients with operations in Hong Kong, Japan and other markets throughout Asia and the United Kingdom with respect to regulatory, compliance, trading and operations. Prior to joining SRZ, Brad served for 12 years in various in-house roles, including as general counsel and chief compliance officer of investment advisers ranging from multi-billion-dollar funds to start-ups, and as a member in the asset management group of a leading investment bank.

A frequent speaker and writer on the topics of fund operations and regulatory compliance, Brad presented "Compliance Spotlight" at the SRZ 23rd Annual Private Investment Funds Seminar and participated in "Private Equity Fund Compliance Update," a recent SRZ webinar. He also recently contributed to *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and co-authored "JOBS Act Update: CFTC Relief Removes Impediment to General Solicitation," which was published in *The Hedge Fund Journal*. He also formerly co-authored a periodic column on regulatory and compliance issues of interest to hedge funds for *HFMWeek*.

Brad received his J.D., *cum laude*, from Boston College Law School and his B.A., *magna cum laude*, from Georgetown University.



Partner
New York Office
+1 212.756.2269
david.efron@srz.com

Practices

Investment Management

Hedge Funds

Regulatory & Compliance

David J. Efron

David practices in the areas of domestic and offshore hedge funds, including fund formations and restructurings. Additionally, he advises hedge fund managers on structure, compensation and various other matters relating to their management companies, and he structures seed capital and joint venture arrangements. David also represents hedge fund managers in connection with SEC regulatory issues and compliance-related matters.

David is listed in *Chambers USA*, *The Legal 500 United States* and *Who's Who Legal: The International Who's Who of Private Funds Lawyers*. In particular, *Chambers USA* has noted that he is praised for his “excellent judgment” and for his “great combination of technical knowledge and street smarts which allows him to navigate the world of hedge funds,” and *The Legal 500 United States* has recognized him as “an extraordinarily capable attorney,” noting, “He has a mastery of the pertinent matters, but he also brings a pragmatic approach.” A published author on subjects relating to investment management, David recently co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). He is also a sought-after speaker for hedge fund industry conferences and seminars and a frequent guest lecturer at New York-area law and business schools. He recently presented “New Product Trends” and “Operational Due Diligence” for the Bank of America Merrill Lynch COO/CFO Hedge Fund Symposium.

David received his LL.M. in securities regulation, with distinction, from Georgetown University Law Center, his J.D. from Syracuse University College of Law, and his B.A. from Vassar College.

Partner
London Office
+44 (0) 20 7081 8002
christopher.hilditch@srz.com

Practices

- Investment Management
- Hedge Funds
- Financial Institutions
- Regulatory & Compliance

Christopher Hilditch

Chris heads SRZ's London office, where he advises a wide range of institutional and entrepreneurial managers on structuring and establishing investment funds, particularly hedge funds, funds of hedge funds, co-investment funds and other innovative products. On an ongoing basis, he advises promoters and managers on operational issues, including prime brokerage arrangements, investment transactions and relations with investors. He also advises on regulatory issues affecting funds and their managers, as well as on corporate, securities and partnership law issues.

Listed as a leading hedge fund lawyer in *Chambers UK*, *The Legal 500 UK*, *PLC Cross-border Investment Funds Handbook*, *The International Who's Who of Private Fund Lawyers* and *Who's Who of Professionals*, Chris is a member of the Legal Experts Group for the Financial Conduct Authority, the Law Society, the City of London Solicitors Company, the International Bar Association and the Sound Practices Committee of the Alternative Investment Management Association (AIMA), and he has participated in a number of ad hoc industry committees. He is a frequent speaker on hedge funds and related topics and a regular contributor to a variety of industry publications. He co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) as well as numerous articles. He also contributed to *Investment Management: Law and Practice* (Oxford University Press). Chris's recent speaking engagements include participating in the SRZ AIFMD and Other EU Regulatory Issues Roundtable and presenting "Corporate Governance" at the *HFMWeek* European Operational Leaders Summit.

Chris graduated with an M.A., with honors, from Oxford University and attended law school at the College of Law, Guildford.

Anna Maleva-Otto

Partner
London Office
+44 (0) 20 7081 8037
anna.maleva-otto@srz.com

Practices

Investment Management

Hedge Funds

Regulatory & Compliance

Anna concentrates her practice on advising asset managers on a range of U.K. financial services regulatory matters, including the impact of EU directives and regulations. She has a particular focus on advising clients on the establishment of regulated businesses, financial crime (including market abuse, money laundering and bribery), financial promotion and offers of securities, regulatory reporting and disclosure obligations, regulatory capital, and conduct of business rules. Prior to joining SRZ, Anna gained substantial experience advising hedge fund managers, brokers, insurance firms and investment banks on a wide spectrum of regulatory matters in her roles in private practice and as an in-house counsel and compliance officer of a hedge fund manager. She frequently participates in industry working groups in connection with new and emerging regulatory initiatives, and has advised asset manager trade associations on their advocacy efforts related to several key pieces of recent EU legislation (including the Short Selling Regulation, Alternative Investment Fund Managers Directive, MiFID II and MAD II). Anna began her career as a regulatory consultant assisting clients in the financial services sector with the design and implementation of compliance procedures, conduct of internal compliance investigations, compliance audits and remediation exercises.

Anna frequently speaks and writes on topics related to her areas of expertise. She recently published “Final UK Rules on AIFMD Implementation” in *The Hedge Fund Journal* and “Changing the Guard — What to Expect from the UK’s FCA” in the *AIMA Journal*. Her recent speaking engagements include participating in the SRZ AIFMD and Other EU Regulatory Issues Roundtable and presenting on “AIFMD, Marketing, Annex IV Reporting and the Swiss CISA” at the Goldman Sachs Twelfth Annual Hedge Fund Seminar in New York.

Anna received her J.D. from Emory University School of Law and her M.A. from Saint Petersburg State University (Russia).

Marketing Challenges: U.S. and EU Considerations

I. Capital Raising Trends/Hurdles/Practical Considerations

A. Flagship Fund Capital Raising

1. Fund Terms

(a) There continues to be pressure on the 2/20 fee structure. Management fees range from 1.5 percent to 2.0 percent. Incentive fees have generally held firm.

(b) Founders classes with lower fees/longer lock-ups continue to attract capital in new funds managed by new hedge fund managers.

(c) Many managers are offering investor-level gates. Some managers are offering variable pricing options with new lower fee/longer lock-up share classes.

(d) Side pockets are still an exception, not the rule. Some managers are launching private equity or hybrid funds for private equity/illiquid investments, and investors who want access to these private deals are investing through these other products.

(e) Investors continue to closely scrutinize expenses being charged to the funds and some investors are asking for expense caps in new funds. In particular, investors are focusing on regulatory, D&O insurance, travel, non-investment related systems and consulting expenses, as well as marketing expenses, including travel for marketing, and Alternative Investment Fund Managers Directive ("AIFMD")-related registration, reporting and marketing expenses.

2. Capital Introduction

(a) Capital introduction services are being used more extensively by some managers to seek out and attract high-net-worth and institutional capital.

(b) Capital introduction services could be deemed "marketing" under the AIFMD. Many cap intro conferences are being set up to create a record of "reverse solicitation," such that each investor is required to make a series of elections and "own initiative" certifications before being provided a list of managers that meet the relevant strategy, geography and size criteria, etc. when registering for the event. Managers need to be careful and assess whether there is genuine "reverse solicitation" in the case of each introduction, particularly in those EU countries where regulators have adopted a more restrictive approach.

3. Placement Agents

(a) More managers are seeking additional distribution channels, capacity and contacts through the use of placement agents in the United States and internationally.

(b) If a manager is using placements agents, the manager needs to ensure the placement agent doesn't jeopardize its reverse solicitation position under the AIFMD. The manager needs to limit the EU jurisdictions where the fund can be marketed and oversee the placement agent's activities to assess whether registrations in certain EU countries may be required by virtue of the placement agent's activities.

(c) Managers should only be dealing with placement agents that are properly registered in the United States and in other countries where they are doing business. In the United States, this issue was highlighted in actions involving Ranieri Partners,[1] where it was made clear that the U.S. Securities and Exchange Commission (the "SEC") can and will impose liability on an adviser for knowingly using an unlicensed broker in placing fund interests. The prominence of this issue was further underscored in an April 2013 speech by the chief counsel of the SEC's Division of Trading and Markets, in which he highlighted broker-dealer registration concerns raised by sales of interests in private funds.

(d) Managers need to ensure that the placement agent agreements are negotiated carefully and include market terms and representations, including but not limited to the following:

(i) Placement Agent Fees/Introduced Investors: Will the fees continue perpetually or terminate after some period? Are fees limited to the specific fund only or other products invested in by the introduced investors? Which investors were introduced by the placement agent?

(ii) Bad Actor Provisions: The placement agent agreement should include clear representations from the placement agent with respect to Rule 506(d) and termination provisions, including with respect to fees, if the placement agent is subject to a disqualifying event under Rule 506(d).

(iii) Anti-Money Laundering ("AML")/Foreign Corrupt Practices Act ("FCPA"): It is critical for the manager to ensure that it is comfortable from an AML/FCPA perspective, and that the manager is comfortable with the placement agent's policies and procedures with respect to AML/FCPA. The manager should have the right to request additional information on certain higher-risk introduced investors so that the manager can be assured that the underlying introduced investors do not cause legal or reputational issues for the manager.

4. Bank/BD Platform Arrangements/Conduit Funds

(a) Managers are looking for distribution opportunities to get their funds on various platforms with access to potential high-net-worth capital.

(b) From the EU perspective, AIFM and UCITS platforms may provide managers with access to an EU investor base without triggering registration and ongoing compliance requirements. However, platform operators will typically look to the managers for assistance with fulfilling certain compliance and reporting obligations, and they will impose various obligations to comply with EU regulatory requirements (*e.g.*, remuneration rules) contractually.

(c) These platforms may also require customized fund documents (including different forms of subdocs), which raise additional issues from an administrative perspective in the review of these documents and from a legal perspective to ensure the manager is receiving the same types of representations and warranties and other legal protections (including AML and FCPA representations).

[1] *Ranieri Partners LLC and Donald W. Phillips*, Exch. Act Rel. No. 69091, Adv. Act Rel. No. 3563, Administrative Proceeding File No. 3-15234 (March 8, 2013); *William M. Stephens*, Exch. Act Rel. No. 69090, Inv. Co. Act Rel. No. 30417, Administrative Proceeding File No. 3-15233 (March 8, 2013).

B. Customized Products

1. Types of Customized Products: Many managers are raising capital through a host of different types of customized products set up through different structures such as managed accounts and funds of one or commingled vehicles.

   (a) Long-Only Funds: Investors continue to ask managers to launch long-only versions of their flagship funds. For some investors, this kind of product falls into a separate (i.e., separate from hedge funds) internal diversification category. Some long-only funds pay incentive compensation to the manager only when the fund outperforms a particular benchmark or index (e.g., the S&P 500 Index or an MSCI index).

   (b) Concentrated Funds: Investors are asking for and managers are launching funds for multiple investors or creating an investor-specific "fund of one" that offers exposure to a concentrated subset of the manager's flagship investment strategy. That subset can be defined in many different ways, depending on the needs of the investor. Common examples include: concentration by security type (e.g., exposure to equities but not fixed income); concentration by conviction level (sometimes referred to in the industry as a "best ideas" fund); selective exposure only to specific portfolio managers (for advisers that internally allocate capital to multiple portfolio managers); concentration by business sector (e.g., only health care or media); and concentration by geographic regions (e.g., an Asia-only fund).

   (c) Sidecar/Co-Investment: Certain investors wish to invest capital alongside a manager in a single investment or group of related investments held by the manager's flagship fund. Common structures for making this type of investment are through a sidecar fund or co-investment vehicle. Sidecar funds or co-investment vehicles are often formed for a single institutional investor willing to invest a significant amount of capital in a particular transaction (e.g., an activist investment or a less-liquid opportunity). Sidecar funds and these types of co-investment vehicles are more likely to be structured as private-equity style investment vehicles with a carried interest paid to the manager only when all capital invested in the particular investment has been returned to the investor. Investors also continue to be interested in overflow funds, which are similar to sidecar funds but usually have a mandate that allows them to invest in multiple securities or opportunities at any time when the manager's flagship fund has reached its capacity. Sidecar funds, on the other hand, tend to focus on co-investing in a single security.

   (d) Levered Funds: Some investors have requested levered versions of the flagship funds that seek a higher return with higher volatility. Levered funds are usually formed as a legal entity separate from the flagship fund and typically state a target for the level of leverage they will seek to employ (e.g., a "3x levered" version of the flagship fund). Levered funds typically charge management fees on the unlevered net assets but may instead charge management fees on the notional assets under management.

   (e) Socially Responsible Funds: A range of investors including individuals, sovereign wealth funds, state and local governments, and corporations may request that a fund limit its exposure to certain assets that are problematic for such investors. Funds that incorporate environmental, social and corporate governance criteria in making investment decisions are often referred to as "socially responsible" funds. Initially, socially responsible funds focused on avoiding investing in companies involved in specific industries such as alcohol, tobacco, gambling, pornography and firearms. Today, that list has broadened to include other areas, such as investments that could have an adverse impact on the environment.

2. Hurdles and Legal/Practical Considerations

   (a) Use of Track Record: Managers launching customized products want to be able to show their track record and performance on the long-only slice of their flagship fund, or their best ideas or private equity type investments only. Managers may want to customize their pitch books and other marketing materials solely on the customized product or strategy of the new fund. This can raise issues under Rule 206(4)-1 (the Advertising Rule, as more fully discussed below) and under SEC guidance as to advertising, including the following issues:

      (i) From an overall perspective, marketing materials must be fair and balanced, and investment advisers must abide by the general antifraud rules under the Investment Advisers Act of 1940, as amended (the "Advisers Act") such that marketing materials must not make false or misleading statements or omit material facts.

      (ii) For this reason, advisers should include the full performance of the flagship fund as well as the performance of the customized portion in marketing materials. Advisers should be very clear in marketing materials for customized products what the performance represents — and does not represent — and about any limitations/assumptions used in showing performance of only a portion of the flagship fund, including the fact that the portfolio may have been managed differently given market conditions if the fund was solely focused on the customized portion of the portfolio and that past performance of the flagship fund, and the customized portion of the portfolio, is not representative or indicative of future performance of the new fund. Managers should include comprehensive disclosures to this effect.

      (iii) Cherry-picking, or showing only the performance of certain investments (those investments in the customized space), also can raise issues under the advertising rules, as discussed more fully below. Many managers will not show the performance of specific investments, but rather may show an equal number of "winners" and "losers" in the customized space as case studies, chosen on an objective non-performance basis to illustrate their investment process and expertise in the long-only, concentrated or private equity space. Managers should not include performance of these specific investments unless they are complying with a specific exception discussed below.

   (b) Fiduciary Issues/Better Rights and Impact on Flagship Fund Investors

      (i) As fiduciaries, managers must act in the best interests of all of their clients, including flagship funds, new customized funds and other clients.

      (ii) Effective disclosure of actual, anticipated and certain potential conflicts may be required under the Advisers Act or under general fiduciary principles. In preparing disclosure documents for customized funds, tailored and understandable disclosure of conflicts that the manager faces or may face in managing the different products is necessary. Managers should also consider inserting disclosures into the offering documents of the flagship fund. If the potential for sidecar or other concentrated products is not properly disclosed in the fund documents for flagship funds, managers must consider whether they may have a duty to offer the right to participate in such products to all flagship investors. Conflicts of interest disclosures should be periodically reviewed and updated.

   (c) Allocation of Investment Opportunities

(i) If a customized fund invests in a subset of securities in which a flagship fund invests (or in which it is eligible to invest), managers need to carefully consider and implement policies and procedures to address potential conflicts in allocations of trades and investment opportunities.

(ii) With customized funds, allocation issues are rarely as simple as a straightforward pro rata split. Allocating investment opportunities between a customized fund and a flagship fund based on percentage guidelines (e.g., 70/30) may still result in material differences in the actual exposure of each fund when hedging and shorting are factored in.

(iii) Dealing with funds that trade on different schedules and with different liquidity can be challenging. For example, managers need to consider front-running concerns and, conversely, if the earlier fund is capturing the entire opportunity. Also managers should consider whether one fund's investments can move the valuations and impact the other fund.

(iv) If a flagship fund has higher fees, or if the principals have more of their own money invested in a flagship fund, managers must be careful to avoid favoring the flagship fund when allocating investment opportunities or making other trade decisions. If principals have more "skin in the game" with respect to particular products, they should not unfairly favor such products.

(d) Expense Allocation

(i) Expense allocation between the manager and the funds or other clients continues to be one of the primary focus areas in examinations by the SEC.

(ii) As a manager's business becomes more complex, with additional funds and managed accounts — including customized products — it becomes even more critical for the manager to reassess its expense allocation policies and procedures and make sure that investment professionals, legal and compliance, and operations and finance are all on the same page.

(iii) Managers launching or running customized funds need to consider whether specific expenses are applicable to the customized fund and its investments and how much of the expense is applicable to the customized fund. If a pro rata formula is going to be used, managers need to consider whether the correct test is pro rata by capital or position size and specifically how the expense will be calculated and allocated. Managers also need to ensure that they are not billing expenses applicable to one client to another fund or client. If a customized fund or managed account has restrictions on certain expenses, it is fine for the manager to pick up that expense, but the manager should not allocate it to another fund or client.

(e) AIFMD

(i) Managed accounts are generally outside the scope of the marketing restrictions in the AIFMD, provided that certain conditions are met; however, offers of managed account services to EU investors may be subject to the restrictions under the Markets in Financial Instruments Directive (MiFID).

3. Retail

(a) U.S.-Registered Funds/Sub-Advisory Arrangements

(i) Managers continue to look to U.S.-registered funds for capital raising opportunities.

(ii) One of the issues with registered funds/retail funds is that managers cannot charge performance/incentive fees on these types of registered/retail funds.

(iii) Some managers have not wanted to launch a registered fund over concerns that the registered fund may "cannibalize" their flagship hedge fund business.

(iv) U.S.-registered funds also entail a significant additional layer of infrastructure, compliance and operations as these funds are subject to restrictions/requirements under the Investment Company Act of 1940, as amended (the "Company Act"), including but not limited to restrictions on affiliated party transactions, short selling and leverage.

(v) Because of the substantial additional operational and compliance responsibilities, "break-even points" for U.S.-registered funds are much higher and these funds require substantial assets and effective distribution for success.

(b) Europe: UCITS

(i) UCITS are "undertakings for collective investment in transferable securities."

(ii) The key benefits of a UCITS structure are:

(1) Pan-EU passport for marketing a UCITS;

(2) UCITS may be offered to retail investors in the EU (e.g., through IFAs, private banks or employer-sponsored pension schemes); and

(3) Certain types of regulated investors in the EU (e.g., insurance companies) may be able to make a larger allocation to a UCITS fund rather than an unregulated fund, because of favorable regulatory capital treatment or restrictions on investment powers.

(iii) Hurdles/Practical Considerations

(1) UCITS funds require significant administrative resources because there are investment-related restrictions, including prohibitions on direct short selling, and liquidity requirements.

(2) UCITS funds require effective distribution channels. As a result, the alternative UCITS market continues to be dominated by a relatively few big names.

(3) U.S. managers typically access UCITS through third-party platforms.

II. EU Regulatory and Switzerland

A. Marketing Under the AIFMD

1. The AIFMD has now been implemented in a majority of member states of the European Economic Area ("EEA").

2. Reverse solicitation exception from AIFMD marketing restriction is available in all EEA member states.

(a) "Marketing" excludes offers made at the initiative of the investor (i.e., reverse solicitation).

(b) Managers are applying a range of compliance measures to document reverse solicitation by EEA investors.

3. Compliance with National Private Placement Regimes

(a) In recent months, an increasing number of U.S. managers have begun considering registering under the national private placement regimes in some EEA member states.

(b) There are two key reasons for this trend: (1) lack of local guidance on the boundaries of reverse solicitation; and (2) new guidance on "Annex IV reporting" (similar to the SEC Form PF). Some jurisdictions will only require feeder-fund level reporting.

(c) In those EEA countries where a national private placement regime ("NPPR") is available, the local law has been amended to incorporate the minimum elements of a private placement regime set out in the AIFMD. These include:

(i) The AIFM must undertake to comply with the initial and ongoing investor disclosure obligations specified in the AIFMD; and

(ii) The AIFM must comply with Annex IV regulatory reporting obligations.

(d) "Gold-plating" refers to variations in local approaches to regulatory notification, investor disclosure and regulatory reporting elements of the AIFMD NPPRs.

4. Marketing Passport

(a) "Third country passport" would allow non-EU managers and non-EU funds to be marketed to professional investors throughout the EEA.

(b) The European Securities and Markets Authority ("ESMA") has been tasked with producing an opinion on the viability of such a third country passport by July 22, 2015. If ESMA produces a positive opinion, the EU Commission may activate the third country passport from late 2015 (at the earliest).

(c) Registration with an EU "member state of reference" and compliance with the whole of the AIFMD is required in order to benefit from the passport.

(d) If the third country passport is introduced, NPPRs will be repealed (from 2018, or earlier in some of the EEA countries).

B. Swiss Private Placement Rules

1. Transitional regime expires on March 1, 2015.

2. Two Categories of Swiss Qualified Investors

(a) Unregulated qualified investors (pension plans, corporates, family offices, family trusts and high-net-worth individuals).

(b) Regulated qualified investors (regulated financial entities, such as banks, securities dealers, fund managers and insurance companies).

3. Distribution to unregulated qualified investors requires appointment of local service providers (representative and paying agent) and appointment of a distributor (the manager can act as distributor for these purposes).

4. Reverse inquiry exception is available but is defined very narrowly in the local law.

III. U.S. Regulatory

A. SEC Examination Process

1. The Office of Compliance Inspections and Examinations ("OCIE") continues to focus on marketing practices, marketing materials, performance reporting, projected performance and expenses associated with marketing in examinations of U.S.-registered investment advisers. This includes full-scale SEC examinations as well in "presence exams" and through OCIE's "Never Before Examined" Initiative announced in February 2014.

2. The results of an SEC examination continue to be a powerful marketing/investor relations issue for managers. Investors continue to request disclosures on the results of an SEC exam, and investors will often request to see a copy of any SEC deficiency letter received by a manager as a result of an examination. If a manager is examined by the SEC and achieves a good result, with no deficiencies or limited deficiencies that the manager has addressed, this can be a positive in the investor due diligence process. If the manager suffers the opposite result, this can raise serious concerns with investors.

B. SEC Rules and Interpretations Regarding Marketing Materials

1. Overview

(a) Marketing materials, including flip books, tear sheets, periodic performance reports, websites and virtually any other type of material used to solicit prospective investors, must comply with various SEC rules and interpretations and must also generally satisfy antifraud standards. The FINRA rules will also apply if a broker-dealer solicits investors.

(b) Section 206(4) of the Advisers Act states, "It shall be unlawful for any investment adviser by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."

(c) Rule 206(4)-1 under the Advisers Act (the "Advertising Rule") governs advertising and marketing activities of registered investment advisers. The Advertising Rule includes a general prohibition against any advertisement that contains an untrue statement of a material fact or that is otherwise false or misleading or omits material information.

(d) Even if marketing materials do not contain any specific item or statement that is in and of itself false or untrue, the materials may nevertheless be deemed misleading or deceptive if they lead an investor to conclusions that are false or misleading (e.g., a belief that an investment will result in "quick profits").[2]

2. Cherry-Picking/Highlighting Select Investments

(a) The general rule is that specific reference to past profitable recommendations of the adviser are prohibited. This is intended to prevent "cherry-picking" (i.e., mentioning profitable recommendations but omitting unprofitable ones).

(b) There are certain very limited exceptions to this rule set forth in the Advertising Rule or in subsequent no-action letters issued by the staff. Managers should carefully analyze the applicability of any exceptions before highlighting specific investments in advertisements.

(i) There is a limited exception if the advertisement "set[s] out … a list of all recommendations made by such investment adviser within the immediately preceding period of not less than one year,"[3] provided that the advertisement includes certain other statements and disclaimers.

(ii) In the Franklin Management Inc., SEC No-Action Letter (Dec. 10, 1998), in recognition of the difficulty involved in providing a complete list of all recommendations made by an investment adviser in the past year, the SEC has permitted advisers to provide information about a limited number of recommendations so long as the presentation would not be misleading and certain other requirements are met. In particular, securities mentioned must be selected based on objective, non-performance-based criteria (e.g., largest dollar amount of purchases/sales; largest positions held, etc.) consistently applied. In addition, there can be no discussion of realized or unrealized profits or losses. There are additional conditions and disclosures required under this no-action letter.

(iii) In the TCW Group, Inc. SEC No-Action Letter (Nov. 7, 2008), the SEC provided additional guidance indicating that a selective list of recommendations would not be misleading if the adviser set out a list of at least 10 holdings that included an equal number of positive and negative recommendations where certain very specific conditions are met and disclosures included.

3. Track Record Presentation

(a) The Advisers Act and rules promulgated thereunder do not prohibit investment advisers from including performance information in advertisements. However, the information contained in the advertisement must not contain any untrue statement of a material fact and must not otherwise be false or misleading. According to the SEC staff, whether any particular advertisement is false or misleading depends on the facts and circumstances involved in its use.

(b) In order to assist investment advisers in determining an appropriate use of their performance in advertisements, the SEC staff set forth a number of practices pertaining to advertising that it believes are inappropriate in a 1986 no-action letter issued to Clover Capital Management Inc.[4]

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[2] *See Spear & Staff, Inc.*, Adv. Act Rel. No. 188 (March 25, 1965).

[3] 17 C.F.R. § 275.206(4)-1(a)(2).

[4] *See Clover Capital Management, Inc.*, SEC No-Action Letter (Oct. 28, 1986).

(c) Net of Fees: Performance information should be presented net of advisory fees, brokerage or other commissions and any other client expenses. An adviser also may show gross-of-fees performance results in other contexts if the adviser also: (1) presents net-of-fees with equal prominence; and (2) includes a disclosure statement explaining how the net-of-fees result was calculated and that the gross performance does not reflect the payment of advisory fees or other expenses incurred in the management of the accounts.

(d) Deduction of Model Advisory Fees: Initially the SEC required that performance figures be presented net of the actual fees charged to clients. However, the SEC staff subsequently issued a no-action letter to J.P. Morgan Investment Management Inc. indicating that it would not object if an investment adviser advertises the composite performance of accounts for which it employs a particular investment strategy by deducting model fees equal to the highest fees charged to any account during the performance period.[5]

(e) Material Economic Conditions: Marketing materials should include disclosures on the effect of any material market or economic conditions on the results.

4. Projected/Model/Hypothetical/Simulated Performance

(a) Use of projected performance is a focus area for the SEC and was highlighted as one of examination priorities by the SEC for 2014.[6]

(b) If a manager is going to use projected/model/hypothetical performance, the SEC will test the reasonableness of these calculations; thus the chief compliance officer ("CCO") should understand and test these assumptions in advance. Also, the manager should include detailed disclosures stating how the numbers were calculated and any limitations and assumptions underlying these calculations.

(c) FINRA rules prohibit the use of projected/model or hypothetical returns.

5. Track Records from Prior Employment or Other Funds: Many portfolio managers want to use performance results from a previous place of employment. An adviser's use of performance results achieved under a previous employer is not per se misleading provided that:

(a) The persons who manage the accounts at the successor employer were primarily responsible for achieving the prior performance results (i.e., no other individual or entity played a significant part in the performance of the accounts);[7]

(b) The accounts managed at the previous adviser are comparable to those currently managed and thus their performance is relevant to prospective clients;

(c) All accounts managed in a substantially similar manner are presented in the marketing materials unless the exclusion of an account does not result in showing materially higher performance;

(d) The materials include disclosure indicating that the performance results were from accounts managed at a different adviser; and

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[5] *See J.P. Morgan Investment Management*, SEC No-Action Letter (May 17, 1996).

[6] SEC, National Exam Program, OCIE, Examination Priorities for 2014 (Jan. 9, 2014).

[7] The portfolio manager claiming the performance results should actually "own" or be primarily responsible for the results. The portfolio manager should be able to prove primary responsibility.

(e) The other requirements relating to the presentation of performance are met.[8]

6. Disclaimer Page: Managers should include comprehensive disclaimers in advertisements that include, among other things, a statement that the materials are intended only for discussion purposes and that potential investors who express an interest in investing in the fund will be provided with an offering memorandum and other fund documents, and specific disclosures tailored to the Mmnager and marketing piece explaining any limitations and assumptions.

7. Risk Factors: The SEC has not stated that risk factors must be included in marketing materials (unlike FINRA, which has stated that its members must disclose relevant risks). Including a summary of the substantial risks associated with investing in the fund can be useful and should be strongly considered.

8. Consistency: All information included in the marketing materials should be consistent with the information provided in the offering memorandum, the Form ADV and other marketing materials.

9. Actual Results: Distinguish clearly between actual results and target returns. (Note that FINRA prohibits target returns in advertisements that are not supported by a "sound basis," and the sound basis should be included in the advertisement. While the SEC has not required investment advisers to meet this burden, investment advisers should only present target returns that are supportable by a "sound basis."[9]

10. Compliance Review: A compliance officer should review all marketing materials prior to the time the materials are sent to prospective investors and whenever changes are made to the materials.

C. Marketing Under the JOBS Act

1. On July 10, 2013, the SEC approved final rules to comply with a congressional mandate under the Jumpstart Our Business Startups Act (the "JOBS Act") to permit general solicitation and general advertising in certain private offerings of securities made pursuant to an exemption from registration under Rule 506 or Rule 144A of the Securities Act of 1933. This development was codified in new Rule 506(c).

2. With the promulgation of Rule 506(c), hedge fund and private equity fund managers — in theory at least — were able to employ general solicitation and general advertising in conducting Regulation D offerings (subject to that rule's limitations and certain additional obligations).

3. This rulemaking effort, however, did not result in a widespread adoption of general solicitation and general advertising activities for private funds; in fact, use of Rule 506(c) by both emerging and established private fund managers has been rare.

4. On Sept. 9, 2014, the U.S. Commodity Futures Trading Commission ("CFTC") staff granted broad relief intended to remove an obstacle to the ability of market participants, under rules previously promulgated by the SEC, to utilize general solicitation and general advertising in conducting placements of hedge fund and private equity fund interests (and other securities). This relief has certain conditions and does not represent a resolution of all of the questions and concerns surrounding the use of general solicitation and general advertising.

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[8] *See Conway Asset Management Inc.*, SEC No-Action Letter (Jan. 27, 1989).

[9] FINRA Rule 2210(d)(1)(A), *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=10648.

5. Although the resolution of the SEC-CFTC discrepancy is a substantial step forward for private fund managers seeking to take advantage of Rule 506(c)'s general solicitation and general advertising liberalization, significant challenges still surround Rule 506(c) offerings, including uncertainty about verification requirements under Rule 506(c), and uncertainty on the SEC's proposed rules still outstanding under the JOBS Act, including changes to the Form D filing requirements, uncertainty on future CFTC requirements, inconsistent foreign offering requirements and potentially heightened SEC examination risk.

IV. New Marketing Technology

A. More firms are utilizing technology such as websites, investor portals and cloud-based services such as Dropbox to provide marketing materials or investor relations services to investors.

B. The use of this technology provides obvious advantages, but it also raises a variety of issues and concerns that managers should be aware of, address through policies and procedures, and monitor closely.

1. Staleness: Managers must keep the information on investor portals updated. The SEC will also review different versions of websites, so it is very important that managers conduct regular reviews of their websites to ensure the website is current, consistent and accurate.

2. Privacy and Security: Managers must carefully monitor who is given access to investor portals and closely monitor access codes and security. Managers should only use these services if they are comfortable with the security features and risks, and they must also make sure that no personal nonpublic financial information about any investors (including investor names) are visible on these portals. Managers should not use cloud-based portals for investor-specific materials due to privacy, security and encryption requirements. There have been security breaches with some cloud-based services.

3. Advertising Rules: All materials included on investor portals or websites must comply with the advertising rules as described above, and the CCO should regularly review portals and websites for compliance.

4. Terms of Use: It is very important for managers to have comprehensive terms of use, disclaimers and privacy terms for use of websites and investor portals, including intellectual property protections.

5. Books and Records: If a manager is permitting the use of Dropbox or other cloud-based services for employees for business purposes, the manager must ensure these documents are being maintained as required under the Advisers Act books and records rules and the manager's internal policies.

6. AIFMD: Websites can also raise issues under the AIFMD and managers should ensure there are appropriate access restrictions so as not to jeopardize any reverse solicitation position.

Trading Compliance

24TH ANNUAL
PRIVATE INVESTMENT FUNDS SEMINAR
JANUARY 21, 2015

Schulte Roth & Zabel

Partner
New York Office
+1 212.756.2758
brian.daly@srz.com

Practices

Investment Management

Energy

Hedge Funds

Regulatory & Compliance

Private Equity

Brian T. Daly

Brian advises hedge 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 SRZ's educational outreach. In addition to hosting SRZ webinars, participating in firm-sponsored seminars and workshops, authoring SRZ alerts and white papers and co-authoring the SRZ Compliance Spark Twitter feed, he recently published "JOBS Act Update: CFTC Relief Removes Impediment to General Solicitation" and "'Knowledgeable Employees' – Recent SEC Guidance Also Details Broker-Dealer Registrations," in *The Hedge Fund Journal*. He presented "What, Me? Yes, You: The Surprising Reach of the Registration Requirements of the Commodity Exchange Act" at the ABA Business Law Section Fall Meeting, and he spoke at the Bank of America Merrill Lynch GC/CCO Hot Topics Dinner. 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 the CFTC Working Group for the Alternative Investment Management Association, and 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 B.A., *magna cum laude*, from Catholic University of America, his M.A. from the University of Hawaii and his J.D., with distinction, from Stanford Law School.

Partner
New York Office
+1 212.756.2075
omoz.osayimwese@srz.com

Practices

Investment Management
Hedge Funds
Private Equity

Omoz Osayimwese

Omoz focuses his practice on the representation of sponsors and investors in the formation and structuring of private equity funds, hedge funds and hybrid funds. He has extensive experience representing sponsors and investors on funds employing real estate, buyout, credit, distressed investment, structured products, activist, multi-strategy and long-short equity strategies. He also represents hedge fund managers and investors in the negotiation of seed-capital transactions, and he advises sponsors of private equity firms in the structuring of complex carry-sharing arrangements among principals and employees. Recent representations of Omoz's include institutional sponsors and boutique firms in the formation of private equity funds, hedge funds and hybrid funds; lead investors on their investments in private equity funds; hedge fund managers and investors in seed-capital arrangements; investment managers in joint venture arrangements; and investment managers and investors in the formation of special purpose acquisition and co-investment vehicles.

Omoz regularly addresses investment managers about current developments relating to private investment funds. His recent speaking engagements include participating in "Private Equity Fund Compliance Update," an SRZ webinar, and presenting "Ongoing Operations and Firm Growth" at the SRZ 2nd Annual Private Equity Fund Conference and "Management Company Structuring and Operations" at the SRZ 23rd Annual Private Investment Funds Seminar. He also contributed to the *Fund Formation and Incentives Report*, released by Private Equity International and SRZ.

Omoz received his J.D. from University of Michigan Law School and his B.A., with highest honors, from Michigan State University.

Special Counsel
Washington DC Office
+1 202.729.7468
jacob.preiserowicz@srz.com

Practices

Investment Management

Hedge Funds

Regulatory & Compliance

Jacob Preiserowicz

Jacob focuses his practice on counseling commodity pool operators, commodity trading advisors, other commodity professionals and private investment fund managers on operational, regulatory and compliance matters. He regularly advises hedge and private equity fund managers with respect to futures and swaps trading; the U.S. Commodity Futures Trading Commission's (CFTC) exemptions, registration and reporting requirements; and compliance with the requirements of the National Futures Association, as well as CFTC and exchange rules concerning OTC and listed derivatives. Jacob conducts training sessions with respect to regulatory compliance matters and helps guide firms through regulatory examinations. He also has expertise in the formation and ongoing operational needs of hedge funds and other private investment funds and provides guidance on a variety of regulatory, compliance and risk management issues related to the implementation of the Dodd-Frank Act. Jacob joined the firm from the CFTC, where he served most recently as Special Counsel in the Division of Swap Dealer and Intermediary Oversight. At the CFTC, he drafted new regulations and worked on a broad range of matters relating to CFTC registration and compliance.

Jacob has spoken at a series of SRZ workshops and seminars on CFTC registration, compliance and swap rules, and he also contributed to *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). He recently co-authored "JOBS Act Update: CFTC Relief Removes Impediment to General Solicitation" in *The Hedge Fund Journal.*

Jacob earned both J.D. and M.B.A. degrees from Fordham University. He was the Notes & Articles Editor of the *Fordham Journal of Corporate & Financial Law* and received *cum laude* honors from the Fordham University Graduate School of Business. He received his B.A., *cum laude*, from Brooklyn College.

Partner
New York Office
+1 212.756.2390
craig.stein@srz.com

Practices

Structured Products & Derivatives

Regulatory & Compliance

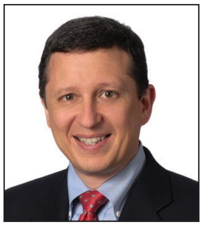
Trading Agreements

Craig Stein

Craig is co-head of the firm's Structured Products & 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).

Craig has been recognized by *Chambers Global*, the *Expert Guide to World's Leading Structured Finance and Securitisation Lawyers*, *The Legal 500 United States*, and *Chambers USA*, which stated: "Clients and peers have 'nothing but great things to say about' him. He is 'a great thinker and excellent credit derivatives operator.'" He is a member of the American Bar Association, the New York State Bar Association, LSTA, Structured Finance Industry Group and various ISDA committees. Craig is a sought-after speaker for hedge fund industry conferences and has written widely on advanced financial products. He recently presented "Navigating Buy-Side Risks and Best Practices for SEFs and Clearing" at the Risk.net Derivatives OTC Clearing conference, "Legal and Structural Considerations: How to Effectively Analyze a CLO" at the IMN 3rd Annual Investors' Conference on CLOs and Leveraged Loans, and "Collateral Management and Margining" at the ISDA OTC Derivatives Clearing Risk and Capital Conference. His articles have appeared in publications such as *The Hedge Fund Journal*, *Credit*, *Loan Market Week*, *Pratt's Journal of Bankruptcy Law* and the *Journal of Derivatives*. He recently co-authored "CLO 3.0: The Impact of Regulations" for *The International Comparative Legal Guide to: Securitisation 2014* and "The New ISDA Protocol: What Investment Managers Need to Know" for *The Hedge Fund Journal*, as well as *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press).

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



Partner
New York Office
+1 212.756.2441
gary.stein@srz.com

Practices

Litigation

Regulatory & Compliance

Securities Enforcement & White Collar Defense

Gary Stein

Gary focuses on white collar criminal defense and securities regulatory matters, complex commercial litigation, internal investigations, anti-money laundering issues, civil and criminal forfeiture proceedings and appellate litigation. He represents public companies, financial institutions, hedge funds, other entities and individuals as subjects, victims and witnesses in federal and state criminal investigations and regulatory investigations by the SEC, SROs and state attorneys general. He has conducted numerous internal investigations involving potential violations of the Foreign Corrupt Practices Act, financial statement fraud, money laundering and other matters, and advises companies on compliance with the FCPA and anti-money laundering and OFAC regulations. As a former Assistant U.S. Attorney and Chief Appellate Attorney in the Southern District of New York, Gary investigated, prosecuted, tried and appealed numerous white collar criminal cases involving money laundering, fraudulent investment schemes, bank fraud, insider trading, art theft, illegal kickbacks, terrorist financing and other financial crimes. His civil litigation experience includes claims of fraud and breach of contract, securities class actions and derivative actions, contests over corporate control, and disputes arising from the sale of a business. He has handled more than 150 appeals in federal and state courts involving issues of both criminal law and procedure and complex commercial law. He successfully argued 15 appeals in the U.S. Court of Appeals for the Second Circuit and most recently led the firm's pro bono representation in *Hurrell-Harring v. State of New York*, which resulted in a historic settlement that lays the foundation for statewide reform of New York's public defense system.

Listed as a leading litigation attorney in *Benchmark Litigation*, *The Legal 500 United States* and *New York Super Lawyers*, Gary serves on the board of directors of The Legal Aid Society and the board of editors of the *Business Crimes Bulletin*. He regularly presents on FCPA, insider trading, risk management and crisis management issues at conferences and is an accomplished writer. In 2008, he was presented with a Burton Award for Achievement in Legal Writing for co-authoring "The Foreign Corrupt Practices Act: Recent Cases and Enforcement Trends," which appeared in the *Journal of Investment Compliance*. He most recently participated in "FCPA, M&A and Private Equity," an SRZ webinar, and he co-authored the "Scienter: Trading 'On the Basis Of'" chapter in the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute), "Sanctions Update: Sectoral Sanctions Against Russia Escalate" in *Westlaw Journal – Securities Litigation & Regulation*, and "Gratuities and Honest Services Fraud" in the *Business Crimes Bulletin*.

Gary obtained his B.A. from New York University and his J.D. from New York University School of Law, where he was senior articles editor of the *New York University Law Review*.

Trading Compliance

I. Insider Trading

A. Recent Securities Law Developments

1. Insider trading remains a key area of focus for both the SEC and the DOJ.

(a) The U.S. Attorney's Office for the Southern District of New York continued its high-profile insider trading prosecutions of hedge fund traders, such as former SAC portfolio manager Mathew Martoma, who was sentenced to nine years in prison.[1] At a recent conference, the deputy chief of the Southern District's Securities Fraud Unit said that insider trading would be an area of focus in 2015 as well.[2]

(b) The SEC charged 80 people in insider trading cases in FY 2014.[3] The SEC has also stated that it is implementing and developing "next generation" analytical tools designed to ferret out patterns of suspicious trading.[4]

(c) At the same time, both the DOJ and the SEC experienced significant defeats over the past year in cases in which defendants fought back and put the government to its proof.

(i) The SEC lost five[5] insider trading cases that went to trial over the past year — more than it won — including its case against hedge fund manager Nelson Obus and two others. These losses come on the heels of the SEC's well-publicized defeat at trial last year in its case against Mark Cuban.[6]

(ii) Southern District prosecutors also suffered their first defeat in the recent wave of insider trading prosecutions when a jury acquitted Rengan Rajaratnam, the brother of Raj Rajaratnam, in July.[7] In addition, the U.S. Court of Appeals for the Second Circuit overturned the convictions of two hedge fund traders in a noteworthy ruling in *United States v. Newman* (discussed below).

(d) This past summer, SEC Enforcement Director Andrew Ceresney announced that the SEC intends to bring more insider trading cases as administrative proceedings, rather than in federal court.[8] This affords the SEC several procedural advantages, including limiting a defendant's ability to take depositions and obtain other pretrial discovery, allowing the SEC to use hearsay evidence

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[1] *United States v. Martoma*, No. 12 Cr. 973 (PGG) (S.D.N.Y. Sept. 8, 2014).

[2] *See* Peter Rawlings, CFTC, Prosecutors Eye Obstruction Cases, Compliance Intelligence (Dec. 15, 2014).

[3] Press Release, SEC's FY 2014 Enforcement Actions Span Securities Industry and Include First-Ever Cases (Oct. 16, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543184660#.VK18zivF91U.

[4] *Id.*

[5] *SEC v. Moshayedi*, No. 12-cv-01179 (C.D. Cal. June 6, 2014); *SEC v. Obus*, No. 06 Civ. 3150 (GBD) (S.D.N.Y. May 30, 2014); *SEC v. Steffes*, No. 1:10-cv-06266 (N.D. Ill. Jan. 27, 2014); *SEC v. Yang*, No. 1:12-cv-02473 (N.D. Ill. Jan. 13, 2014); *SEC v. Schvacho*, No. 1:12-CV-2557-WSD (N.D. Ga. Jan. 7, 2014).

[6] *SEC v. Cuban*, No. 3:08-cv-02050-D (N.D. Tex. Oct. 16, 2013).

[7] *United States v. Rajaratnam*, No. 13-00211 (S.D.N.Y. July 8, 2014).

[8] Sarah N. Lynch, U.S. SEC to File Some Insider-Trading Cases in Its In-House Court, Reuters (June 11, 2014), *available at* http://www.reuters.com/article/2014/06/11/sec-insidertrading-idUSL2N0OS1AT20140611.

and depriving a defendant of the right to a jury trial as administrative proceedings are decided by an administrative law judge appointed by the SEC.

(i) Since Ceresney's announcement, the SEC has filed six administrative actions involving insider trading charges.[9]

(ii) Some defendants charged by the SEC in administrative proceedings, however, have brought actions against the SEC in federal district court claiming that the SEC's use of administrative proceedings is unconstitutional.[10]

2. *United States v. Newman*

(a) Background

(i) In a highly-anticipated decision on Dec. 10, 2014, the U.S. Court of Appeals for the Second Circuit held in *United States v. Newman*[11] that in order to sustain insider trading charges against a remote tippee who trades on material nonpublic information, the government *must prove that the remote tippee knew* that the tipper breached his fiduciary duties by: (1) disclosing confidential corporate information to a tippee (2) in exchange for a personal benefit. The court thus rejected the position of the district court, which had charged the jury that it could convict if it found that the remote tippee knew that the information had been disclosed in breach of the tipper's duty of trust and confidence, regardless of the remote tippee's knowledge of whether the tipper had received a personal benefit.

The court further held that the requisite personal benefit may not be inferred by the mere fact of friendship between the tipper and tippee but rather requires proof a meaningfully close relationship that generates an exchange that is objective, consequential and represents at least a potential gain of a pecuniary or similarly valuable nature.

(ii) In *Newman*, Todd Newman and Anthony Chiasson, portfolio managers at separate hedge fund managers, appealed their insider trading convictions.

(1) At trial, the government presented evidence that a group of financial analysts exchanged information obtained directly, or, more often, indirectly from corporate insiders about the companies' quarterly earnings before those results were publicly announced.

(2) The nonpublic earnings information was ultimately passed to Newman and Chiasson, who were several levels removed from the original tippers.

(3) The government asserted that Newman and Chiasson were not permitted to trade on that information because the insiders had disclosed it in breach of duties of trust and

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[9] Michael S. Geist, Adm. Proc. File No. 3-16269 (Nov. 12, 2014); Steven Durrelle Williams, Civ. Act. No. 3-146246 (Nov. 3, 2014); Filip Szymik, Adm. Proc. File No. 3-16183 (Sept. 30, 2014); Jordan Peixoto, Adm. Proc. File No. 3-16184 (Sept. 30, 2014); George T. Bolan, Jr., Adm. Proc. File No. 3-16178 (Sept. 29, 2014); Richard O'Leary, Adm. Proc. File No. 3-16166 (Sept. 25, 2014).

[10] *Compare Chau v. SEC*, No. 1:14-cv-01903-LAK (S.D.N.Y. Dec. 11, 2014) (Kaplan, J.) (dismissing complaint alleging that SEC's use of administrative proceedings is unconstitutional for lack of subject matter jurisdiction) *with Gupta v. SEC*, 796 F. Supp. 2d 503 (S.D.N.Y. 2011) (Rakoff, J.) (holding that the court had jurisdiction over the plaintiff's equal protection violation claim and denying motion to dismiss). While the complaint in *Gupta* survived a motion to dismiss, it was jointly dismissed pursuant to an agreement between the parties that the SEC's administrative proceeding against Gupta would be dropped and refiled in federal court.

[11] Nos. 13–1837–cr (L) & 13–1917–cr (con), 2014 WL 6911278 (2d Cir. Dec. 10, 2014).

confidence to their respective corporations, and that the defendants knew the insiders had committed such a breach.

(iii) The Second Circuit, however, held that the district court erred by failing to require that the government prove that Newman and Chiasson, as remote tippees, knew that a personal benefit existed.

(1) That result, the court explained, "follows naturally" from the U.S. Supreme Court's decision in *Dirks v. SEC*, which "counsels us that the exchange of confidential information for personal benefit is not separate from the tipper's fiduciary breach; it *is* the fiduciary breach."[12]

(2) The court added that the tippee need not know "the details of the insider's disclosure of information," such as "how information was disclosed" or "the identity of the insiders," so long as the defendant tippee "understands that some benefit is being provided in return for the information."[13]

(iv) Instead of sending the case back for a retrial before a properly instructed jury, the Second Circuit also held that the evidence was insufficient as a matter of law to establish the defendants' guilt beyond a reasonable doubt, and therefore ordered that the indictment against them be dismissed with prejudice.

(1) The court found that the government failed to prove that the tippers in the case had received a personal benefit, rejecting the government's theory that "career advice" provided to one of the tippers by his immediate tippee satisfied this requirement, and noting that the other tipper and immediate tippee were merely casual acquaintances without any history of loans or personal favors between the two.

(2) The court further found that the government failed to prove that Newman or Chiasson knew that the information they allegedly traded on originated with corporate insiders, or that those insiders received any personal benefit in exchange for disclosing the information.

3. New York Attorney General Initiative: "Insider Trading 2.0"

(a) In September 2013, New York Attorney General Eric Schneiderman identified the combination of: (1) high-frequency trading; (2) the sale of early access to market-moving information; and (3) efforts to obtain early access to analyst reports as "Insider Trading 2.0" and established a hotline for financial industry insiders to confidentially report improper and illegal conduct for investigation by the Attorney General's office. According to Schneiderman, these practices "undermine[] confidence in the markets by setting up a small minority of traders to receive enormous profits at the expense of the rest of the market."[14]

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[12] *Id.* at *7 (emphasis in original).

[13] *Id.* at *8 n.3.

[14] Press Release, A.G. Schneiderman Highlights Growing Threat Early Access to Market-Moving Data & High-Frequency Trading Pose to U.S. Markets, Announces Confidential Hotline for Reporting Abuses (Sept. 24, 2013), *available at* http://www.ag.ny.gov/press-release/ag-schneiderman-highlights-growing-threat-early-access-market-moving-data-high.

(b) On Jan. 9, 2014, the Attorney General's office announced a settlement with BlackRock, Inc. whereby BlackRock agreed to end its global analyst survey program.[15] Through the program, BlackRock would pose a series of questions to research analysts at an array of brokerage firms regarding the companies that the analysts were covering. The analysts' responses were generally solicited in numeric form (e.g., by selecting a response on a scale of 1 to 9), and BlackRock's quantitative investment group used this data, aggregated and averaged by issuer, to help inform trading decisions. Based on the design, timing and structure of the surveys, the program was allegedly being used to obtain "market-moving" information prior to the dissemination of such information to the public, purportedly in violation of New York's Martin Act (discussed below). On Feb. 26, 2014, the Attorney General's office announced that it had reached interim agreements with 18 financial firms to no longer permit, or to continue to prohibit, cooperation by the firms and their employees in any such analyst survey programs.[16]

(c) Another recent focus of the New York Attorney General's office has been the ability of high-frequency traders to obtain information from major wire services split seconds before the information is available to the general public (or other subscribers). In July 2013, Thomson Reuters agreed to discontinue its practice of providing high-frequency traders early access to a University of Michigan consumer survey, pending an investigation by the Attorney General's office.[17] Thereafter, in October 2014, Bloomberg LP, pursuant to its agreement with the University of Michigan, took over distribution of the University's consumer survey and announced that early access to the survey results would not be provided.[18] Since July 2013, several other major subscription wire services, including Business Wire, Marketwired and PR Newswire, have agreed not to provide direct feeds of the information they distribute to high-frequency traders, thereby eliminating the traders' split-second advantage.

(d) The New York Attorney General's "Insider Trading 2.0" initiative relies primarily on New York's broad Martin Act, codified at Article 23 of the New York General Business Law. The Martin Act, enforceable by the Attorney General but not by private action, establishes civil and criminal liability for securities fraud and grants the Attorney General extensive investigatory powers. Under the Martin Act, the definitions of "fraud" and "fraudulent practices" are much broader than under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. Moreover, the Attorney General does not need to establish any purchase or sale of securities or (in certain circumstances) scienter, making it easier for the Attorney General to bring successful securities fraud claims.

4. Reviewing Insider Trading Policies and Procedures

(a) Training

[15] Press Release, A.G. Schneiderman Announces Agreement with BlackRock to End Its Analyst Survey Program Worldwide (Jan. 9, 2014), *available at* http://www.ag.ny.gov/press-release/ag-schneiderman-announces-agreement-blackrock-end-its-analyst-survey-program-worldwide.

[16] Press Release, A.G. Schneiderman Announces Far-Reaching Agreements with Wall Street Firms to Stop Cooperating with Analyst Surveys (Feb. 26, 2014), *available at* http://www.ag.ny.gov/press-release/ag-schneiderman-announces-far-reaching-agreements-wall-street-firms-stop-cooperating.

[17] Press Release, A.G. Schneiderman Secures Agreement by Thomson Reuters to Stop Offering Early Access to Market-Moving Information (July 8, 2013), *available at* http://www.ag.ny.gov/press-release/ag-schneiderman-secures-agreement-thomson-reuters-stop-offering-early-access-market.

[18] Press Release, A.G. Schneiderman Applauds Deal Between University of Michigan and Bloomberg Ending Early Release of Market-Moving to High-Frequency Traders (Oct. 7, 2014), *available at* http://www.ag.ny.gov/press-release/ag-schneiderman-applauds-deal-between-university-michigan-and-bloomberg-ending-early.

(i) These recent cases reinforce the need for robust internal training regimes. The recent cases show that the law in this area continues to evolve and become more nuanced, which means that many managers correspondingly will need to update their training presentations.

(ii) Insider trading prevention training should be tailored to the manager and its population. For many managers, a one-size-fits-all, firmwide annual training session may not be sufficient; additional tailored, focused training sessions for personnel with higher exposure potential (e.g., analysts and traders) may be useful.

(b) Expert Networks

(i) Despite the large number of insider trading cases over the last several years, so-called "expert networks" continue to be a part of many managers' investment research processes.

(ii) Managers that permit their personnel to utilize these services should have strict access controls in place and should review usage levels. Other safeguards, such as required compliance department approval of experts and "chaperoning" of calls, may be appropriate in certain situations.

(c) Conferences and Broker-Arranged "One-on-Ones"

Fourteen years after the promulgation of Regulation FD, there are still situations involving disclosure of inside information by public company insiders. Managers should have programs in place to provide compliance departments with information regarding in-person or small group interactions with public company insiders, including training concerning the need to promptly report questionable disclosures to a compliance officer.

(d) Advisory Committees and "Value Added Investors"

Managers that have committees of outside industry luminaries or subject matter experts, as well as managers that allow these kinds of individuals to invest in a fund, must be cognizant of the potential disclosure of proprietary client or manager information outside of the firm, as well as the possibility of inside information being communicated to the manager or its personnel. Appropriate information barriers and training should be considered.

(e) Forensic Testing

One element of any insider trading prevention program long advocated by the SEC is "forensic testing" by managers. Given the increasing sophistication of the surveillance tools utilized by exchanges and regulators, managers should consider whether their review of firm trading is sufficient to identify potentially troublesome patterns or incidents. The documentation of such testing and the resolution of exceptions is important in earning the respect of regulators.

B. Futures

1. Historically, the CFTC has not had formal insider trading rules (derivatives markets operate in a way that allows for market participants to trade on the basis of lawfully obtained material nonpublic information). In 2011, as required by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act,[19] the CFTC finalized new Rule 180.1[20] (discussed in more detail below, under Market

[19] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 753, 124 Stat. 1739 (2010) (the "Dodd-Frank Act").

[20] Prohibition on the Employment, or Attempted Employment, of Manipulative or Deceptive Devices, 17 C.F.R. § 180.1 (2011).

Manipulation). Rule 180.1 prohibits deceptive or manipulative conduct in connection with any commodity interest. The CFTC provided two examples of such conduct:

(a) Trading on the basis of material nonpublic information in breach of a pre-existing duty (established by another law or rule, or agreement, understanding or some other source); or

(b) Trading on the basis of material nonpublic information that was obtained through fraud or deception.

C. Debt Investments and PIPEs

1. Managers that manage funds that invest in privately negotiated debt investments in public companies (or in PIPEs) and — either within the same fund or in a separate fund — simultaneously invest in publicly traded equity securities must have appropriate policies and protocols in place to ensure that confidential information acquired in their investments in private negotiated debt investments or PIPEs is not part of the investment decision-making process concerning public equities investments.

2. Appropriate policies and protocols include:

(a) Establishing separate investment teams for privately negotiated debt investments (or PIPEs) and for public equities investments and implementing information barriers between the two teams. The different teams should be both physically segregated (e.g., it is helpful to have them in different parts of the office or in different offices) and operationally segregated (i.e., computer files and other books and records should be maintained separately).

(b) Placing issuers for which the manager has considered making a privately negotiated debt (or PIPE) investment on the restricted list for not only the debt investments or PIPEs team but also the public equities team.

II. Market Manipulation

A. Spoofing and Layering: "Spoofing" (entering and canceling orders without the intent to actually fill the orders) and "layering"[21] continue to be a focus of enforcement actions by numerous regulators across a wide swath of enforcement regimes.

1. "Spoofing" Enforcement Activity in the Futures Markets

(a) The Dodd-Frank Act

(i) Section 747 of the Dodd-Frank Act incorporated anti-spoofing concepts into prohibitions on "disruptive practices" in Section 4c(a) of the Commodity Exchange Act (the "CEA") through the addition of a subparagraph (5).[22]

[21] "Layering" is generally thought to be slightly different than spoofing because: (1) layering generally implies multiple orders at different price points; and (2) the orders may have a longer lifespan than in a typical spoofing case; however, for purposes of this summary, the two offenses are similar.

[22] Dodd-Frank Act § 747.

(ii) Subparagraph (5) of Section 4c(a) of the CEA provides:

(5) DISRUPTIVE PRACTICES — 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 —
(A) violates bids or offers;
(B) demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period; or
(C) 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).[23]

(iii) On May 28, 2013, the CFTC issued an "interpretive guidance and policy statement" respecting subparagraph (5).[24]

(b) CME Rule 575 (Anti-"Spoofing")

(i) On Sept. 15, 2014, the CME Group exchanges (i.e., the CME, the Chicago Board of Trade, NYMEX and COMEX) adopted new Rule 575 ("Disruptive Practices Prohibited").[25] Rule 575 and its accompanying "Questions & Answers"[26] effectively declare "spoofing" to be a type of "disruptive order entry and trading practice" that is "abusive to the orderly conduct of trading or the fair execution of transactions."

(ii) New Rule 575 states that:

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; [and]

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) *Moncada*

(i) In a notable 2014 settlement, the CFTC obtained a federal consent order against Eric Moncada for alleged manipulation of the wheat futures markets.[27] The CFTC Director of Enforcement Aitan Goelman characterized this as "the wholesale entering and cancelling of orders without the intent to actually fill the orders."[28] The consent order imposed a $1,560,000 civil monetary penalty and trading and registration restrictions.

(ii) According to the consent order, by electronically entering and immediately canceling numerous large-lot orders for wheat futures, Moncada attempted to create a misleading impression of rising liquidity in the marketplace for the affected futures contracts. Moncada

[23] Commodity Exchange Act, codified at 7 U.S.C. § 4c(a)(5) (2012).

[24] CFTC Interpretive Guidance and Policy Statement, Antidisruptive Practices Authority, 78 Fed. Reg. 31890 (May 28, 2013), *available at* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-12365a.pdf.

[25] CME Grp. RA 1405-5, Market Regulation Advisory Notice (Sept. 15, 2014), *available at* http://www.cmegroup.com/tools-information/lookups/advisories/market-regulation/files/RA1405-5.pdf.

[26] *Id.*

[27] *CFTC v. Moncada,* Civil Action No. 12-cv-08791 (CM) (S.D.N.Y Oct. 1, 2014), *available at* http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfmoncadaorder100114.pdf.

[28] Press Release, CFTC, Federal Court Orders Eric Moncada to Pay $1.56 Million Penalty for Attempting to Manipulate the Wheat Futures Market (Oct. 1, 2014), *available at* http://www.cftc.gov/PressRoom/PressReleases/pr7026-14.

then allegedly profited by executing opposite direction small-lot orders at market prices he had distorted with the illusory large-lot order activity.

(iii) The *Moncada* settlement is notable for many reasons, including the fact that the number of manipulative trades is relatively small. The allegations involved attempts to manipulate the price of the #2 Soft Red Winter Wheat futures contract on eight days in October 2009 and entering into fictitious sales and non-competitive transactions on four days in October 2009.

(d) *Coscia*

(i) The DOJ has also taken an interest in spoofing activity. In October 2014, the DOJ obtained an indictment against Michael Coscia, a registered floor trader, for allegedly violating the Dodd-Frank Act's anti-spoofing provisions (i.e., subparagraph (5) of Section 4c(a) of the CEA).[29] The indictment is a follow-on action (i.e., a "parallel proceeding") that builds on civil and SRO enforcement actions against Coscia and his former trading firm (Panther Energy Trading LLC) by the CFTC, the CME Group and the U.K. Financial Conduct Authority.

(ii) As with *Moncada,* the number of alleged spoofing violations is in the single digits (six alleged instances). However, *Coscia* is also notable for the level of DOJ and CFTC "parallel proceeding" cooperation it evidences. For example, Coscia's 2013 settlement with the CFTC required Coscia to expressly waive "any claims of Double Jeopardy based on the institution of this proceeding or the entry in this proceeding of any order imposing a civil monetary penalty or any other relief[.]"[30]

2. "Spoofing" Enforcement Activity in the Securities Markets

The SEC and other securities regulators continue to focus on spoofing and layering activity. In April 2014, the SEC charged a trading firm, Visionary Trading LLC and a number of its affiliates and controllers with violations related to layering activity.[31] According to the settlement order, the misconduct occurred from 2008 through 2011. The SEC found violations of Sections 9(a)(2) and 10(b) of the Securities Exchange Act, Rule 10b-5 and Section 15(a)(1) of the Securities Exchange Act. It also found liability for willfully aiding and abetting violations, failures to supervise and registration violations. The total disgorgement and penalties agreed to were well in excess of $1,000,000.

B. CFTC Antifraud

1. Prior to the Dodd Frank Act, the CFTC's antifraud provisions required proof of price manipulation. Pursuant to the Dodd-Frank Act, the CFTC adopted Rule 180.1 as a new liability provision for fraud-based manipulation.[32] Under Rule 180.1, unlike the previous antifraud provision (now Rule 180.2[33]), the CFTC does not need to prove price manipulation to find a person liable.

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[29] *United States v. Coscia*, No. 14-cr-551 (N.D. Ill. Oct. 1, 2014), *available at* http://www.justice.gov/usao/iln/pr/chicago/2014/pr1002_01a.pdf.

[30] *CFTC v. Panther Energy Trading LLC*, CFTC Docket No. 13-26 (Jul 22, 2013) *available at* http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfpantherorder072213.pdf.

[31] *In re Visionary Trading LLC,* SEC Release No. 71871 (April 4, 2014), *available at* http://www.sec.gov/litigation/admin/2014/34-71871.pdf.

[32] 17 C.F.R. § 180.1 (2011).

[33] Rule 180.2 requires proof that: (1) the accused had the ability to influence market prices; (2) the accused specifically intended to create or effect a price or price trend that does not reflect legitimate forces of supply and demand; (3) artificial prices existed; and (4) the accused caused the artificial prices. 17 C.F.R. § 180.2 (2011).

2. The CFTC closely modeled Rule 180.1 on Rule 10b-5 of the Exchange Act; both Rule 180.1 and Rule 10b-5 focus on conduct involving manipulation or deception. The CFTC has stated that it intends to be guided, but not controlled by, securities law precedent insofar as such precedent is applicable to the futures and swaps markets.

3. Rule 108.1 prohibits fraud-based manipulations and attempts: (1) by any person (2) acting intentionally or recklessly (3) in connection with (4) any commodity interest.[34] The CFTC relies on precedent that defines recklessness as an act or omission that ‘‘departs so far from the standards of ordinary care that it is very difficult to believe the actor was not aware of what he or she was doing.”[35] Proof of knowledge, however, is not necessarily required.

III. Managing Large Positions

A. Position Limits

1. Exchange-based trading in derivative instruments is often subject to position limit rules.

2. In the United States, the CFTC, pursuant its authority under the CEA, has long maintained a system of position limits for speculative trading in certain futures contracts (and certain related instruments). These are currently found in Part 150 of the CFTC Regulations.[36] The Part 150 limits (referred to as "legacy contract" limits due to a proposal that would expand the position limits regime beyond this small set) apply to the following nine contracts: Corn and Mini-Corn, Oats, Soybeans and Mini-Soybeans, Wheat and Mini-Wheat, Soybean Oil, Soybean Meal, Hard Red Spring Wheat, Cotton No. 2 and Hard Winter Wheat.

3. There are three types of speculative position limits:

   (a) An "all months" combined limit applies to the total number of contracts held (net long or net short) at any point in time for a given commodity.

   (b) A "single month" limit applies to the number of contracts with the same expiration month that are held at any point in time.

   (c) A "spot month" limit applies to the number of contracts that can be held for a contract that is entering its delivery cycle.

4. In addition to the CFTC legacy contract limits, the various exchanges and boards of trade maintain position limits. Non-U.S. regulators and exchanges also maintain position limits of various kinds.

5. Throughout 2014, U.S. futures and options exchanges continued to aggressively pursue enforcement actions against fund managers and others for position limit violations. Further, the fines and penalties imposed continued to increase, even for in actions involving inadvertent first-time offenses.

6. Enforcement actions against hedge fund managers are not infrequent occurrences and often result in large fines, public disclosures by the exchanges and ADV-level disclosures. They also carry the risk of parallel CFTC actions when the violations also violate an applicable CFTC limit. Managers

[34] 17 C.F.R. § 180.1.

[35] *Drexel Burnham Lambert Inc. v. CFTC*, 850 F.2d 742, 748 (D.C. Cir. 1988).

[36] 17 C.F.R. §§ 150 *et seq.* (2011).

engaging in domestic or foreign futures and options trading are well-advised to research their position limit obligations in advance and set up appropriate monitoring and management systems.

B. Securities

1. The firm's own position in a publicly traded security, if sufficiently large to be market-moving, can itself constitute material nonpublic information.

2. In September, the SEC instituted insider trading charges against two people relating to a widely publicized $1-billion short position taken by a hedge fund in Herbalife Ltd.[37]

(a) The SEC alleges that a fund analyst told his roommate (Filip Szymik) about the firm's plans to publicly announce its negative view of Herbalife. Szymik, contrary to assurances he had given to the analyst that he would keep information of this nature confidential, then allegedly tipped a friend of his (Jordan Peixoto), who used the information to trade in Herbalife options the day before the short position was publicly announced, earning $47,100 in trading profits.

(b) The material nonpublic information alleged by the SEC therefore consisted of the "market-moving information" inherent in the public disclosure of the large short position, as opposed to confidential information belonging to Herbalife itself.

(c) The charges against Szymik were settled (Szymik agreed to pay a $47,100 fine) whereas the charges against Peixoto were poised for litigation in an SEC administrative proceeding. In December 2014, however, the SEC moved to dismiss the action on the basis that its two main witnesses for trial had left the United States with no intent to return.

3. The Herbalife case highlights the importance of protecting the confidentiality of trading positions, particularly when those positions can themselves be market-moving.

IV. Derivatives Compliance Issues

A. Central Clearing of Derivatives

1. Background

(a) The obligation to centrally clear certain interest rate swaps and credit default swap indices has been in effect in the United States since 2013.[38]

(b) Derivatives clearing is modeled after exchange trading, where buy and sell orders are matched. This means that the clearing house intermediates trades between ISDA parties. Once the trade clears, the ISDA no longer applies since both parties are facing the clearing house.

(c) In the United States, trades are submitted to a central counterparty ("CCP"). The CCP requires that clearing members collect initial and variation margin. The clearing member sets its own margin requirements, which may be above the amount the member is obligated to post to the CCP. Buy-side counterparties that "clear" will have credit exposure to both their futures commission merchant ("FCM"), which is also a clearing member, and to the CCP.

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[37] *In re Filip Szymik*, SEC Release No. 73262 (Sept. 30, 2014), *available at* http://www.sec.gov/litigation/admin/2014/34-73262.pdf; *In re Jordan Peixoto*, SEC Release No. 73263 (Sept. 30, 2014), *available at* http://www.sec.gov/litigation/admin/2014/34-71871.pdf.

[38] Final Rule, Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. 74284 (Dec. 13, 2012) (*effective* Feb. 11, 2013).

(d) The customer protection rules heavily regulate entities that accept customers' margin for cleared swaps — the FCMs. Margin is collected by the CCP from the clearing member on a gross basis (i.e., for all of its customers), and the clearing member also makes the margin call to its customer, the buy-side. The initial, or upfront, margin is retained by the CCP. The role of the CCP is to centralize counterparty credit risk. The goal of the new regulatory regime is to ensure that risk is properly collateralized, which closely resembles the long-established exchange-traded derivatives market.

(e) Considerable product uniformity is required for clearing to be practical. As a consequence, the pace at which OTC derivatives are being migrated to the cleared market model depends substantially on how readily OTC derivatives can be standardized. The operational and risk management challenges associated with the transition to the cleared market model are considerable; these include the preparation of legal documentation, establishment of market access and connectivity, on-boarding and account opening at clearing brokers, and the implementation and management of complex margining and collateral processes.

2. Adjusting Risk Management Procedures

Generally, market participants should consider the following benefits to centralized clearing as part of their risk management:

(a) The first benefit is its minimal credit risk — the clearing house is arguably too big to fail. This really depends, however, on whether the clearing house is properly funded. Currently, clearing house margin amounts are at about 97 percent.

(b) The second benefit is its low default risk. The clearing house is permitted to call for intra-day margin as often as it deems necessary to be fully secured. The CCP will call for initial margin to cover its potential future exposure; this is the potential cost of closing out the positions of a defaulting clearing member under "normal" market conditions. Clearing members are also required to make contributions to the CCP's default fund, which stands as a further line of defense against multiple counterparty failures in stressed markets. The CCP's pool of initial margin, default fund contributions from clearing members and the CCP's own capital together act as a buffer to absorb potential credit losses associated with the failure of one or more clearing members. Moreover, the clearing house is continuously running stress testing to maintain appropriate capital requirements for the default fund.

(c) The third benefit is its managed systemic risk. Because the clearing house intermediates the OTC derivatives market, it will isolate the effects of defaulting members. Each clearing house has rules and procedures in place to address instances where a clearing member defaults. Essentially, a typical default waterfall is: Terminate or auction trades by collecting bids from remaining clearing members, liquidate margin, draw on the guarantee fund, haircut variation margin, and get more capital from clearing members or use its own money.

(d) The final benefit is netting. Only new trades have to be cleared, but some clients have opted to clear existing trades in order to get better netting terms. With centralized clearing, valuation and pricing should become more transparent and liquidity should improve.

B. Swap Execution Facilities ("SEFs")

1. Introduction of SEFs

(a) In November 2013, U.S. persons trading swaps on a "multi-to-multi" platform were required to begin trading through SEFs. In February 2014, U.S. persons were required to trade through a SEF for any made available to trade ("MAT") transaction.[39] SEFs are intended to promote pre-trade price transparency in the swaps market. The thinking is that market participants will benefit from the price competition that comes from trading platforms on which multiple participants have the ability to trade swaps by accepting bids and offers made by multiple participants.

2. Models For Executing Trades on a SEF

(a) Managers that trade certain interest rate swaps and certain credit default swap indices through clearing houses need to execute such trades on SEFs. There are four different models for executing trades on a SEF:

(i) Direct Access: A manager becomes a member of the SEF and places orders directly onto the SEF. Managers execute the SEF on-boarding documents and are subject to the rulebooks/CFTC rules as a "member" of the SEF.

(ii) Sponsored Access: A manager accesses the SEF using a sponsor as the member. Managers place the orders directly onto the SEF. Managers execute a separate agreement with the sponsor and the SEF.

(iii) Agency Access: A manager accesses the SEF through an agent (similar to futures trading). Under this model, the agent places the order in the SEF on behalf of the manager. Managers execute a separate agreement with the agent.

(iv) Aggregator Access: A manager accesses the SEF through an aggregator. Under this model, the aggregator places the order in the SEF on behalf of the manager. Until central limit order books ("CLOBs") are relevant for SEFs, there is no difference between the agency/aggregator models of execution.

(b) Managers are only subject to the rulebooks/CFTC rules as a "member" of the SEF under the direct access model. Under the other three models, managers are subject to less onerous provisions of the rulebooks/CFTC rules as they are not SEF members.

C. Package Transactions

In May 2014, the CFTC granted no-action relief postponing the date that execution of package transactions on SEFs would be required.[40] That relief expired for some types of transactions in May and June 2014. In November 2014, the CFTC issued another no-action letter providing additional time to comply with the requirement to execute package transactions on SEFs for those types of package transactions for which the original extended deadline had not expired.[41]

D. Dodd-Frank Protocols

[39] Press Release, The Commodity Futures Trading Commission Staff Announces Trade Execution Mandate for Certain Interest Rate Swaps (Jan. 16, 2014), *available at* http://www.cftc.gov/PressRoom/PressReleases/pr6831-14.

[40] CFTC Letter No. 14-62, CFTC No-Action Letter (May 1, 2014), *available at* http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-62.pdf.

[41] CFTC Letter No. 14-137, CFTC No-Action Letter (Nov. 10, 2014), *available at* http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-137.pdf.

1. In August 2012, the International Swaps and Derivatives Association ("ISDA") launched its first "Dodd-Frank Protocol,"[42] which was designed to serve as an industry-wide means to amend bilaterally negotiated ISDA Master Agreements and to impose a number of the swaps-related provisions of the Dodd-Frank Act (such as the new CFTC "know your counterparty" obligations) on these agreements.

2. In March 2013, ISDA launched a second protocol.[43] In each case, parties must submit an Adherence Letter to ISDA (along with a one-time $500 fee) and deliver a completed questionnaire to its adhering swap dealer counterparty. Pursuant to the protocols, managers are obligated to have certain policies and procedures in place and to understand their ongoing obligations, including portfolio reconciliation obligations. In addition, ISDA has published protocols relating to reporting, to which managers should consider whether to adhere.

E. European Market Infrastructure Regulation ("EMIR")

1. EMIR's central reporting obligations (i.e., the reporting of derivative transactions to trade repositories) began earlier this year and applies to all derivative trades, whether they are entered bilaterally (i.e., OTC) or are exchange-traded. EMIR "in-scope" funds are those managed by Alternative Investment Fund Managers ("AIFMs") registered or authorized under the AIFM Directive or EU funds managed by AIFMs.

2. Funds managed by AIFMs that are in-scope should:

(a) Decide whether to delegate the reporting obligation to its counterparty or to a service provider (delegating AIFMs remain liable for any misreporting and should therefore delineate the terms of the delegation in a formal contract); and

(b) Obtain a legal entity identifier (i.e., a "GMEI" or a "CICI") (discussed below).

3. Mandatory clearing of OTC derivatives with CCPs has not come into force yet but is expected in 2015. Information about trades that can be cleared and about the CCPs that may clear them will be available to the market through a (not yet created) public register. AIFMs should ascertain their status under EMIR to determine the applicability of the obligation to their fund and trades.

V. Recordkeeping

A. CFTC Recordkeeping Changes

1. CPOs and CTAs have an obligation to maintain and have ready access to a prescribed set of books and records. Historically (although rarely enforced) the CFTC has required such records to be maintained at the main business office of the registrant. In recognition of widespread market practice, the CFTC adopted regulations permitting CPOs to maintain their books and records with a third party. To rely on this books and records exemption, a CPO must do the following:

(a) File the appropriate exemption with the NFA (a Rule 4.23 exemption with respect to CPO records and a Rule 4.7(b)(4) exemption with respect to each applicable fund). This filing includes:

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[42] ISDA August 2012 DF Protocol, International Swaps & Derivatives Association (Aug. 13, 2012), *available at* http://www2.isda.org/functional-areas/protocol-management/protocol/8.

[43] ISDA March 2013 DF Protocol, International Swaps & Derivatives Association (March 22, 2013), *available at* http://www2.isda.org/functional-areas/protocol-management/protocol/12.

(i) Contact information of the third-party recordkeeper;

(ii) A description (by category) of the records that will be maintained by the third-party recordkeeper;

(iii) Representations by the CPO that the records will be retrieved and made available for inspection within 48 to 72 hours (depending on the location of the CPO); and

(iv) The filing of a letter from the third-party recordkeeper representing that it will maintain such records in compliance with CFTC Rule 1.31.

(b) Update its disclosure document to include the third-party recordkeepers, to the extent necessary.

B. Derivatives Recordkeeping: "Global Markets Entity Identifier"

The CFTC's swap data recordkeeping and reporting rule, promulgated under the Dodd-Frank Act, requires swap counterparties (including buy-side private funds) to be identified by a unique "legal entity identifier."[44] The CFTC requires a unique identifier called a Global Markets Entity Identifier ("GMEI") (formerly known as a "CFTC Interim Compliant Identifier" or "CICI").

C. Evidence Preservation

1. In the context of a government investigation, it is critical to avoid conduct that the government may perceive as constituting obstruction of justice, both because it could give rise to stand-alone charges of obstruction and because it could be portrayed as evidence of so-called "consciousness of guilt" as to the underlying conduct at issue.

2. Both the U.S. Attorney's Office for the Southern District of New York and the CFTC have recently stated that they are looking to bring cases for obstruction of justice.[45]

   The CFTC has new enforcement powers to pursue obstruction cases pursuant to the Dodd-Frank Act, which makes it unlawful to make any false or misleading statement of fact to the Commission.[46]

3. To mitigate this risk, steps to preserve documents should be undertaken at the outset of any government investigation. Such steps normally include: (1) circulating a document preservation notice directing all relevant firm personnel to preserve and to not destroy or alter any relevant records, whether in hard-copy or electronic form; and (2) ensuring that electronically stored information on firm servers is preserved in its current form, back-up tapes are not "written over" and information is not automatically deleted pursuant to standard document destruction protocols. It is also generally advisable to: (1) direct employees not to talk among themselves about the underlying events under investigation (which may be viewed by the government as getting together to come up with a "party line"); and (2) refrain from speaking to law enforcement authorities about the underlying facts without having had the opportunity to prepare for the interview by reviewing the relevant documents and events with the assistance of counsel.

[44] Final Rule, Swap Data Recordkeeping and Reporting Requirements, 77 Fed. Reg. 2136 (Jan. 13, 2012).

[45] *See* Rawlings, *supra* note 2.

[46] Dodd-Frank Act § 753.

VI. Multi-Jurisdictional Issues

A. U.S. managers who have offices in other jurisdictions have another layer of regulation to contend with. In many non-U.S. jurisdictions there are registration or license requirements that managers must satisfy in order to be able to provide investment advisory services or other investment management-related functions (e.g., solicitation of investors) in those jurisdictions.

B. There are also tax issues (e.g., permanent establishment, transfer pricing issues, investment team personnel that are taxpayers in different jurisdictions, etc.) to be addressed when establishing and running non-U.S. offices.

C. One key issue for U.S. managers with non-U.S. offices is that, because the applicable regulatory regimes are different, the standard of conduct required of personnel in each office may vary. An action by an employee of the manager required to be reported to the local regulator may not be a reportable offense in another jurisdiction. However, a number of the national regulators across jurisdictions (e.g., the SEC, the U.K.'s FCA and Hong Kong's SFC) share information (and sometimes cooperate) with each other. Therefore, it may be advisable for a U.S. manager to report to the SEC misconduct that occurred in another jurisdiction even where such misconduct is not subject to required reporting, so as to avoid a situation where the SEC first learns of the misconduct from a non-U.S. regulator.

D. In some non-U.S. jurisdictions, particularly those with less developed regulatory regimes and/or less rigorous enforcement of applicable rules, the standards of conduct by market participants is not as robust as in the United States. Consequently, managers need to pay particular attention to potential FCPA and insider trading violations in non-U.S. offices and devote adequate resources to ensuring that employees and their activities are adequately supervised.

Main Program

Regulatory Outlook: Exams, Enforcement and AIFMD

Investing in the Oil and Gas Sector

Co-Investments and Sidecars: Structuring Opportunities

24TH ANNUAL
PRIVATE INVESTMENT FUNDS SEMINAR
JANUARY 21, 2015

Schulte Roth & Zabel

Partner
New York Office
+1 212.756.2124
philippe.benedict@srz.com

Practices

Tax

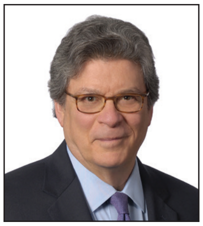
Real Estate Capital Markets & REITs

Philippe Benedict

Philippe focuses his practice on the tax aspects of investment funds, mergers and acquisitions, international transactions, real estate transactions and financial instruments. He has advised on many major transactions involving sales or spinoffs of investment fund managers, including Senator Investment Group LP's sale of a minority stake to The Blackstone Group LP; Caxton Associates LP's sale of a minority percent interest to the Petershill II Fund affiliated with the Goldman Sachs Group Inc.; Credit Suisse's sale of Strategic Partners to The Blackstone Group LP; and Signet Capital Management's sale of its fund-of-funds business to investment management firm Morgan Creek Capital Management LLC. Philippe advises on the tax aspects of securitizations, including his recent representation of affiliates of Fortress Investment Group LLC and affiliates of Highbridge Capital Management in the securitization of their leveraged facilities. He has also advised multiple alternative asset managers on the formation and structuring of funds, including Mount Kellett Capital Management LP on the launch of a new fund; SG Capital Partners in the formation of a new fund; Gunnar Overstrom, formerly a partner at Maverick Capital Ltd., in the formation of Three Corner Global Investors LP; Junto Capital Management LP on the launch of Junto Capital Partners LP and Junto Offshore Fund Ltd.; Trian Fund Management LP on all aspects of launching new co-investment hedge funds; Incapture Investments LLC on the launch of a systemic trading fund that relies on proprietary technology called Rapture to trade in all markets; Sachem Head Capital Management LP with the launch of hedge funds and the establishment of long/short equity funds; and Capstone Investment Advisors LLC, MKP Capital Management LLC and Scopia Fund Management LLC in their respective sales of a passive minority interest to Neuberger Berman Group-managed private equity fund Dyal Capital Partners. Philippe's recent real estate transactions include advising the Related/Oxford joint venture developing Hudson Yards on closing nearly $1.4 billion in equity investments and debt financing for the center's first tower; advising Arel Capital in a number of equity investments, including operating multi-family properties with significant retail components and ground-up development projects for modern condominium buildings in Manhattan and Brooklyn; and advising Perella Weinberg Partners on the acquisition of 50-percent ownership of interests in two hotels and the structuring of a REIT joint venture with Loews Corporation.

Chambers USA, *The Legal 500 United States* and *Tax Directors Handbook* have recognized Philippe as a leading lawyer. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and also speaks at prominent industry events. In the past year, he presented "A New Paradigm: Customized Solutions for Investors" and "Management Company Structuring and Operations" at the SRZ 23rd Annual Private Investment Funds Seminar, and he participated in "FATCA Update for Investment Fund Managers," an SRZ webinar.

Philippe earned his LL.M. in taxation and his J.D. from New York University School of Law. While pursuing his J.D., he was the recipient of a Gruss Fellowship and served on the staff of the *Journal of International Law and Politics*. He obtained his B.S., *summa cum laude*, from Adelphi University.



Partner
New York Office
+1 212.756.2380
barry.bohrer@srz.com

Practices

Litigation

Securities Enforcement & White Collar Defense

Barry A. Bohrer

Barry has extensive litigation experience handling white collar criminal and complex civil matters in federal and state courts for individual and corporate clients. He also has an active trial and appellate practice. Barry has successfully defended clients, including major corporations, financial institutions, political figures, corporate executives and individuals, professionals and prominent law firms, in a wide variety of high-profile and complex cases, jury trials, regulatory actions and investigations. He regularly represents clients in matters pertaining to securities and commodities litigation and regulatory enforcement; other forms of financial fraud; antitrust litigation; and allegations of environmental offenses. Barry frequently represents clients in parallel enforcement proceedings involving the U.S. Department of Justice, the Securities and Exchange Commission and the Commodity Futures Trading Commission. He also conducts corporate internal investigations and counsels individuals involved in them. In his appellate practice, Barry has won appeals at all levels of the federal and state court systems throughout the nation, and is retained in high-stakes appellate cases where he is brought in by other legal teams specifically for his appellate proficiency.

Barry has been named a leading lawyer by *Chambers USA*, *Benchmark Litigation: The Definitive Guide to America's Leading Litigation Firms and Attorneys*, *The International Who's Who of Investigations Lawyers*, *The International Who's Who of Business Crime Defence Lawyers*, *The International Who's Who of Business Lawyers*, *The Legal 500 United States*, *Expert Guide: Best of the Best USA*, *The Best Lawyers in America*, *New York's Best Lawyers* and *New York Super Lawyers* (Top 100 New York Super Lawyers). In 2014, Barry received The Norman S. Ostrow Award from the New York Council of Defense Lawyers in recognition of his outstanding contributions as a defense lawyer. He is a Fellow of the American College of Trial Lawyers, former president of the New York Council of Defense Lawyers, and chair of the Executive Committee of the Fund for Modern Courts and Committee for Modern Courts, non-profit organizations dedicated to judicial reform in New York State. He served on the board of directors of the Legal Aid Society (chairman of the Audit Committee) and received awards in 2005 and 2006 for Outstanding Pro Bono Service for his advocacy. Barry is also a member of the New York City Bar Association (former member of the Criminal Law Committee) and the New York State and American Bar Associations (Criminal Justice and Litigation sections). He was the author of the "White Collar Crime" column in the *New York Law Journal* from 2002 to 2013 and is on the Board of Editors of the *White Collar Crime Reporter*. He speaks frequently on issues relating to trial and appellate practice, securities enforcement and arbitration, internal investigations and insider trading.

Barry holds a J.D. from New York University School of Law and a B.A. from Duke University.

Partner
New York Office
+1 212.756.2542
stephanie.breslow@srz.com

Practices

- Investment Management
- Energy
- Financial Institutions
- Hedge Funds
- Private Equity

Stephanie R. Breslow

Stephanie is co-head of SRZ's Investment Management Group and a member of the firm's Executive Committee. Her practice includes investment management, partnerships and securities, with a focus on the formation of private equity funds (LBO, mezzanine, distressed, real estate, venture) and liquid-securities funds (hedge funds, hybrid funds) as well as providing regulatory advice to investment managers and broker-dealers. She also represents fund sponsors and institutional investors in connection with seed capital investments in fund managers and acquisitions of interests in investment management businesses, and she represents funds of funds and other institutional investors in connection with their investment activities.

Stephanie is chair of the Private Investment Funds Subcommittee of the International Bar Association, a founding member and former chair of the Private Investment Fund Forum, a member of the Advisory Board of Third Way Capital Markets Initiative, a founding member of the Wall Street Hedge Fund Forum and a former member of its Steering Committee, and a member of the Board of Trustees of 100 Women in Hedge Funds. She is listed in *Chambers USA*, *Chambers Global*, *The Legal 500 United States*, *Best Lawyers in America*, *America's Leading Lawyers*, *Who's Who Legal: The International Who's Who of Business Lawyers* (which ranked her one of the world's "Top Ten Private Equity Lawyers"), *Who's Who Legal: The International Who's Who of Private Funds Lawyers* (which placed her on its "Most Highly Regarded Individuals" list), *Expert Guide: Best of the Best USA* (Investment Funds), *Expert Guide to the World's Leading Investment Funds Lawyers*, *Expert Guide to the World's Leading Women in Business Law* (Investment Funds), *Expert Guide to the World's Leading Private Equity Lawyers* and *PLC Cross-border Private Equity Handbook*, among other leading directories. She was named "Private Funds Lawyer of the Year" at the Who's Who Legal Awards 2014 as well as a New York State Bar Association Empire State Counsel honoree in 2014. She was also named one of *The Hedge Fund Journal*'s 50 Leading Women in Hedge Funds and the *Euromoney Legal Media Group*'s "Best in Investment Funds" at the inaugural Americas Women in Business Law Awards. Additionally, Stephanie was recognized by the Girl Scouts of Greater New York as one of 2012's Women of Distinction. Stephanie is a much sought-after speaker on fund formation and operation and compliance issues, and she also regularly publishes books and articles on the latest trends in these areas. She recently contributed to the 2014 *Fund Formation and Incentives Report* (in association with Private Equity International) and co-authored *Private Equity Funds: Formation and Operation* (Practising Law Institute), the leading treatise on the subject. She also contributed a chapter on "Hedge Funds in Private Equity" for inclusion in *Private Equity 2004-2006* (PLC Cross-border Handbooks), contributed a chapter on "Advisers to Private Equity Funds — Practical Compliance Considerations" for *Mutual Funds and Exchange Traded Funds Regulation* (Practising Law Institute, Volume 2), and wrote *New York and Delaware Business Entities: Choice, Formation, Operation, Financing and Acquisitions* (West) and *New York Limited Liability Companies: A Guide to Law and Practice* (West).

Stephanie earned her J.D. from Columbia University School of Law, where she was a Harlan Fiske Stone Scholar, and her B.A., *cum laude*, from Harvard University.

Partner
New York Office
+1 212.756.2555
kirby.chin@srz.com

Practices

Finance

Energy

Distressed Investing

Kirby Chin

Kirby focuses his practice on financing and debt transactions and has substantial experience representing clients in transactions involving private and public debt financings, working with special distressed asset situations, and structuring and executing multi-layered debt tranches. He represents finance firms, public and private companies, and hedge and private equity funds on matters that have included debtor-in-possession and exit financings; workouts and restructurings; private equity portfolio financings, including acquisition and leveraged buyout financings; traditional asset-based and working capital financings; cash flow financings; factoring and related transactions; term "B" financings; second lien and first-out/last-out financings; investment fund financings, including fund of funds financings; capital call and liquidity facility transactions; and subordinated and mezzanine debt offerings.

Kirby has been recognized by *The Legal 500*, a listing of the top lawyers in the United States by practice area. A member of the Turnaround Management Association, the American Bar Association and the Commercial Law and Uniform State Laws Committee of the New York City Bar Association, he is often invited to speak at industry events. He most recently presented on the annual financing and lending outlook at the Argyle Executive Forum Leadership in the Distressed Markets.

Kirby earned his B.A., *cum laude*, from New York University and his J.D. from New York University School of Law, where he served on the *Journal of International Law and Politics*.

Partner
New York Office
+1 212.756.2758
brian.daly@srz.com

Practices

Investment Management

Energy

Hedge Funds

Regulatory & Compliance

Private Equity

Brian T. Daly

Brian advises hedge 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 SRZ's educational outreach. In addition to hosting SRZ webinars, participating in firm-sponsored seminars and workshops, authoring SRZ alerts and white papers and co-authoring the SRZ Compliance Spark Twitter feed, he recently published "JOBS Act Update: CFTC Relief Removes Impediment to General Solicitation" and "'Knowledgeable Employees' — Recent SEC Guidance Also Details Broker-Dealer Registrations," in *The Hedge Fund Journal*. He presented "What, Me? Yes, You: The Surprising Reach of the Registration Requirements of the Commodity Exchange Act" at the ABA Business Law Section Fall Meeting, and he spoke at the Bank of America Merrill Lynch GC/CCO Hot Topics Dinner. 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 the CFTC Working Group for the Alternative Investment Management Association, and 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 B.A., *magna cum laude*, from Catholic University of America, his M.A. from the University of Hawaii and his J.D., with distinction, from Stanford Law School.

Partner
New York Office
+1 212.756.2009
jennifer.dunn@srz.com

Practices

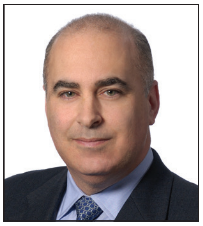
Investment Management
Hedge Funds
Private Equity

Jennifer Dunn

Jennifer advises hedge funds, private equity funds (including mezzanine and distressed funds), hybrid funds, funds of funds and investment advisers in connection with their structuring, formation and ongoing operational needs, general securities law matters, and regulatory and compliance issues. Her experience includes structuring and negotiating seed and strategic investments, advising investment managers regarding the structure and sale of their investment management businesses and the structure of their compensation arrangements, and representing investment managers in connection with managed accounts and single-investor funds.

Recognized by *The Legal 500 United States* and the *Expert Guide to the World's Leading Women in Business Law* (Investment Funds) and as an IFLR 1000 Rising Star (Investment Funds), Jennifer recently co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and presented at conferences sponsored by the New York City Bar Association, 100 Women in Hedge Funds, KPMG and Bank of America Merrill Lynch. She also presented "Marketing Opportunities and Challenges" at the SRZ 23rd Annual Private Investment Funds Seminar and participated in the "Allocation of Investment Opportunities Workshop" at an SRZ Investment Management Hot Topics seminar.

Jennifer earned her J.D. from Columbia University Law School, where she was a Harlan Fiske Stone Scholar, and her B.A., *cum laude*, from the University of Pennsylvania.



Partner
New York Office
+1 212.756.2269
david.efron@srz.com

Practices

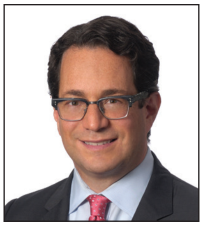
Investment Management
Hedge Funds
Regulatory & Compliance

David J. Efron

David practices in the areas of domestic and offshore hedge funds, including fund formations and restructurings. Additionally, he advises hedge fund managers on structure, compensation and various other matters relating to their management companies, and he structures seed capital and joint venture arrangements. David also represents hedge fund managers in connection with SEC regulatory issues and compliance-related matters.

David is listed in *Chambers USA*, *The Legal 500 United States* and *Who's Who Legal: The International Who's Who of Private Funds Lawyers*. In particular, *Chambers USA* has noted that he is praised for his "excellent judgment" and for his "great combination of technical knowledge and street smarts which allows him to navigate the world of hedge funds," and *The Legal 500 United States* has recognized him as "an extraordinarily capable attorney," noting, "He has a mastery of the pertinent matters, but he also brings a pragmatic approach." A published author on subjects relating to investment management, David recently co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). He is also a sought-after speaker for hedge fund industry conferences and seminars and a frequent guest lecturer at New York-area law and business schools. He recently presented "New Product Trends" and "Operational Due Diligence" for the Bank of America Merrill Lynch COO/CFO Hedge Fund Symposium.

David received his LL.M. in securities regulation, with distinction, from Georgetown University Law Center, his J.D. from Syracuse University College of Law, and his B.A. from Vassar College.



Partner
New York Office
+1 212.756.2553
marc.elovitz@srz.com

Practices

Regulatory & Compliance
Hedge Funds
Investment Management
Litigation

Marc E. Elovitz

Marc is the chair of SRZ's Investment Management Regulatory & Compliance Group. He advises private fund managers on compliance with the Investment Advisers Act of 1940 and other federal, state and self-regulatory organization requirements, including establishing compliance programs, registering with the SEC and CFTC, and on handling SEC and NFA examinations. Marc provides guidance to clients on securities trading matters and represents them in regulatory investigations and enforcement actions, arbitrations and civil litigation. He also regularly leads training sessions for portfolio managers, analysts and traders on complying with insider trading and market manipulation laws, and has developed and led compliance training sessions for marketing and investor relations professionals. Marc works closely with clients undergoing SEC examinations and responding to deficiency letters and enforcement referrals. He develops new compliance testing programs in areas such as trade allocations and conflicts of interest. He also leads macro-level compliance infrastructure reviews with fund managers, identifying the material risks specific to each particular firm and evaluating the compliance programs in place to address those risks.

The Legal 500 United States, *Who's Who Legal: The International Who's Who of Private Funds Lawyers* and *New York Super Lawyers* have recognized Marc as a leading lawyer in his field. He is a member of the Steering Committee of the Managed Funds Association's Outside Counsel Forum, the American Bar Association's Hedge Funds Subcommittee and the Private Investment Funds Committee of the New York City Bar Association. A prolific writer in his areas of expertise, Marc recently co-authored "JOBS Act Update: CFTC Relief Removes Impediment to General Solicitation" for *The Hedge Fund Journal*. He is also a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), the "Protecting Firms Through Policies and Procedures, Training, and Testing" chapter in the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute, 2011-2015) and the "Market Manipulation" chapter in the leading treatise, *Federal Securities Exchange Act of 1934* (Matthew Bender). He also wrote the chapter on "The Legal Basis of Investment Management in the U.S." for *The Law of Investment Management* (Oxford University Press). Marc is also frequently invited to discuss current industry-related topics of interest at leading professional and trade association events. He most recently presented "Staying Ahead of the Curve(ball): How to Respond as Authorities Shift Focus from Creating New Regulations to Enforcing Them," at the Houlihan Lokey 2014 Alternative Asset Valuation Symposium, and "SEC Inspections and Examinations of Hedge and Private Equity Funds," at the PLI Hedge Fund and Private Equity Enforcement and Regulatory Developments 2014 conference.

Marc received his J.D. from New York University School of Law and received his B.A., with honors, from Wesleyan University.

Partner
New York Office
+1 212.756.2567
steven.fredman@srz.com

Practices

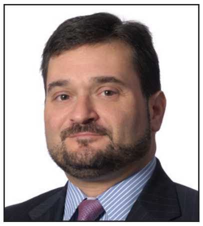
Investment Management
Hedge Funds
Private Equity
Regulatory & Compliance
Securities & Capital Markets

Steven J. Fredman

Steve is co-head of SRZ's Investment Management Group. He concentrates his practice in the areas of investment funds (domestic and offshore), investment advisers and broker-dealers, the acquisition and related financing of investment management firms, and securities regulation. Steve structures and organizes private investment partnerships and offshore funds, including general equity, arbitrage, global investment, private equity, distressed company, small cap and funds of funds, and he counsels clients on issues relating to partnership law, new product development and other matters. He also structures and organizes investment advisers and broker-dealers, handles the registration of commodity pool operators and commodity trading advisers, and provides ongoing advice to investment advisers on securities laws, rules, regulations and information. He represents clients in connection with the acquisition and sale of investment management firms or their assets as well.

Steve is recognized by many ranking publications, including *Chambers Global*, *Chambers USA*, *The Legal 500 United States*, *Expert Guide: Best of the Best USA* (Investment Funds), *Expert Guide to the World's Leading Investment Funds Lawyers*, *Expert Guide to the World's Leading Private Equity Lawyers*, *International Who's Who of Private Funds Lawyers* and *The Best Lawyers in America*. A past member of the American Bar Association's Committee on Partnership and the New York City Bar Association's Committee on Art Law, Steve is a frequent speaker and writer in his areas of expertise. He most recently presented at the Goldman Sachs Seventeenth Annual Hedge Fund Conference, and he discussed "Distressed Investments: Structured Products" at the SRZ 23rd Annual Private Investment Funds Seminar. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and "Asset Manager M&A Deals," an SRZ white paper.

Steve holds a J.D. from Georgetown University Law Center, where he was an editor of *Law and Policy in International Business*, and a B.A. from Columbia University, where he was Phi Beta Kappa.



Robert Goldstein

Partner
New York Office
+1 212.756.2519
robert.goldstein@srz.com

Practices

- Mergers & Acquisitions
- Distressed Investing
- Energy
- PIPEs
- Private Equity

Rob's practice focuses on private equity and leveraged buyout transactions, mergers and acquisitions, PIPE transactions, and capital markets and general corporate representations. Some of Rob's recent M&A representations include Pouschine Cook Capital Management LLC in its sale of Great Lakes Caring Home Health & Hospice to Wellspring Capital Management; private equity fund Castle Harlan Partners V LP in its acquisition of Gold Star Foods Inc., its acquisition of Pretium Packaging Corporation and Pretium's contemporaneous acquisition of Novapak Corporation; Morton's Restaurant Group Inc. in its sale to affiliates of Tilman J. Fertitta; the sale of Ames True Temper to Griffon Corporation; the sale of Associated Packaging Technologies to Sonoco Inc.; and NewPage Corp. in its acquisition of the North American business of Stora Enso Oyj.

Rob has been recognized by *The Legal 500 United States* as a leading lawyer handling private equity buyouts and is often invited to write or speak on topics of interest to the industry. He authored "Distressed M&A: Lots of Distress and Not Much M&A — But Some Interesting Opportunities for Creative Private Equity Dealmakers" for *SRZ Private Equity Developments*, and he presented "Auctions" at the SRZ 2nd Annual Private Equity Fund Conference and "Private Equity M&A Panel: Harnessing the Capital Flood" at ACG Capital Connection.

Rob received his J.D., *cum laude*, from Tulane University School of Law, where he served as executive editor of the *Sports Lawyers Journal* and was elected into the Order of Barristers, and his B.A. from Columbia University.

Partner
New York Office
+1 212.756.2191
christopher.harrison@srz.com

Practices

Mergers & Acquisitions

Nonprofit

Private Equity

Christopher S. Harrison

Chris specializes in mergers and acquisitions in the financial industry, corporate governance and business issues for public and private corporations. He has successfully structured numerous acquisitions of control and non-control stakes in asset managers with varied investment strategies holding collectively over $100 billion in assets under management.

Prior to becoming a partner at SRZ, Chris was selected as the only associate in the United States for BTI's Client Service All-Star Team. Since 2009, he has been teaching popular courses at the New York University School of Law on the financial and legal aspects of investing in business transactions. Chris frequently speaks and writes on market trends in corporate law and is on the advisory board of Bloomberg's *M&A Law Report*. He authored *M&A Legal: Understanding and Negotiating Transactions* (Bloomberg Law, forthcoming 2015).

Chris earned his J.D., *cum laude*, from New York University School of Law, where he concentrated on law and economics. He received his B.A. from Friedrich-Schiller-Universität in Germany, where his work included statistical analysis and behavioral economics.

Partner
New York Office
+1 212.756.2201
daniel.hunter@srz.com

Practices

Investment Management
Hedge Funds
Private Equity
Regulatory & Compliance

Daniel F. Hunter

Dan concentrates his practice on the design, structure and regulation of alternative investment products, including hedge funds, hybrid opportunity funds and private equity funds. Among the various investment advisers he represents are some of the larger and more well-known fixed income, bank loan and distressed debt managers. Dan also provides day-to-day regulatory, operational, mergers and acquisitions and restructuring advice to his fund clients, and advises funds regarding the receipt or allocation of seed capital.

Dan has been recognized in *The Legal 500 United States* in the Investment Fund Formation and Management and Private Equity Funds categories. A sought-after speaker, he recently presented "AIFMD: Practical Implications for U.S. Managers" at the KB Associates Global Fund Distribution: New Opportunities, New Challenges conference and "Global Regulatory Issues" at the IIR 3rd Annual InvestorOps conference. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), and he served as a guest lecturer at the New York University School of Continuing and Professional Studies, where he taught "Introduction to Hedge Funds."

Dan received his J.D. from the University of Michigan Law School, where he was articles editor of the *University of Michigan Journal of Law Reform*, and his A.B., *cum laude* and with high honors in history, from the University of Michigan.

Jason S. Kaplan

Partner
New York Office
+1 212.756.2760
jason.kaplan@srz.com

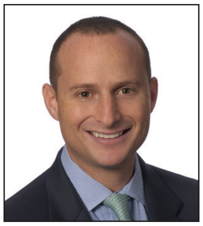
Practices

- Investment Management
- Hedge Funds
- Private Equity
- Regulatory & Compliance

Jason's practice concentrates on corporate and securities matters for investment managers and alternative investment funds. He represents institutional and entrepreneurial investment managers, financial services firms and private investment funds in all aspects of their business. Jason's practice focuses on advising managers of hedge, private equity and hybrid funds regarding the structure of their businesses and on day-to-day operational, securities, corporate and compliance issues; structuring and negotiating seed and strategic investments and relationships and joint ventures; and advising investment managers with respect to regulatory and compliance issues.

Jason's recent speaking engagements include discussing "Marketing Opportunities and Challenges" at the SRZ London Investment Management Hot Topics conference and "Current Terms: Hedge Funds" at the IBA 15th Annual International Conference on Private Investment Funds. He co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and was recently quoted in "Co-Investments Enable Hedge Fund Managers to Pursue Illiquid Opportunities While Avoiding Style Drift (Parts One, Two and Three)" in *The Hedge Fund Law Report*.

Jason earned his J.D. from Fordham University School of Law, where he was a member of the *Fordham Law Review*, and his B.S. from the University of Michigan.



Partner

New York Office
+1 212.756.2175

London Office
+44 (0) 20 7081 8048

david.karp@srz.com

Practices

Business Reorganization

Distressed Debt & Claims Trading

Distressed Investing

Energy

Regulatory & Compliance

Trading Agreements

David J. Karp

David leads the firm's Distressed Debt & Claims Trading Group, which provides advice in connection with U.S., European and emerging market debt and claims trading matters. His practice focuses on corporate restructuring, special situations and distressed investments, and distressed mergers and acquisitions. David has represented debtors, ad hoc and official committees, and individual secured and unsecured creditors. He also advises investment funds in connection with oil and gas royalty investments and distressed energy investments, and his recent energy representations include investors in Stallion Oilfield Services Ltd., Seahawk Drilling Inc., ATP Oil & Gas and Trident Resources Corporation. David frequently represents broker-dealers, investment funds, private equity funds and CLOs in connection with the auction and trading of distressed and non-performing assets and NPL portfolios across a wide range of issuers and in jurisdictions spanning the globe, including Arcapita, Swiss Air, Landsbanki, Glitnir, Kaupthing, Lehman Brothers Holdings Inc. and its affiliated debtors, MF Global Inc. and its affiliated debtors, and American Airlines.

Recognized as a leading lawyer by *New York Super Lawyers*, and by the founder of *Reorg Research* as "undoubtedly one of the best in the field at what he does best: making sure funds and their investments are protected when transacting and executing trades in distressed debt and claims," David is an active member of the American Bankruptcy Institute, Loan Market Association, Asia Pacific Loan Market Association, INSOL Europe, Emerging Markets Trade Association, National Association of Royalty Owners and the Loan Syndications and Trading Association. He is a frequent author and speaker on distressed investing and oil and gas topics and recently wrote articles including "Investing in Oil and Gas Royalties: Distressed Counterparty Risk Considerations," "Structuring Winning Bids: European NPL Portfolio Transactions," "Bank Debt Trading on the Modern Day Back of the Napkin" and "Trade Dispute Litigation: Debtor vs. Secondary Market Claims Purchaser."

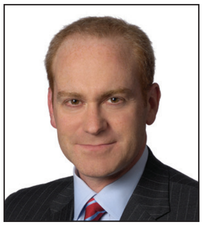
David earned his J.D. from Fordham University School of Law and his B.S. from Cornell University.

Founding Partner, CEO &
Portfolio Manager
Silver Point Capital, L.P.

Edward A. Mulé

Ed is the CEO of Silver Point Capital and Portfolio Manager of Silver Point's funds, having built and run the firm since its inception in 2002. Silver Point is a registered investment adviser specializing in credit and special situations investments. The firm has over 150 employees and manages approximately $8.5 billion in assets. Prior to founding Silver Point, Ed worked for more than 16 years at Goldman Sachs where he headed or co-headed Goldman's Special Situations Investing Business from 1999 to 2001 and the Asian Distressed Debt Investing Business from 1998 to 2001. Before joining Goldman's distressed debt efforts in 1995, he worked in the Office of the Chairman from 1991 to 1994, and prior to that as an investment banker in the Mergers and Acquisitions group.

Ed graduated *magna cum laude* from the University of Pennsylvania's Wharton School, contemporaneously receiving both his M.B.A. and B.S. degrees at the age of 21.



Partner
New York Office
+1 212.756.2227
david.nissenbaum@srz.com

Practices

Investment Management
Energy
Financial Institutions
Hedge Funds
Private Equity

David Nissenbaum

David's practice focuses on corporate, bank regulation and securities matters and he primarily represents institutional and entrepreneurial investment managers, financial services firms and private investment funds in all aspects of their business. David structures and advises investment management and financial services firms as well as hedge, private equity, credit, distressed investing and hybrid funds, funds of funds and scalable platforms for fund sponsors. He also advises on management company partnerships, succession planning, seed capital deals, mergers and acquisitions of investment firms and on all aspects of U.S. banking laws that affect investment and financial services firms and investment funds, including investments in banking organizations, bank-sponsored funds and investments in funds by banking organizations.

David has been recognized by *Chambers Global*, *Chambers USA*, *Expert Guide to the World's Leading Investment Funds Lawyers*, *The International Who's Who of Private Funds Lawyers*, *The Legal 500 United States* and *PLC Cross-border Private Equity Handbook*. A member of the advisory board of The Financial Executives Alliance and past member of the Banking Law Committee of the New York City Bar Association, David is a sought-after writer and speaker in his areas of expertise. "Just Like Starting Over: A Blueprint for the New Wall Street Firm," published by *The Deal*, "Hedge Fund Manager Succession Planning" and "Federal Reserve Provides Greater Flexibility for Non-Controlling Investment in Banks and Bank Holding Companies" are among his publications, and he also co-authored the chapter "Management Company Structures and Terms" in *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). David recently participated in "The Final Volcker Rule: What Private Fund Managers Not Affiliated with a Bank Need to Know," an SRZ webinar, and presented a talk on capital raising at a prior SRZ Annual Private Investment Funds Seminar.

Partner
New York Office
+1 212.756.2075
omoz.osayimwese@srz.com

Practices

Investment Management

Hedge Funds

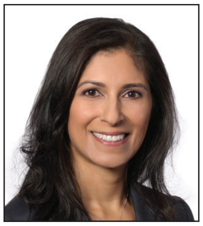
Private Equity

Omoz Osayimwese

Omoz focuses his practice on the representation of sponsors and investors in the formation and structuring of private equity funds, hedge funds and hybrid funds. He has extensive experience representing sponsors and investors on funds employing real estate, buyout, credit, distressed investment, structured products, activist, multi-strategy and long-short equity strategies. He also represents hedge fund managers and investors in the negotiation of seed-capital transactions, and he advises sponsors of private equity firms in the structuring of complex carry-sharing arrangements among principals and employees. Recent representations of Omoz's include institutional sponsors and boutique firms in the formation of private equity funds, hedge funds and hybrid funds; lead investors on their investments in private equity funds; hedge fund managers and investors in seed-capital arrangements; investment managers in joint venture arrangements; and investment managers and investors in the formation of special purpose acquisition and co-investment vehicles.

Omoz regularly addresses investment managers about current developments relating to private investment funds. His recent speaking engagements include participating in "Private Equity Fund Compliance Update," an SRZ webinar, and presenting "Ongoing Operations and Firm Growth" at the SRZ 2nd Annual Private Equity Fund Conference and "Management Company Structuring and Operations" at the SRZ 23rd Annual Private Investment Funds Seminar. He also contributed to the *Fund Formation and Incentives Report*, released by Private Equity International and SRZ.

Omoz received his J.D. from University of Michigan Law School and his B.A., with highest honors, from Michigan State University.



Special Counsel
New York Office
+1 212.756.2588
seetha.ramachandran@srz.com

Practices

Litigation

Bank Regulatory

Financial Institutions

Regulatory & Compliance

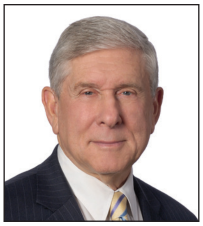
Securities Enforcement & White Collar Defense

Seetha Ramachandran

Seetha focuses on white collar criminal defense and investigations, banking and securities enforcement, anti-money laundering issues and civil litigation. As a former Deputy Chief in the Asset Forfeiture and Money Laundering Section (AFMLS), Criminal Division, U.S. Department of Justice, Seetha has expertise in matters that include allegations of violations of the Bank Secrecy Act (BSA), complex money laundering, economic sanctions, and civil and criminal forfeiture. During her tenure at AFMLS, she served as one of the first co-heads of the Money Laundering and Bank Integrity Unit, where she supervised a broad range of investigations and prosecutions of global financial institutions including HSBC, MoneyGram, Standard Chartered Bank and ING, as well as emerging areas of money laundering and BSA enforcement such as online payment systems and virtual currencies. Seetha also worked closely with state and federal banking regulators and U.S. Attorneys' offices nationwide. Prior to her appointment at AFMLS, Seetha served as an Assistant U.S. Attorney for the Southern District of New York for nearly six years, where she worked in the Complex Frauds, Major Crimes and Asset Forfeiture units, investigating and prosecuting bank fraud, mail and wire fraud, tax fraud, money laundering, stolen art and cultural property, and civil and criminal forfeiture cases and appeals. She is also a former law clerk for the Hon. Richard J. Cardamone of the U.S. Court of Appeals for the Second Circuit.

An accomplished public speaker, Seetha has presented on topics that include enforcement trends in the financial services industry, effective AML programs and asset forfeiture. She most recently presented on sanctions penalties and financial institutions at ACI's 5th Annual Economic Sanctions Bootcamp, regulatory enforcement issues at ACI's 2nd National Forum on Virtual & Digital Currency and Payment Systems, and enforcement actions under the Bank Secrecy Act at the Pennsylvania Association of Criminal Defense Lawyers' White Collar Practice Seminar. Seetha is also the co-author of "The Interplay Between Forfeiture and Restitution in Complex Multi-Victim White Collar Cases" in the *Federal Sentencing Reporter*.

Seetha earned her J.D. from Columbia Law School, where she was articles editor for the *Columbia Law Review*, and her B.A., *magna cum laude*, from Brown University.



Partner
New York Office
+1 212.756.2450
paul.roth@srz.com

Practices

Investment Management
Hedge Funds
Mergers & Acquisitions
Private Equity
Regulatory & Compliance
Securities & Capital Markets

Paul N. Roth

Paul is a founding partner of SRZ and chair of its Investment Management Group. Throughout his career, he has acted as counsel to leading public and private companies in financial services and to their boards of directors. Paul's extensive private investment funds practice, an area in which he has more than 45 years of experience, includes the representation of hedge funds, private equity funds, offshore funds, investment advisers and broker-dealers in connection with fund formations and compliance, securities regulation, mergers and acquisitions (domestic and cross-border) and other financial transactions.

Paul has been consistently recognized as a leading funds lawyer by *The Best Lawyers in America*, which also named him *New York City Private Funds/Hedge Funds Law Lawyer of the Year.* He continues to be recognized by *Chambers Global*, *Chambers USA*, *The Legal 500 United States*, *IFLR1000*, *Expert Guides: Best of the Best USA* (Investment Funds), *Expert Guide to the World's Leading Investment Funds Lawyers, Expert Guide to the World's Leading Private Equity Lawyers*, *Expert Guide to the World's Leading Capital Markets Lawyers*, *The International Who's Who of Private Funds Lawyers*, *Lawdragon 500 Leading Lawyers in America*, *PLC Cross-border Investment Funds Handbook*, *Who's Who in American Law* and *Who's Who in America*. He received a Lifetime Achievement Award from Hedge Funds Care in recognition of his prominence in the hedge funds industry and his extraordinary commitment to philanthropy, as well as The Hedge Fund Journal Award for Outstanding Achievement in the Hedge Fund Industry. He was also named to *HFMWeek's* 2010 list of the 50 most influential people in hedge funds.

Paul serves as a special adviser to the board of directors of the Managed Funds Association (MFA) and he is a former member of the Legal Advisory Board to the National Association of Securities Dealers (NASD). He chairs the Subcommittee on Hedge Funds of the American Bar Association's Committee on Federal Securities Regulation and is a former chair of the New York City Bar Association's Committee on Securities Regulation. Paul is a member of the boards of directors of the NAACP Legal Defense and Educational Fund and the Advisory Board of the RAND Center for Corporate Ethics and Governance, and he is a fellow of the New York Bar Foundation and the Phi Beta Kappa Society. He served on the Advisory Board of Harvard Law School's Center on Lawyers and the Professional Services Industry and formerly served as president, vice president and a trustee of the Harvard Law School Alumni Association of New York City. He is also a member of The Economic Club of New York and a former member of the board of directors of the Citizens Committee for New York City. Additionally, Paul has served as a lecturer at the University of Pennsylvania's Wharton School, where he taught "Responsibility in Professional Services." He is also an adjunct professor of finance at NYU Stern School of Business, where he has taught "Managing Financial Businesses," and an adjunct professor of law at New York University School of Law, where he teaches "Advising and Managing Financial Services Businesses." He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press).

Paul received his J.D., *cum laude*, from Harvard Law School, after which he was awarded a Fulbright Fellowship to study law in the Netherlands. He received his A.B., *magna cum laude*, from Harvard College, where he was Phi Beta Kappa.

Partner
New York Office
+1 212.756.2510
shlomo.twerski@srz.com

Practices

Tax

Energy

Real Estate Capital Markets & REITs

Shlomo C. Twerski

Shlomo focuses his practice on the tax aspects of onshore and offshore investment funds, registered investment companies and business development companies, private equity partnerships, real estate and corporate transactions, restructurings and workouts, securitizations, and existing and emerging financial instruments. He also provides ongoing tax advisory services to a number of hedge fund managers regarding fund structuring and formation, distressed debt investments and other complex transactions.

Recognized as a leader in his field by *Chambers USA*, *The Best Lawyers in America*, *The Legal 500 United States* and the *Tax Directors Handbook*, Shlomo is also a member of the Tax Section of the New York State Bar Association. He regularly speaks at industry conferences and events, and his most recent presentations include the SRZ webinar "FATCA Update for Investment Fund Managers" and "U.S. Tax" at the Bank of America Merrill Lynch COO/CFO Hedge Fund Symposium. He is also a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) as well as various SRZ alerts.

Shlomo earned his J.D. from Hofstra University School of Law, where he was an articles editor of the *Hofstra Law Review*.

Partner
London Office
+44 (0) 20 7081 8022
steven.whittaker@srz.com

Practices

Investment Management

Hedge Funds

Regulatory & Compliance

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 cited by *Chambers UK* and *The Legal 500 UK* for his preeminence in the investment funds sector, with interviewees describing him as "top notch" and "fantastic." He is a member of the International Bar Association, a member of the Collective Investment Schemes Sub-Committee of The Law Society and the co-chair of the Sound Practices Committee and a member of the AIFMD Working Group of the Alternative Investment Management Association. He also chairs the AIMA working group which is updating the *Offshore Alternative Fund Directors' Guide*. Steven is the author of "Top 10 Things You Should Know About the New Swiss Rules on Distribution of Funds" which appeared in the *Hedge Fund Journal*. He most recently addressed the UBS Breakfast on Swiss Distribution and presented "Impact of AIFMD on Fund Governance" at the Infoline Fund Governance Thought Leadership Conference.

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

Regulatory Outlook: Exams, Enforcement and AIFMD

I. Examination Insights

A. SEC Examinations

1. Recent Examination Initiatives

(a) Presence Examinations

(i) The U.S. Securities and Exchange Commission's Office of Compliance Inspections and Examinations ("OCIE") created the "Presence Exam" Initiative in 2012 to introduce the new private fund adviser registrants to the SEC. Almost 400 presence examinations had been completed by the fall of 2014.

(ii) Key Issues in Presence Examinations

(1) Appropriateness of fees/allocation of expenses;

(2) Marketing (issues such as performance reporting, backtesting, portability of performance and cherry-picking);

(3) Custody rule compliance; and

(4) Valuation (issues such as differences between disclosures and actual practices, and changes to valuation methodologies).

(b) "Routine" Examinations

Even so-called routine or periodic exams by the SEC are now conducted on a risk basis. The staff has technology that allows it to identify the riskier advisers and leverage SEC staff reserves.

(c) "Cause" Examinations

The SEC staff is receiving record numbers of tips and complaints, particularly in light of new whistleblower provisions. Examinations for "cause" often look similar to SEC enforcement investigations.

(d) "Never Before Examined" Initiative

(i) In February 2014, OCIE announced a special examination initiative for advisers "never before examined" despite having been registered for three or more years.

(ii) This initiative is not focused on private fund advisers but a way to pick up dual registrants or hedge fund managers that also advise registered funds.

(e) Sweep Examinations. There have been two novel sweep examinations recently:

(i) Cybersecurity and Information Security Sweep Examination

(1) Information-gathering exercise by OCIE, from which observations from OCIE are expected to be released in the coming year.

(2) Observations from the cybersecurity sweep are expected to be released in the coming year in order to help firms improve their systems.

(ii) "Liquid Alternative" Strategies Sweep Examination

(1) The rapid increase in registered fund products offering alternative strategies led to a sweep examination by OCIE in August 2014.

(2) The sweep focused on issues such as:

a. Liquidity;

b. Leverage limits and controls;

c. Allocation of investments; and

d. Governance.

(f) Corrective Action Reviews

(i) After finding deficiencies, the exam staff will often return in a year or two to evaluate whether appropriate "corrective action" was taken and followed through on.

(ii) Several such reviews have led to enforcement actions (see Section I.A.4, below).

(g) Examination of Non-U.S. Managers

(i) These examinations have historically been conducted by dedicated examination staff based in Washington, D.C.

(ii) Examination staff have more frequently been conducting on-site reviews in the United Kingdom and Hong Kong.

2. New Technologies Used in SEC Examinations

(a) The SEC has a new quantitative analytics unit staffed by experienced specialists, which is developing sophisticated data analytic tools. One use for these tools is in examinations of hedge fund managers.

(b) Machine Analyzed Risk Scoring ("MARS"): MARS assesses registered investment advisors in terms of risk, allowing OCIE staff to focus its finite resources on those firms it deems riskiest.

(c) National Exam Analytics Tool ("NEAT")

(i) Examination staff can use this tool to analyze large volumes of trade data.

(ii) NEAT can review trade data by using 50 different factors. Issues it can identify include suspicious trading ahead of large price movements and anomalous trade allocations or patterns of trade allocations that suggest improper cherry-picking of profitable trades.

3. Common Examination Deficiency Areas for Private Investment Fund Managers

   (a) Valuations;

   (b) Compliance programs;

   (c) Principal transactions and cross trades;

   (d) Marketing; and

   (e) Insider trading.

4. Recent Enforcement Actions Arising Out of Examinations

   (a) *ZPR Investment Management, Inc*, Adv. Act. Rel. No. IA-3574 (April 4, 2013): SEC examinations of investment adviser found performance marketing was misleading because adviser claimed compliance with the Global Investment Performance Standards, though that was not the case.

   (b) *GMB Capital Management LLC*, Adv. Act Rel. No. IA-3399 (April 20, 2012): SEC examination of fund managers GMB (currently known as Clearstream Investments LLC) showed that performance claims had no basis, and personnel created false documents during the course of the examination to try to support the performance claims.

   (c) *F-Squared Investments, Inc.*, Adv. Act Rel. No. IA-3988 (Dec. 22, 2014): An SEC examination showed that backtested returns were not properly identified as such. The firm settled, agreeing to disgorgement and penalties of $35,000,000. The former CEO of the firm was charged with fraud under Sections 206 and 207 of the Advisers Act for his role in the misleading performance marketing.[1]

   (d) *Modern Portfolio Management, Inc.*, Adv. Act Rel. No. IA-3702 (Oct. 23, 2013): During an on-site examination in 2008, OCIE staff found the registered investment adviser had failed to complete an annual compliance review in 2006 and that it made misleading statements on its website. The firm failed to take corrective action, and it, along with its owners G. Thomas Damasco II and Bryan Ohm, agreed to pay $175,000 in penalties, hire an independent compliance consultant for three years, and undergo compliance training to settle the charges.

   (e) *Judy K. Wolf*, Adv. Act Rel. No. IA-3947 (Oct. 15, 2014): The SEC charged a compliance officer at Wells Fargo Advisors, LLC, a dually-registered investment adviser and broker-dealer, with fabricating reports produced to OCIE staff in order to make it seem as though she had conducted a more thorough investigation of insider trading than was actually the case. The SEC alleged that Wolf altered the reports after an investment adviser representative at Wells Fargo was charged by the SEC with insider trading in the securities that were the subject of the report in question.

   (f) *George B. Franz III*, Adv. Act Rel. No. IA-3826 (April 30, 2014): The SEC charged George B. Franz III, the CEO of Ruby Corporation, a registered investment adviser, with several violations of the Advisers Act, noting that he lied to examination staff when he told them that he first learned of any potential misconduct by his son involving firm clients earlier that year and that he immediately fired his son, when neither was the case. The SEC also charged Franz with providing fabricated documents to the enforcement staff to try to show that he spoke with

[1] Complaint at 1–4, *SEC v. Present*, No. 1:14-cv-14692 (D. Mass. Dec. 22, 2014).

clients impacted by his son's fraud and addressed the issue in writing to these clients, as well as with lying under oath during the Enforcement Division's investigation.

B. NFA Examinations

1. The National Futures Association ("NFA") is the self-regulatory organization ("SRO") for commodity pool operators ("CPOs") and commodity trading advisors ("CTAs") registered with the Commodity Futures Trading Commission ("CFTC"). As part of its SRO functions, the NFA examines CPOs and CTAs for compliance with its and with the CFTC's rules and regulations.

2. The Examination Process

(a) Between one week and 30 days before beginning an exam, the NFA will contact the CCO or other compliance contact to announce the upcoming exam.

(b) At this time, the NFA will send a "first-day letter" outlining the following: (1) the anticipated duration of the exam; (2) a list of requested documents; and (3) a questionnaire on the examinee's business functions.

(c) Examiners will generally remain on-site for one to three weeks, during which NFA teams of four to five individuals review documents, observe operations and conduct interviews with management and employees. Subsequent off-site work follows.

(d) The NFA will conduct an exit interview summarizing findings and recommendations and issue a report after the on-site portion of an examination. However, due to the newness of the process, the NFA expects examinees to be prepared for follow-up visits and additional inquiries.

3. NFA Areas of Focus

(a) NFA examinations focus on noncompliance with CFTC and NFA rules. Some common violations the NFA focuses on include:

(i) Unregistered Associated Persons and Unlisted Principals: CFTC and NFA rules require all individuals employed by a CPO or CTA to be registered with the CFTC and to update their Form 7-Rs (registration forms) to reflect the addition of any new principal within 20 days.

(ii) Unregistered Branch Offices: NFA rules require all branch offices to be identified on a firm's Form 7-R and have an appointed branch manager.

(iii) Dealing with Non-NFA Members: NFA Bylaw 1101 — referred to as the "cornerstone" of NFA regulation — prohibits NFA registrants from doing business with any unregistered person or entity of which the CFTC and/or NFA requires registration.

(iv) Improper Promotional Materials and Sales Practices: NFA Rule 2-29 requires that promotional materials that communicate a level of performance contain specific data.

(b) At the beginning of each year, the NFA releases a list of issues that it will focus on during the examination process. For FY 2015, which began in July 2014, NFA exams will focus on compliance issues, including the role and function of compliance officers, implementation of and adherence to effective policies and procedures, due diligence, and risk management.

(c) NFA examinations no longer simply review compliance with NFA and CFTC rules and regulations. Now, examinations are looking at *risk*, i.e., the potential that a firm will have problems arise in the future.

II. Enforcement Insights

A. Recent SEC Enforcement Actions Against Private Funds Cover Various Types of Conduct

1. Principal Transactions

(a) Section 206(3) of the Investment Advisers Act ("Advisers Act") prohibits an investment adviser acting as principal for his own account from knowingly buying or selling securities to a client without first disclosing his principal capacity to the client and obtaining written consent.

(i) *Paradigm Capital Management, Inc.*, Adv. Act Rel. No. IA-3857 (June 16, 2014): Candace King Weir, owner of Paradigm, conducted transactions between Paradigm and another broker-dealer that she owned while trading on behalf of a hedge fund client, yet never properly disclosed this conflict of interest to the client or obtained consent for principal transactions. Paradigm and Weir paid $2,200,000 to settle charges with the SEC.

(ii) *Strategic Capital Group, LLC*, Adv. Act Rel. No. IA-3924 (Sept. 18, 2014): An SEC examination found that Strategic Capital Group ("SCG") engaged in over 1,000 principal transactions, purchasing fixed-income securities from its affiliated broker-dealer on behalf of client accounts, without making disclosures to its clients. SCG paid nearly $600,000 to settle the SEC's claims. CCO N. Gary Price also paid a $50,000 penalty for failing to implement policies that effectively prevented principal transactions from taking place.

(iii) *Highland Capital Management, L.P.*, Adv. Act Rel. No. IA-3939 (Sept. 25, 2014): In September 2008, Highland purchased over $3,300,000 in securities from one of its advisory clients. It also and advised two of its clients to sell approximately $15,000,000 in debt securities to four accounts in which Highland had ownership interests. Highland did not disclose these principal transactions to its clients, paying $225,000 in penalties as a result.

2. Improper Expense Allocations

(a) Although no rule explicitly prohibits improper expense allocations, the SEC has many tools to enforce against this conduct. Sections 206(1), 206(2) and 206(4) of the Advisers Act prohibit fraudulent conduct by investment advisers. Similarly, Section 17(a) of the Securities Act ("Securities Act") and Section 10(b) of the Securities Exchange Act ("Exchange Act") widely prohibit fraudulent conduct in connection with securities transactions.

(i) *Clean Energy Capital, LLC*, Adv. Act Rel. No. IA-3955 (Oct. 17, 2014): The SEC filed its first action alleging fraudulent allocation of expenses to a firm's funds, claiming that the advisory firm and its manager Scott A. Brittenham used the assets of 19 funds to pay over $3,000,000 in expenses such as rent, salaries, employee benefits, and management bonuses. In October 2014, Clean Energy settled the charges, agreeing to pay $2,200,000 and hire an independent consultant to review and update its compliance and accounting procedures.

(ii) *Lincolnshire Management, Inc.*, Adv. Act Rel. No. IA-3927 (Sept. 22, 2014): Lincolnshire integrated two portfolio companies owned by two different private equity funds that it advised, but did not allocate expenses properly between them. The SEC particularly noted the misallocation of monitoring fees. Lincolnshire paid over $2,300,000 to settle the charges.

3. Improper Investment Allocations

(a) The SEC relies on the various fraud provisions of the securities laws, including Sections 206(1), 206(2) and 206(4) of the Advisers Act; Section 10(b) of the Exchange Act; and Section 17(a) of the Securities Act, to bring enforcement actions against firms and individuals that allocate trades improperly.

(i) *J. S. Oliver Capital Management, L.P.*, Decision Rel. No. 649 (Aug. 5, 2014): J. S. Oliver and its president, Ian O. Mausner, engaged in a cherry-picking scheme, allocating trades after the close of trading to give more favorably-priced securities to particular clients – four hedge funds that held investments for Mausner and his family. An administrative judge imposed a $15,000,000 penalty against J. S. Oliver, ordered Mausner to pay a $3,000,000 penalty, and required disgorgement of roughly $1,400,000. Additionally, J. S. Oliver's investment adviser registration was revoked and Mausner was permanently barred from associating with investment advisers, brokers and dealers.

(ii) *Structured Portfolio Management, LLC*, Adv. Act Rel. No. IA-3906 (Aug. 28, 2014): One trader acted as the portfolio manager for each of three funds yet traded daily in Treasury securities for each fund. Despite the potential for improper allocation of purchases among the three funds, Structured Portfolio Management failed to have effective, written policies and procedures in place to protect against trade misallocations. To settle the charges, it paid a $300,000 penalty and retained an independent compliance consultant to settle the charges.

(iii) *Transamerica Financial Advisors, Inc.*, Adv. Act Rel. No. IA-3808 (April 3, 2014): Transamerica offered breakpoint discounts that reduced fees owed by clients that increased their assets in certain investment programs, allowing clients to aggregate accounts to obtain these discounts. However, Transamerica failed to process every aggregation request, leading to some clients being overcharged. It paid $1,100,000 and agreed to hire a compliance consultant to settle the claims.

4. Violations of the Custody Rule

(a) Rule 206(4)-2 of the Advisers Act sets forth a number of requirements intended to safeguard client funds and securities from an adviser's misappropriation. The Custody Rule applies to advisers or related persons that have the authority to hold and do hold client funds or securities.

(i) *Further Lane Asset Management LLC*, Adv. Act Rel. No. IA-3707 (Oct. 28, 2013): Despite maintaining custody of the assets of its managed funds, Further Lane failed to arrange an annual "surprise" examination to verify assets and failed to provide investors with quarterly account statements from a qualified custodian of the funds. Further Lane paid $347,000 in disgorgement to settle claims, and its CEO, Jose Miguel Araiz, agreed to pay a $150,000 penalty and be suspended from the securities industry for one year.

(ii) *Knelman Asset Management Group, LLC*, Adv. Act Rel. No. IA-3705 (Oct. 28, 2013): Knelman, an investment adviser, had custody of Rancho Partners I, a fund of funds, but never subjected Rancho's assets to surprise exams or distributed quarterly account statements to investors. To settle these and several other charges, Knelman agreed to pay

$60,000 and implement compliance measures and training, and its CEO and CCO agreed to pay $75,000 individually and be barred from acting as CCO for three years.

5. Violations of the "Pay-to-Play" Rule regulating Political Contributions

   (a) Rule 206(4)-5 of the Advisers Act makes it unlawful for a registered investment adviser to provide advisory services to a government entity for compensation within two years after making a political contribution to an official of that government. Contributions of certain associates of the adviser are also prohibited under this rule.

      (i) *TL Ventures Inc*., Adv. Act Rel. No. IA-3859 (June 20, 2014): In the SEC's first case under the pay-to-play rule, it charged a Philadelphia-based private equity firm for receiving advisory fees from city and state pension funds although one of its associates made campaign contributions to the Pennsylvania state governor and a candidate for mayor of Philadelphia in 2011. TL Ventures paid nearly $260,000 of disgorgement and a penalty of $35,000.

6. Fraudulent and Manipulative Valuation Practices

   (a) The SEC uses the general fraud provisions of the Advisers Act, the Exchange Act, and the Securities Act to charge funds and managers for employing manipulative valuation techniques.

      (i) *GLG Partners, Inc.*, Exch. Act Rel. No. 34-71050 (Dec. 12, 2013): Due to poor internal controls, one of GLG's funds overvalued its equity stake in an emerging market coal company, resulting in inflated fees to GLG and the overstatement of assets under management in SEC filings. GLG agreed to pay nearly $9,000,000 to settle the charges.

      (ii) *Brian Williamson*, Adv. Act Rel. No. IA-3760 (Jan. 22, 2014): Williamson, a former Oppenheimer portfolio manager, valued the fund's largest investment at a significant markup and sent misleading marketing materials regarding internal rates of return to investors. To settle the claims, Williamson paid a $100,000 penalty and was barred from the securities industry.[2]

7. Misleading Advertising

   (a) Rule 206(4)-1 of the Advisers Act prohibits false or misleading advertisements by investment advisers. Additionally, the SEC relies on the general fraud provisions of the securities laws to file charges for misleading promotional materials.

      (i) *F-Squared Investments, Inc.*, Adv. Act Rel. No. IA-3988 (Dec. 22, 2014): F-Squared falsely advertised its "AlphaSector" investment strategy, claiming a successful seven-year track record although it was based on an algorithm not even in existence for seven years. The claim in the advertisements was based on back-tested hypothetical data that inflated results by roughly 350 percent. F-Squared paid $35,000,000 to settle the charges. The SEC filed a civil complaint against co-founder and former CEO Howard Present in federal district court in Massachusetts in December 2014.[3]

      (ii) *Navigator Money Management, Inc.*, Adv. Act Rel. No. IA-3767 (Jan. 30, 2014): Money manager Mark Grimaldi and his firm Navigator were charged with making false claims in

[2] Oppenheimer settled related charges with the SEC for $2,800,000 in 2013. *Oppenheimer Asset Mgmt. Inc.*, Adv. Act Rel. No. IA-3566 (Mar. 11, 2013).

[3] Complaint, *SEC v. Present*, No. 1:14-cv-14692 (D. Mass. Dec. 22, 2014).

newsletters and on Twitter, exaggerating the success of investment advice. The advertisements cherry-picked specific successful recommendations made to clients while ignoring unsuccessful ones. To settle the charges, Grimaldi agreed to pay a $100,000 penalty and retain an independent compliance consultant for three years.

(iii) *Strategic Capital Group, LLC*, Adv. Act Rel. No. IA-3924 (Sept. 18, 2014): SCG provided prospective investors with misleading advertisements. One advertisement failed to disclose that the portrayed results were partly based on returns of an index rather than SCG's actual historical returns, and the other advertisement didn't disclose that the portrayed results included fees, thus materially overstating SCG's investment performance. SCG paid a $200,000 penalty and $368,459 in disgorgement to settle charges.

8. Rule 105 Violations

(a) Rule 105 of Regulation M prohibits a person from short selling a security within five business days of participating in an offering for that same security. No intent is required for the SEC to allege a Rule 105 violation.

(b) On Sept. 17, 2013, the SEC revealed charges against 23 investment advisers and private equity firms for Rule 105 violations. Twenty-two of the 23 firms charged settled the claims for a total of over $14,400,000 in sanctions.[4]

(i) In resolving these 2013 charges, the SEC impliedly made the point that there is no de minimis exclusion for Rule 105 violations; the one matter not immediately settled resulted in a civil penalty of $75,000 despite wrongful profits of merely $841.[5]

(c) On Sept. 16, 2014, the SEC sanctioned 19 firms and one individual trader for violating Rule 105. The 19 firms and the individual trader all agreed to settle the charges, paying a combined total of more than $9,000,000 in disgorgement, interest and penalties.[6]

(i) *Antipodean Advisors LLC*, Exch. Act Rel. No 34-73115 (Sept. 16, 2014): On August 22, 2013, Antipodean sold short over 150,000 shares of J.C. Penney during the restricted period for $13.18 per share. Five days later, J.C. Penney announced the pricing of a follow-on offering at $12.90 per share; Antipodean received 100,000 shares in this offering, profiting $27,970. It settled claims by disgorging the $27,970 in illicit profits and paying a $65,000 penalty.

(ii) *Seawolf Capital, LLC*, Exch. Act Rel. No. 34-73107 (Sept. 16, 2014): Seawolf short sold 105,600 shares of a REIT during the restricted period, and the REIT announced a follow-on offering at a lower price later that day. Seawolf received an allocation of 50,000 shares in the follow-on offering, profiting $192,730. It settled all claims by agreeing to pay $192,730 in disgorgement and a $96,365 civil penalty.

(d) *Worldwide Capital, Inc*., Exch. Act Rel. No. 34-71653 (March 5, 2014): From October 2007 to February 2012, Jeffrey Lynn and his proprietary trading firm, Worldwide Capital, participated in 60 public stock offerings covered by Rule 105 after having short sold those same securities during the pre-offering restricted period. Lynn agreed to pay $7,200,000 to settle the charges,

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[4] Press Release, Sec. & Exchange Comm'n, SEC Charges 23 Firms with Short Selling Violations in Crackdown on Potential Manipulation in Advance of Stock Offerings (Sept. 17, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539804376.

[5] *G-2 Trading LLC*, Exch. Act Rel. No 34-72231 (May 22, 2014).

[6] Press Release, Sec. & Exch. Comm'n, SEC Sanctions 19 Firms and Individual Trader for Short Selling Violations in Advance of Stock Offerings (Sept. 16, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542963767.

marking the SEC's largest-ever monetary sanction for a Rule 105 violation. In July 2014, the SEC brought charges against five Worldwide traders for Rule 105 violations, who agreed to settle all claims for a collective total of nearly $750,000.[7]

9. Delinquent Disclosure of Beneficial Ownership

(a) The SEC has increased enforcement of two provisions of the Exchange Act that require corporate insiders and major shareholders to file certain forms reporting beneficial ownership:

(i) Section 13(d) requires shareholders to file beneficial ownership reports after acquiring 5 percent or more of a class of securities.

(ii) Section 16(a) requires corporate officers, directors and shareholders with 10 percent or more ownership to file Form 3s initially disclosing their beneficial ownership and Form 4s and Form 5s disclosing subsequent transactions. Though the obligation to file is with the individual, Item 405 of Regulation S-K requires companies to annually review the Section 16 filings of their directors, officers and 10-percent shareholders and disclose to investors the names of those who failed to make required disclosures.

(b) On Sept. 10, 2014, the SEC announced charges against 28 officers, directors or major shareholders for 13(d) and 16(a) violations.[8] It also charged six public companies for failing to report on filing failures, as required by Regulation S-K. Of the 34 individuals and companies charged, 33 agreed to settle the claims, paying penalties totaling $2,600,000. Ten of the 34 entities charged were investment firms, including:

(i) *Ridgeback Capital Management LP*, Exch. Act Rel. No. 34-73032 (Sept. 10, 2014): Ridgeback violated Section 16(a) by failing to properly file multiple required reports regarding its transactions in Ironwood Pharmaceutical securities, which it executed on behalf of one of its managed funds. Ridgewood also violated Section 13(d) by failing to file reports disclosing its own beneficial ownership in Ironwood. Ridgeback settled the charges for $104,500.

(ii) *Trinad Management LLC*, Exch. Act Rel. No. 34-73034 (Sept. 10, 2014): Trinad violated Section 16(a) by failing to disclose holdings and transactions in certain securities that it executed on behalf of an affiliated fund under its management and violated Section 13(d) by never disclosing its own beneficial ownership in those securities. Trinad paid a $95,000 civil penalty to settle the claims.

(iii) *P.A.W. Capital Partners, L.P.*, Exch. Act Rel. No. 34-73038 (Sept. 10, 2014): PAW executed transactions in securities of Crumbs Bake Shop on behalf of affiliated funds it managed, but it didn't make the filings required by Section 16(a). PAW also violated Section 13(d), as it never disclosed its own beneficial ownership and ensuing transactions in Crumbs securities.

B. Increasing Regulation of Market Manipulation and Aggressive Enforcement by the CFTC

1. Overview of Market Manipulation Enforcement

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[7] Derek W. Bakarich, Exch. Act Rel. No. 34-72517 (July 2, 2014); Carmela Brocco, Exch. Act Rel. No. 34-75218 (July 2, 2014); Tina M. Lizzio, Exch. Act Rel. No. 34-15959 (July 2, 2014); Steven J. Niemis, Exch. Act Rel. No. 34-75250 (July 2, 2014); William W. Vowell, Exch. Act Rel. No. 34-72521 (July 2, 2014).

[8] Press Release, Sec. & Exchange Comm'n, SEC Announces Charges Against Corporate Insiders for Violating Laws Requiring Prompt Reporting of Transactions and Holdings (Sept. 10, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542904678.

(a) CFTC

(i) The CFTC is the agency tasked with regulating market manipulation and fighting fraud and other abusive practices in the derivatives markets. Recent anti-manipulation provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") have expanded the CFTC's enforcement opportunities dramatically by prohibiting manipulation and fraud broadly (in connection with "any swap, or a contract of sale of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity").

(ii) CFTC enforcement has surged in recent years. In FY 2014, the CFTC obtained a record $3,270,000,000 in monetary sanctions, bringing CFTC total monetary sanctions over the past two years to more than $5,000,000,000 — more than the total sanctions imposed during the prior 10 fiscal years combined.

(iii) Enforcement activity will likely increase; in November 2014, CFTC Enforcement chief Aitan Goelman announced the agency would soon begin bringing cases administratively, like the SEC.

(b) Exchanges and other self-regulatory organizations also regulate market manipulation. Enforcement efforts of these groups — including the National Futures Association ("NFA"), the Intercontinental Exchange ("ICE") and the Chicago Mercantile Exchange ("CME") Group — have increased over past years. A CFTC report faulted exchanges for lax enforcement in the past, so they are looking to change that by aggressively hiring from places like DAs' offices to enhance prosecutorial talent and expertise.

(c) Signaling increased efforts to regulate market manipulation, on Jan. 1, 2015, the Chicago Board of Exchange and the Options Regulatory Surveillance Authority ceded most of their regulatory responsibilities to the Financial Industry Regulatory Authority ("FINRA"), giving FINRA greater ability to bring enforcement actions based on market manipulation. The consolidation moves roughly 125 regulatory employees to FINRA, uniquely positioning it to detect cross-market and cross-product manipulation.

(d) The SEC and DOJ are two other primary regulators of market manipulation, often working in tandem with the CFTC. During FY 2014, approximately 95 percent of the CFTC's major fraud and manipulation cases involved a parallel criminal proceeding filed by DOJ.

2. Spoofing

"Spoofing" (a.k.a. "layering")[9] is the entering and canceling of orders without the intent to actually fill the orders. It continues to be a focus of enforcement actions by numerous regulators and across a wide swath of enforcement regimes.

(a) The Dodd-Frank Act

(i) Dodd-Frank Section 747 incorporated anti-spoofing concepts into the Commodity Exchange Act's ("CEA") prohibitions on "disruptive practices" (adding subparagraph (5) to Section 4c(a)).

[9] "Layering" is generally thought to be slightly different than spoofing because: (1) layering generally implies multiple orders at different price points; and (2) the orders may have a longer lifespan than in a typical spoofing case. However, for purposes of this summary, the two offenses are similar.

(ii) Subparagraph (5) of CEA Section 4c(a) provides:

(5) DISRUPTIVE PRACTICES — 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 —
(A) violates bids or offers;
(B) demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period; or
(C) 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).

(iii) On May 28, 2013, the CFTC issued an "interpretive guidance and policy statement" with respect to subparagraph (5).[10]

(b) CME Rule 575

(i) On Sept. 15, 2014, the CME Group exchanges (i.e., the CME, the Chicago Board of Trade, NYMEX and COMEX) adopted new Rule 575 ("Disruptive Practices Prohibited"). New Rule 575 (and its accompanying "Questions & Answers") effectively declares "spoofing" to be a type of "disruptive order entry and trading practices" that are "abusive to the orderly conduct of trading or the fair execution of transactions."

(ii) New Rule 575 states that:

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; [and]

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) On Jan. 14, 2015, the ICE Futures Exchange will implement rules to prohibit "spoofing." It will also clarify the exact disruptive practices that will be barred, including entering orders with the intent to cancel or modify before their execution, as well as the very broad practice of disrupting the "orderly conduct of trading." The rules, which ICE announced in December 2014, will also bar traders from entering bids or offers for the purpose of making a market price that doesn't reflect the true state of the market.

(d) *CFTC v. Moncada*, No. 12-cv-8791 (S.D.N.Y. Sept. 30, 2014)

(i) By electronically entering and immediately canceling numerous large-lot orders for wheat futures, trader Eric Moncada attempted to create a misleading impression of rising liquidity in the marketplace for the affected futures contracts and to profit through executing opposite direction small-lot orders at market prices distorted by the illusory large-lot order activity.

(ii) The CFTC obtained a federal consent order against Eric Moncada for alleged manipulation of the wheat futures markets, imposing a $1,560,000 civil monetary penalty and trading and registration restrictions.

[10] CFTC, Antidisruptive Practices Authority, Interpretive Guidance & Policy Statement, 78 Fed. Reg. 31,890 (May 28, 2013).

(iii) This settlement is notable for many reasons, including the fact that the number of manipulative trades is relatively small, i.e., alleged attempts to manipulate the price of the #2 Soft Red Winter Wheat futures contract on eight days in October 2009 and allegedly entering into fictitious sales and non-competitive transactions on four days in October 2009. The CFTC Director of Enforcement Aitan Goelman characterized this as "the wholesale entering and cancelling of orders without the intent to actually fill the orders."

(e) *United States v. Coscia*, No. 14-cr-551 (N.D. Ill. Oct. 2, 2014)

(i) DOJ has also taken an interest in spoofing activity. In October 2014, in the first criminal prosecution for spoofing, DOJ obtained an indictment against Michael Coscia, a registered floor trader, for allegedly violating the Dodd-Frank Act's anti-spoofing provisions. The indictment is a parallel proceeding, building on civil and SRO enforcement actions against Coscia and his former trading firm (Panther Trading LLC) by the CFTC,[11] the CME Group[12] and the U.K. Financial Conduct Authority.[13]

(ii) As with *Moncada,* the number of alleged spoofing violations is in the single digits (six alleged instances). However, *Coscia* is also important for the level of DOJ and CFTC "parallel proceeding" cooperation it evidences. The 2013 CFTC enforcement settlement, for example, required Coscia expressly to waive "any claims of Double Jeopardy based on the institution of this proceeding or the entry in this proceeding of any order imposing a civil monetary penalty or any other relief."

(f) *Visionary Trading LLC*, Exch. Act Rel. No. 34-71871 (April 4, 2014):

(i) In April 2014, the SEC charged a trading firm, Visionary Trading LLC, and a number of affiliates and controllers for violations related to layering activity. According to the SEC's settlement order, the misconduct occurred from 2008 through 2011. The SEC's order found violations of Sections 9(a)(2) and 10(b) of the Exchange Act, Rule 10b-5 and Section 15(a)(1) of the Securities Exchange Act. It also found liability for willfully aiding and abetting violations, failures to supervise and registration violations. Total disgorgement and penalties agreed to were well in excess of $1,000,000.

3. The CFTC's Growing Power As Demonstrated Though a Range of Notable Enforcement Actions

(a) *CFTC v. Wilson*, No. 13-cv-7884 (S.D.N.Y. Nov. 6, 2013): The CFTC filed claims in federal court against Donald R. Wilson and his company, DRW Investments LLC, alleging they manipulated the prices of interest rate futures contracts by making bids they knew would not be accepted in order to influence settlement prices in their favor. This conduct generated illicit profits of at least $20,000,000. In June 2014, the CFTC successfully defeated a motion to dismiss.[14] The outcome of the action is still pending.

(b) *CFTC v. Hunter Wise Commodities, LLC*, No. 12-81311-cv (S.D. Fla. May 16, 2014): Hunter Wise claimed to arrange loans for investors to purchase metals, advising investors that the metals

[11] *Panther Energy Trading LLC*, CFTC Docket No. 13-26 (July 22, 2013).

[12] CME Docket No. 11-8581-BC (July 22, 2013); CBOT Docket No. 11-8581-BC (July 22, 2013); NYMEX Docket No. 11-8581-BC-Michael Coscia (July 22, 2013); COMEX Docket No. 11-8581-BC-Michael Coscia (July 22, 2013). *All available at* http://www.nfa.futures.org/basicnet/CaseInfo.aspx?entityid=0465462&type=reg.

[13] Michael Coscia, Final Notice, Fin. Conduct Auth. (July 3, 2013), *available at* http://www.fca.org.uk/static/documents/final-notices/coscia.pdf.

[14] *CFTC v. Wilson*, No. 13-cv-7884 (S.D.N.Y. 2014).

would be stored in a secure depository. However, Hunter Wise never purchased any metals nor arranged any loans for its investors to do so, while charging exorbitant storage fees and "interest" on the nonexistent loans. The scheme defrauded over 3,200 investors. At trial, a federal court in Florida held that Dodd-Frank required the type of precious metal transactions at issue to be executed on an exchange, and the post-trial verdict ordered Hunter Wise to pay $52,600,000 in restitution and a $55,400,000 civil penalty, the maximum allowable in the case. This enforcement action is a prime example of how the CFTC is using its new authority under Dodd-Frank to pursue persons looking to prey on investors in precious metal markets.

(c) *FirstRand Bank, Ltd.,* CFTC Docket No. 14-23 (Aug. 27, 2014); *Absa Bank, Ltd.*, CFTC Docket No. 14-30 (Sept. 25, 2014); *Fan Zhang*, CFTC Docket No. 14-33 (Sept. 29, 2014): In all three CFTC actions, defendants entered into prearranged, noncompetitive trades that negated market risk and stripped away price competition. FirstRand's and Absa's prearranged trades involved corn and soybeans futures contracts, and Zhang's involved housing market contracts, cheese futures contracts and ethanol futures contracts. All three parties entered into settlement agreements; First Rand and Absa each paid $150,000 in civil penalties to settle claims, while Zhang paid a penalty of $250,000.

(d) *CFTC v. EJS Capital Mgmt., LLC*, No. 14-cv-3107 (S.D.N.Y. May 1, 2014): EJS issued false account statements to customers that listed profits from foreign exchange trading, though no profits were ever generated from such activity. Several individuals affiliated with EJS also misappropriated customer funds for personal and business expenses, such as vacations and automobile leases. Federal District Judge Kevin Castel of the Southern District of New York entered a restraining order against EJS and some of its traders, freezing assets and prohibiting the destruction or concealment of books and records.

4. Regulation and Prosecution of the Manipulation of LIBOR and Other Foreign Exchange Benchmarks

(a) New Laws Increasingly Regulate Benchmark Manipulation

(i) The United Kingdom passed legislation in 2013 in response to LIBOR manipulation and is now attempting to amend this legislation to criminalize rate-rigging. Amendments currently in the pipeline would, if enacted, impose up to seven-year prison sentences on those found guilty of manipulating foreign exchange rates. The proposed amendments will also create additional oversight requirements for several of the U.K. indices, such as requiring them to appoint compliance personnel, keep records of suspicious benchmark submissions, and put oversight committees in place.

(ii) Though the United States does not have any similar legislation in the works, it is likely headed in that direction. In November 2014, CFTC Chairman Timothy Massad told U.S. policymakers that LIBOR regulations in Europe will affect U.S. markets and that the CFTC "stands ready to work with its counterparts in the U.S. financial regulatory sector to address this issue further."

(b) Notable Enforcement Actions and Settlement Agreements Addressing Benchmark-Rigging

(i) *United States v. Lloyds Banking Group* (D. Conn. July 28, 2014); *Lloyds Banking Group Plc*, CFTC Docket No. 14-18 (July 28, 2014): The CFTC and DOJ alleged that traders at the financial giant manipulated the bank's LIBOR submissions to benefit their own trading positions and the trading positions of their friends. Lloyds entered into a deferred prosecution agreement with DOJ in July 2014, agreeing to pay $86,000,000 and admitted to committing wire fraud, as alleged in a filed criminal information. Lloyds further agreed to cooperate with DOJ in its continuing investigations of other financial institutions, as well as nine of its traders who were criminally charged in connection with the rate-rigging. Lloyds settled claims with the CFTC by agreeing to pay a $105,000,000 civil penalty.

(ii) *United States v. Robson* (S.D.N.Y. Aug. 18, 2014); *United States v. Cooperative Centrale Raiffeisen-Borenleenbank, B.A*. (D. Conn. Oct. 29, 2013); *Cooperative Central Raiffeisen-Boerenleenbank B.A.*, CFTC Docket No. 14-02 (Oct. 29, 2013): DOJ alleged that Rabobank employee Paul Robson manipulated Rabobank's yen LIBOR submissions to benefit his own trades, charging him with wire fraud and conspiracy to commit wire fraud and bank fraud. DOJ and the CFTC also filed charges against Rabobank as a corporate entity for LIBOR manipulation. Robson pleaded guilty to one of 15 counts in August 2014. His sentencing is scheduled for June 9, 2017. Rabobank entered into a deferred prosecution agreement with DOJ in October 2013, pleading guilty to charges of wire fraud and paying a $325,000,000 penalty in connection with LIBOR manipulation. That same month, it settled charges with the CFTC for $475,000,000.

(iii) In November 2014, the CFTC filed settlements with five of the world's largest banks — JPMorgan, Citibank, UBS, RBS and HSBC — for manipulating foreign exchange benchmark rates to benefit the positions of certain traders.[15] In the aggregate, the five settlement agreements imposed over $1,400,000,000 in civil penalties. The penalties were allocated as follows: $310,000,000 each for Citibank and JPMorgan; $290,000,000 each for RBS and UBS; and $275,000,000 for HSBC. Repercussions may multiply for some of the banks in 2015; DOJ has launched criminal probes into the foreign exchange activities of both JPMorgan and UBS.[16]

C. Whistleblower Information Fuels New Enforcement Initiatives

1. Relevant Statutes and Regulations

(a) The False Claims Act ("FCA")[17] allows whistleblowers to file complaints against persons who submit false claims to the government for payment. These are known as qui tam complaints. The FCA was amended in 2009 to allow the government to file its own complaints based on whistleblowers' tips.

(b) Section 806 of the Sarbanes-Oxley Act of 2002 ("SOX") and Section 922 of Dodd-Frank provide for whistleblower reporting. While SOX's provisions do not provide for monetary awards to whistleblowers, Dodd-Frank's provisions require the SEC to reward individuals for voluntarily providing original information that leads to a successful enforcement action, with payouts of 10 to 30 percent of the total monetary penalties.

(c) Dodd-Frank also provides for awards for those who report information to the CFTC regarding violations of the CEA. These whistleblowers receive monetary awards if the information leads to a successful enforcement action imposing more than $1,000,000 in sanctions. Akin to payouts under Dodd-Frank's SEC whistleblower program, whistleblowers who tip the CFTC can receive

[15] Citibank, N.A., CFTC Docket No. 15-03 (Nov. 11, 2014); HSBC Bank plc, CFTC Docket No. 15-07 (Nov. 11, 2014); JPMorgan Chase Bank, N.A., CFTC Docket No. 15-04 (Nov. 11, 2014); Royal Bank of Scotland plc, CFTC Docket No. 15-05 (Nov. 11, 2014); UBS AG, CFTC Docket No. 15-06 (Nov. 11, 2014).

[16] Hugh Son & Michael J. Moore, JPMorgan Faces U.S. Criminal Probe into Currency Trading, Bloomberg News (Nov. 4, 2014), *available at* http://www.bloomberg.com/news/2014-11-03/jpmorgan-faces-u-s-criminal-probe-into-foreign-exchange-trading.html.

[17] 31 U.S.C. §§ 3729–3733.

10 to 30 percent of total monetary penalties. In May 2014, the CFTC announced its first whistleblower award, in the amount of $240,000.[18]

2. Aggressive Enforcement Based on Whistleblower Tips

   (a) Increasingly, DOJ has relied on FCA whistleblowers in its enforcement efforts. In FY 2014, it paid out $435,000,000 in whistleblower awards in connection with FCA cases and announced $5,690,000,000 in FCA settlements and judgments.

      (i) Courts are approving high payouts to FCA whistleblowers. The U.S. Court of Appeals for the Fourth Circuit permitted a whistleblower to recover $24,000,000 in damages, although the defendant had only defrauded the government in the amount of $3,300,000.[19] In its decision, the court noted that under a civil damages provisions (where the penalty is calculated based on the number of individual false claims submitted), statutory damages can far exceed actual monetary damages. This decision shows a willingness to approve excessive awards for FCA whistleblowers, giving DOJ a powerful tool to obtain information.

   (b) DOJ is employing new strategies to leverage whistleblower tips as part of its enforcement efforts.

      (i) In September 2014, Leslie Caldwell, Assistant Attorney General for the Criminal Division, announced a new system where the Civil Division will share all qui tam complaints with the Criminal Division as "a vital part of the Criminal Division's future efforts."

      (ii) Before 2010, the FCA contained a "public disclosure bar," preventing whistleblowers from filing complaints based on facts that had already been publicly disclosed. In 2010, the FCA was amended to allow the government to waive the public disclosure bar, enabling the government to bring an action after knowledge of the underlying fraud becomes public. This change makes it far easier for DOJ to file FCA claims.

   (c) The number of whistleblowers reporting information to the SEC is steadily increasing. In FY 2014, the SEC received 3,620 tips, up from 3,001 in 2012 and 3,238 in 2013. The SEC issued whistleblower awards to more individuals in FY 2014 than in all previous years combined. The awards are also increasing in size — the SEC authorized an award of $30,000,000, its largest whistleblower award to date, in September 2014.[20]

3. Recent New York Federal Court Decisions Expand Potential FCA Liability

   (a) In *United States v. Wells Fargo Bank N.A.*,[21] DOJ brought FCA claims against Wells Fargo for fraudulent loan origination activities occurring from 2001 to 2005, arguing that the statute of limitations was tolled by the Wartime Suspension of Limitations Act ("WSLA").[22] Congress authorized military force to combat terrorism in the days following the attacks of Sept. 11, 2001. Judge Jesse Furman, a New York federal judge, held that because no formal declaration to end

[18] Press Release, Commodity Futures Trading Comm'n, CFTC Issues First Whistleblower Award (May 20, 2014), *available at* http://www.cftc.gov/PressRoom/PressReleases/pr6933-14.

[19] *U.S. ex rel. Bunk v. Gosselin World Wide Moving, N.V.*, 741 F.3d 390 (4th Cir. 2013).

[20] Press Release, Sec. & Exchange Comm'n, SEC Announces Largest-Ever Whistleblower Award (Sept. 22, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543011290.

[21] *United States v. Wells Fargo Bank N.A.*, 972 F. Supp. 2d 593 (S.D.N.Y. 2013).

[22] The WSLA suspends the statute of limitations for offenses involving fraud against the United States while the country is at war or Congress has authorized the use of military force until five years after the conflict ends.

hostilities has been made by the President or by Congress, the WSLA's suspension of the statute of limitations has not ended. Thus, FCA claims were not time-barred. The decision provides significant benefits to DOJ, allowing all false claims submitted since Congress's authorization of military force in September 2001 to be prosecuted, without any time constraint, until Congress or the President makes a formal declaration revoking the authorization. The decision grants seemingly unending amounts of time to bring FCA claims for post-2001 activity, giving DOJ ample time to investigate tips of whistleblowers and build cases.

(b) *In United States v. Countrywide Financial Corp.*,[23] Edward O'Donnell, a former executive at Bank of America subsidiary Countrywide Financial, gave the government information on the bank's mortgage fraud. Based on this information, the government filed FCA claims, alleging the bank engaged in fraudulent loan origination practices and misrepresented the quality of loans to Fannie Mae and Freddie Mac. New York federal judge Jed Rakoff recognized that the 2009 amendments to the FCA may extend FCA liability to false claims made to government-sponsored enterprises — such as Fannie Mae and Freddie Mac.[24] The decision gives DOJ the ability to bring claims against persons who submit false claims to government-sponsored *enterprises* as well as those who submit them to the government.[25]

4. Notable Settlement Agreements and Administrative Proceedings

(a) *United States v. JPMorgan Chase* (S.D.N.Y. Feb. 4, 2014): JPMorgan violated the FCA by originating and underwriting noncompliant mortgage loans and submitting them for insurance coverage to the Federal Housing Administration ("FHA") and the Department of Veteran Affairs. JPMorgan agreed to pay $614,000,000 to resolve the claims. The whistleblower, who worked in senior management for JPMorgan, was awarded $63,900,000, one of the highest FCA whistleblower awards ever.[26]

(b) *United States v. SunTrust Mortgage Inc.* (D.C. Cir. June 17, 2014): From 2006 to 2012, SunTrust originated and underwrote mortgages for submission to the FHA though as many as 50 percent of these mortgages did not comply with FHA requirements. To settle the claims, SunTrust agreed to pay $968,000,000, admit its wrongdoing, make changes in oversight and install an independent monitor to oversee compliance with the settlement agreement. The agreement also imposed fines of up to $1,000,000 for any violations of its terms.

(c) *United States v. U.S. Bank National Association* (N.D. Ohio June 30, 2014): DOJ alleged that the bank violated the FCA by originating and underwriting noncompliant loans, emphasizing its lack of an internal control system to identify deficiencies in the loan certification process. U.S. Bank settled DOJ's claims in June 2014 for a $200,000,000 penalty.

(d) *Whistleblower Award Proceeding No. 2014-9*, Exch. Act Rel. No. 34-72947 (Aug. 29, 2014): A compliance officer reported misconduct learned through his position to his employer-organization, and reported later to the SEC after the organization failed to respond or correct

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[23] *United States v. Countrywide Fin. Corp.*, 961 F. Supp. 2d 598 (S.D.N.Y. 2013).

[24] However, the court dismissed the claims on the basis that the 2009 amendments to the FCA do not apply retroactively. Countrywide's fraudulent submissions to Fannie Mae and Freddie Mac occurred prior to May 20, 2009 — the date the amendments were enacted — so they were not actionable.

[25] Though FCA claims were dismissed by this decision, DOJ reached a global settlement of $16,650,000,000 with Bank of America for omnibus financial fraud allegations, including FCA violations, in August 2014. In December 2014, New York federal judge Richard Sullivan approved an agreement granting O'Donnell $58,000,000 in whistleblower awards for providing information vital to the settlement.

[26] Jonathan Stempel, JPMorgan Whistleblower Gets $63.9 Million in Mortgage Fraud Deal, Reuters News (May 7, 2014), *available at* http://www.reuters.com/article/2014/03/07/us-jpmorgan-whistleblower-idUSBREA261HM20140307.

the misconduct. Ordinarily, Dodd-Frank's whistleblower provisions prohibit awards to compliance, audit and legal personnel who obtain information in carrying out their job-related duties, and permit awards only for whistleblowers who obtain information through "independent knowledge" or "independent analysis." However, the SEC awarded the whistleblower $300,000, maintaining that employees in compliance roles can be eligible for awards if they first go to their companies, which then fail to take action in a timely fashion. The decision is an example of the "120-day look-back" provision of the whistleblower regulations at work.[27]

(e) *Whistleblower Award Proceeding No. 2014-5*, Exch. Act Rel. No. 34-72301 (June 3, 2014): Two whistleblowers provided information to the SEC, which led to a successful enforcement action. The SEC awarded $875,000 to be shared evenly by the two whistleblowers. In calculating this award, the SEC included a portion of the disgorgement and prejudgment interest that was deemed satisfied by the respondent's payment of that amount in another government action.

D. Regulators Incentivize and Reward Self-Reporting and Cooperation

1. Just as they reward whistleblowers for reporting securities violations and financial crimes, the SEC, DOJ and other regulators provide incentives to companies to report their own violations and cooperate in investigations. Regulators' approach to self-reporting and cooperation is a double-edged sword: The SEC and DOJ have declared that self-reporting will yield reduced sanctions yet also that failing to voluntarily come forth with information will lead to higher penalties.

2. The Principles of Federal Prosecution of Business Organizations, which guide DOJ in bringing charges against and reaching agreements with corporations, instruct prosecutors to consider "timely and voluntary disclosure of wrongdoing and … cooperation" with investigations. The Principles also state that cooperation can allow potential defendants to gain "credit in a case that otherwise is appropriate for indictment and prosecution."

3. The increasing use of deferred prosecution agreements ("DPAs") and non-prosecution agreements ("NPAs") illustrates the importance the government places on cooperation. In 2014, DOJ entered into 19 DPAs and 10 NPAs, agreeing to defer or entirely forgo criminal prosecution against a party in exchange for that party's cooperation in other investigations and/or its promise to comply with specified remedial measures. The SEC entered into one DPA in 2014 — its third ever since its first in 2011 — and entered into its first NPA in April 2014 (see Section F.4.(a), below).

4. Recent Enforcement Shows Negative Effects of Insufficient Cooperation

(a) *United States v. Alstom Grid, Inc.* (D. Conn. Dec. 22, 2014): DOJ charged Alstom, a French power and transportation company, with violations of the Foreign Corrupt Practices Act ("FCPA"). It alleged that Alstom paid bribes to government officials and falsified its books in connection with power and transportation projects for state-owned entities around the world, namely in Indonesia, Egypt, Saudi Arabia and the Bahamas. Alstom pled guilty to FCPA violations and agreed to pay DOJ a record $772,000,000 — the largest ever criminal fine levied by the government against a company for bribery — on Dec. 22, 2014.[28] The DOJ cited Alstom's failure to voluntarily disclose its misconduct when it became aware of it and its failure to cooperate

[27] The "120-day look-back" provision encourages internal reporting by allowing employees to remain eligible for whistleblower awards and giving them priority status over any subsequent whistleblower for 120 days after reporting misconduct to their companies. The provision also states that a whistleblower who reports internally will receive credit from the SEC for all information subsequently self-reported by the company.

[28] Alstom's sentencing hearing is scheduled for June 23, 2015.

with DOJ investigations for several years as the reasons for the record penalty. On the other hand, DOJ agreed to defer prosecution of two of Alstom's U.S. subsidiaries — including one in Connecticut that carried out a substantial amount of the illegal conduct — because they agreed to cooperate in criminal investigations of Alstom executives and other subsidiaries.[29]

(b) *United States v. BNP Paribas S.A.* (S.D.N.Y. June 30, 2014): BNP Paribas knowingly moved over $8,800,000,000 through the U.S. financial system on behalf of Iranian, Cuban and Sudanese entities, in clear violation of U.S. economic sanctions. These violations occurred despite clear and repeated warnings of compliance officers that violations were occurring. Additionally, when contacted by law enforcement, the bank did not fully cooperate. In June 2014, BNP Paribas pled guilty to violating the International Emergency Economic Powers Act and the Trading with the Enemy Act and paid $8,900,000,000 in penalties. DOJ cited its failure to cooperate as a key reason for the steep penalty.

(c) *George B. Franz III, Adv. Act Rel. No. IA-3826* (SEC, April 30, 2014): George Franz owned and managed investment adviser Ruby Corporation. His son, Andrew Franz, misappropriated over $490,000 from roughly 50 of Ruby's client accounts. When the SEC investigated Andrew's fraud, George impeded the investigation, providing the SEC with fabricated documents, shredding key records and lying to SEC staff. Franz settled civil charges for a $675,000 penalty and $425,000 in disgorgement. An Ohio federal judge also sentenced him to three years' probation, imposed a $25,000 criminal fine and ordered payment of $250,000 to the SEC for diversion of investigative resources.[30]

(d) *Judy K. Wolf*, Adv. Act Rel. No IA-3947 (SEC, Oct. 15, 2014): Wolf, a former Wells Fargo compliance officer, admitted to altering a document before submitting it to the SEC in order to make her review of a particular broker's trading appear more thorough. Wolf's hearing is scheduled to begin on Feb. 23, 2015.

E. The Resurgence of FIRREA

1. Overview of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA")

(a) FIRREA[31] allows DOJ to seek civil money damages against persons who violate one or more of 14 enumerated statutes (such as the mail fraud statute and the wire fraud statute) in a manner that "affects" federally-insured financial institutions. It is a powerful weapon for the government for reasons that include the following:

(i) Because it is a civil statute, the burden of proof is low; the government need only prove that a defendant violated one of the enumerated predicate statutes by a preponderance of the evidence. By contrast, criminal suits require proof of guilt beyond a reasonable doubt.[32]

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[29] Press Release, Dep't of Justice, Alstom Pleads Guilty and Agrees to Pay $722 Million Criminal Penalty to Resolve Foreign Bribery Charges (Dec. 22, 2014), *available at* http://www.justice.gov/opa/pr/alstom-pleads-guilty-and-agrees-pay-772-million-criminal-penalty-resolve-foreign-bribery.

[30] *SEC v. Franz III*, No. 1:15-cr-159 (N.D. Ohio 2014).

[31] 12 U.S.C. § 1833a.

[32] Notably, in a FIRREA case the government need not prove the violation of a predicate statute at the heightened standard required to be proven in criminal cases, even though the predicate offenses are in fact criminal offenses that if prosecuted alone would require the higher standard of proof.

(ii) FIRREA grants the government broad subpoena powers, giving it the ability to depose key witnesses and compel the production of documents without obtaining prior judicial authorization.

(iii) FIRREA has a 10-year statute of limitations, far longer than the time period to bring most civil lawsuits (typically two to five years). The 10-year period affords DOJ a long time to conduct investigations before filing claims.

(iv) The monetary penalties for FIRREA violations can be extremely high; the statute authorizes penalties of up to $1,100,000 per violation. For continuing violations, the maximum increases up to $1,100.000 per day or $5,500,000 per violation, whichever is less. The statute also grants courts discretion to increase penalties to match the pecuniary gains of violators or the pecuniary losses of victims.

A 2014 decision of the federal court for Manhattan confirms that FIRREA monetary penalties can be very steep.[33] In a case against a Bank of America subsidiary for mortgage fraud, the court held that in calculating FIRREA penalties, the starting point is gross — rather than net — gains or losses attributable to a defendant's conduct. It stressed that FIRREA penalties are aimed at deterrence and punishment, not simply compensation for losses. Accordingly, the court imposed a $1,300,000,000 penalty.

2. Enforcement Developments and Trends

(a) FIRREA was passed in response to the savings and loans crisis of the 1980s, but until recently, was dormant. The statute was barely used since its passage in 1989 until the late 2000s, but DOJ has ramped up FIRREA enforcement, often bringing FIRREA claims in tandem with FCA claims. There is little case law limiting the scope of FIRREA claims to inhibit these DOJ efforts.

(b) Through its increasing use of FIRREA, DOJ wants to encourage individuals to provide information on FIRREA violations. On Sept. 17, 2014, U.S. Attorney General Eric Holder proposed amending FIRREA to increase whistleblower awards, which are currently statutorily capped at $1,600,000, in contrast to those under the FCA and Dodd-Frank, which authorize awards up to 30 percent of the government's recovery and the SEC's recovery, respectively.

(c) In the past two years, New York federal courts have made it easier for the government to bring FIRREA suits against financial institutions, finding that an institution can be liable for fraudulent behavior that only affects *itself* and has no other victims.[34] Courts have also held that fraud may "affect" an institution for purposes of FIRREA merely by exposing that institution to an increased *risk* of loss; *actual* loss is not necessary to show that fraud affected the institution.[35]

3. Notable Settlement Agreements and Administrative Proceedings

(a) *United States v. Citigroup Inc.* (E.D.N.Y. July 14, 2014): FIRREA claims were filed based on Citigroup's fraudulent securitization, packaging, sale and issuance of residential mortgage-backed securities. In July 2014, Citigroup reached a settlement agreement that included a $4,000,000,000 FIRREA penalty (which, at the time, was the largest penalty ever imposed

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[33] *United States ex rel. O'Donnell v. Countrywide Home Loans, Inc.*, No. 12-cv-1422 (S.D.N.Y. 2014).

[34] *United States v. Wells Fargo Bank, N.A.*, 972 F. Supp. 2d 593 (S.D.N.Y. 2013); *United States v. Bank of N.Y. Mellon*, 941 F. Supp. 2d 438 (S.D.N.Y. 2013).

[35] *U.S. v. Bank of N.Y. Mellon*, *supra* note 34.

under the statute, only to be trumped the following month by DOJ's $5,000,000,000 agreement with Bank of America).[36]

(b) *United States v. McGraw-Hill Cos.,* No. CV13-000779 (C.D. Cal. Feb. 4, 2013): DOJ alleged that Standard & Poor's Financial Services (S&P) failed to objectively and accurately rate issuances of residential mortgage-backed securities and collateralized debt obligations in the onset of the 2008 financial crisis. DOJ claimed that this behavior violated the mail and wire fraud statutes, thereby affecting federally-insured financial institutions. DOJ's complaint invokes the statutory provision giving courts discretion to increase penalties to reflect the economic harm done, seeking over $5,000,000,000 in civil penalties. The case has been filed but has not yet been heard.

F. Developments and Trends in Insider Trading

1. Fiduciary Duties: It is a longstanding principle of the securities laws that to be liable for insider trading, the tipper — the person who provides material, nonpublic information — must: (1) breach a fiduciary duty to the source of the information; and (2) receive a benefit for sharing the information. Recently, federal courts have examined the intricacies of fiduciary breaches that can lead to insider trading liability for these tippers or their "tippees" (those who receive the inside information).

(a) *United States v. Newman*:[37] The Most Recent Word from Federal Courts

(i) The government alleged that Todd Newman and Anthony Chiasson, portfolio managers at two separate hedge funds, traded in Dell and Nvdia securities after receiving inside information. Evidence showed that analysts at the defendants' funds had received information about Dell and Nvidia earnings from insiders at those companies prior to public earnings announcements and passed it onto defendants, who then traded on the information.

(ii) The U.S. Court of Appeals for the Second Circuit reversed the defendants' convictions and remanded their charges to the trial court with order to dismiss the charges with prejudice, finding that for a tippee to be guilty of insider trading, the government must prove that he or she not only know that the tip came from a person who breached a fiduciary duty to the source of the information, but that he or she also *knew that the tipper received a personal benefit* by sharing inside information. Furthermore, the court opined on what constitutes a benefit, holding that nebulous benefits, such as social clout, are not enough; rather, the tipper must receive some concrete benefit, such as pecuniary gain, *and* the tippee must know about this benefit, for liability to attach.

(iii) The case and its repercussions will resound in 2015. Prosecutors have said that they are reviewing their options and could ask for the full Second Circuit to review the three-judge panel's decision or file a petition with the U.S. Supreme Court. In the aftermath of the decision, the Second Circuit has put appeals of insider trading convictions — such as the appeal of SAC Capital Advisors' Michael Steinberg — on hold while prosecutors plan their next step. It has also made judges question guilty pleas; Andrew Carter, a federal judge in New York, indicated in December hearings that he was inclined to vacate the guilty pleas of four defendants alleged to have traded on nonpublic information of an IBM acquisition.

[36] In August 2014, Bank of America Corp. entered into a global settlement agreement with DOJ for omnibus financial fraud, settling numerous claims for $16,650,000,000. It is the largest civil settlement with a single entity in U.S. history, as well as representing the largest FIRREA penalty to date ($5,000,000,000). *United States v. Bank of America Corp.* (D.N.J. Aug. 21, 2014).

[37] *United States v. Newman*, Nos. 13-1837 & 13-1917 (2d Cir. 2014).

(b) *United States v. Rajaratnam*, No. 1:13-cr-00211 (S.D.N.Y. 2014): Rengan Rajaratnam, the younger brother of former hedge fund tycoon Raj Rajaratnam, who was convicted of insider trading and sentenced to 11 years in 2013, was criminally charged with insider trading violations in connection with the same activity that put Raj in prison. First, the court dismissed two insider trading charges because the government failed to present evidence that Rengan *knew* that the tip provided a benefit to the tipper. The remaining count, conspiracy to engage in insider trading, was submitted to a jury, which returned a verdict of not guilty. The jury didn't believe the evidence — wiretapped calls between Rengan and Raj — was sufficient to convict.[38]

(c) *Steginsky v. Xcelera, Inc*., 741 F.3d 365 (2d Cir. 2014): Steginsky was a minority shareholder of Xcelera, a Cayman Islands holding corporation. After its stock plummeted from $110 to just $1, three Xcelera officers created a separate entity and made a tender offer for Xcelera stock at a price of $0.25 per share. Steginsky sold pursuant to this offer, and then filed an insider trading suit. In its decision, the court reiterated the principle that insider trading liability requires that defendants breach a fiduciary duty in disclosing the inside information. It clarified that this duty is governed by federal common law, *not* the local law of the defendant. Because the law of the Cayman Islands does not recognize the duty of disclosure, defendant could not be found liable for insider trading.

2. Promoting Prevention of Insider Trading: Regulators have begun to prosecute financial institutions for failing to ensure that their employees and other affiliates abstain from insider trading, launching investigations of and imposing penalties for failures to oversee employees and implement compliance programs to prevent this activity.

(a) *Wells Fargo Advisors*, *LLC*, Adv. Act Rel. No. IA-3928 (SEC, Sept. 22, 2014): A broker at Wells Fargo learned confidential information about an acquisition from one of his clients. He then traded on the information ahead of the public announcement. In addition to an insider trading suit against the broker, the SEC brought charges against Wells Fargo for failing to have adequate controls in place to prevent its employees from trading on inside information learned from clients. The SEC claimed that multiple supervisory personnel were told that this broker traded on insider information but failed to act. Wells Fargo settled the claims for $5,000,000.

(b) *Liquidnet, Inc.*, Exch. Act Rel. No. 34-72339 (SEC, June 6, 2014): Employees of Liquidnet, a broker-dealer with a dark pool trading system, traded on confidential information about the dark pool's subscribers. The SEC brought charges for Liquidnet's failure to have a compliance system to protect the confidential information of dark pool subscribers and prevent insider trading by employees. Liquidnet settled the claims for $2,000,000.

(c) *Thomas E. Meade*, Adv. Act Rel. No. IA-3855 (SEC, June 11, 2014): Meade was the former CEO & COO of investment adviser Private Capital Management ("PCM"). A vice president of PCM — a firm of only four or five people — received a tip from his own father, the chairman of an audit committee of a public company, and traded on the information. He pled guilty to insider trading in an SEC enforcement action in 2011. In June of 2014, the SEC brought claims against Meade, alleging that he was aware of the vice president's relationship with his father and the father's position at a public company yet failed to put any oversight mechanisms in place to curb the high risk of insider trading (Meade failed to adequately collect and review personal trading records of his few employees, failed to maintain restricted stock lists and failed to investigate misconduct when alerted to it.) Meade was fined $100,000 and was barred from future

[38] However, Rajaratnam agreed to pay civil penalties of $840,000 and be barred from all future work in the securities industry in October 2014 to settle SEC claims. *SEC v. Rajaratanam*, No. 13-cv-1894 (S.D.N.Y. 2014).

employment in any director or officer positions with investment advisers, effectively banning him from the securities industry.[39]

(d) *Jefferies LLC,* Exch. Act Rel. No. 34-71695 (SEC, March 12, 2014): The SEC alleged that Jefferies failed to supervise employees on its mortgage-backed securities desk, allowing them to lie to customers about pricing. The failure to supervise enforcement was based in part on the fact that one of the employees found to have lied to customers had been charged by the SEC for securities fraud in recent years; yet Jefferies did not enhance oversight of this rogue employee. Jefferies agreed to pay $25,000,000 to settle the claims.

(e) *Citigroup Global Markets, Inc*., FINRA Case No. 2013036054901 (Nov. 24, 2014): Research analysts at the financial institution hosted "idea dinners" with Citigroup's traders and institutional clients, at which they shared stock picks inconsistent with their public research. Though Citigroup issued roughly 100 internal warnings to analysts about impermissible communications, FINRA alleged that punishment was often untimely and not severe enough to deter similar conduct in the future. Citigroup was fined $15,000,000 in November 2014 as a result of these supervisory failures.

3. Courts Increasingly Approve High Penalties for Insider Trading

(a) *SEC v. Contorinis*, 743 F.3d 296 (2d Cir. 2014): Contorinis, a managing director at Jefferies, received multiple tips concerning the acquisition of supermarket chain Albertsons. He then traded on Albertsons stock on behalf of a Jefferies fund, reaping $7,000,000 in profits and avoiding $5,000,000 in potential losses. He also earned roughly $400,000 in compensation as a result of these trades. The court held that insider trading penalties are not confined to the disgorgement of personal profits derived from insider trading; the SEC can also seek recovery of profits realized by an innocent third party. Accordingly, the court affirmed the SEC's order that Contorinis disgorge the $7,000,000 in profits realized by Jefferies from the trades. But the court also capped disgorgement, saying it cannot exceed the total proceeds realized by insider trading.

(b) In 2014, the U.S. Supreme Court denied an application for certiorari filed by the defendants in *SEC v. Pentagon Capital Management PLC*.[40] In that case, the Second Circuit upheld a disgorgement award imposed jointly and severally on the two defendants (a hedge fund and its CEO), although neither defendant ever received, possessed or transferred the insider trading profits; rather, all profits were transferred to an independent third party. Though the cert petition cited the decision's "grave implications for the investment advisory industry," the Court implicitly approved of this broad penalty scheme by refusing to hear the case.

4. Rewarding Cooperation in Investigations: Regulators are taking steps to develop the cooperation of defendants (and uncharged parties) in insider trading schemes.

(a) In 2011, eBay had talks with executives at GSI Commerce Inc. about a potential acquisition. GSI's CEO, Christopher Saridakis, shared this information with friends, who profited over $300,000 from trading on it. In March of 2014, before bringing charges, the SEC entered into its first NPA

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[39] In censuring Meade, the SEC found that Section 203(e)(6) of the Advisers Act — which provides a safe harbor in failure-to-supervise cases — wasn't available to Meade because his compliance failures were so pervasive.

[40] *SEC v. Pentagon Capital Mgmt. PLC*, 725 F.3d 279 (2d Cir. 2013).

ever with an individual involved in the insider trading scheme. It agreed not to prosecute him because he provided vital information early on in the investigation. [41]

(b) In the insider trading case against SAC Capital portfolio manager Mathew Martoma, Martoma's primary source of insider information, Dr. Sidney Gilman, cooperated with the government, earning lenient treatment for himself. Gilman, a respected neurologist, moonlighted as a medical consultant, receiving large sums of money for providing Martoma with nonpublic information on a potential treatment for Alzheimer's disease, which led to insider trading activity in pharmaceutical companies. Gilman avoided any criminal charges by entering into a non-prosecution agreement, agreeing to act as the government's primary witness in Martoma's trial. He paid a civil penalty of $234,000.[42]

(c) In 2012, the government charged Doug Whitman, the founder of Whitman Capital LLC, for trading on information received from his neighbor, a former employee of the Galleon Group. Wesley Wang, a former Whitman analyst, was also charged, for passing along inside information on Cisco — obtained from his neighbor, a Cisco employee — to his bosses. Though Whitman was found guilty of insider trading in 2012 and sentenced to two years in prison, Wang pled guilty pursuant to a cooperation agreement in 2013 and only received probation.[43]

G. The Importance of Compliance: Increasing Enforcement for the Failure to Act

1. Overview of Anti-Money Laundering ("AML") Compliance Programs

(a) Relevant Statutes and Regulations

(i) Money Laundering Control Act ("MLCA"), 18 U.S.C. §§ 1956 and 1957

(ii) Bank Secrecy Act ("BSA") of 1970, 31 U.S.C. §§ 5311 – 5330, as amended, by USA PATRIOT Act of 2001

(iii) Economic Sanctions enforced by the U.S. Department of Treasury's Office of Foreign Assets Control ("OFAC") prohibit U.S. citizens, businesses and financial institutions from engaging in financial transactions with persons designated on OFAC lists (for example, entities OFAC designates as involved with terrorism or narcotics trafficking).

(iv) The Anti-Terrorism Act ("ATA"), 18 U.S.C. § 2333(a), provides for a private right of action for damages to any U.S. national "injured in his or her person, property, or business by reason of an act of international terrorism."

(b) Entities Required to Have Effective AML Compliance Programs

(i) The BSA currently requires "financial institutions" to have effective AML compliance programs. "Financial institutions" currently include banks, broker-dealers, any entity required to register under the CEA (including FCMs, IB-Cs, CTAs and CPOs), mutual funds,

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[41] Press Release, Sec. & Exchange Comm'n, SEC Charges Six Individuals with Insider Trading in Stock of E-Commerce Company Prior to Acquisition of eBay (April 25, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541642140.

[42] Doug Cornelius, Now We Are Talking About Real Money — SEC Brings $250 Insider Trading Case, Compliance Building (Nov. 21, 2012), *available at* http://www.compliancebuilding.com/2012/11/21/now-we-are-talking-about-real-money-sec-brings-250-million-insider-trading-case/.

[43] *United States v. Wang*, No. 12-cr-00541 (S.D.N.Y. 2013).

operators of credit card systems and prepaid cards, money service businesses, insurance companies, casinos, and dealers of precious metals, stones, and jewels.

(ii) The AML program rules instituted under the USA PATRIOT Act do not yet apply to private funds and investment advisers. On Sept. 26, 2002, the Financial Crimes Enforcement Network ("FinCEN") proposed an AML rule that would apply to hedge funds, private equity funds, venture capital funds, companies that invest primarily in real estate and/or interests therein, commodity pools and REITs, as well as investment advisers that are registered with the SEC or that have at least $30,000,000 under management.

(iii) This proposed rule was withdrawn on Sept. 30, 2008 but is widely expected to take effect at some point in the near future, particularly given the pace at which AML enforcement is expanding to very wide range of financial institutions. In the meantime, the best practice is to develop and maintain a AML program consistent with the proposed rule.

(c) An AML Program Must be Approved in Writing by Senior Management and Employ Four Pillars:

(i) A system of internal controls to ensure ongoing compliance;

(ii) Designation of a qualified individual responsible for coordinating and monitoring day-to-day compliance;

(iii) Training for appropriate personnel; and

(iv) Independent testing for compliance.

The government evaluates AML programs according to their effectiveness. Recent enforcement actions demonstrate that deficiencies in *any* of these four AML pillars can result in liability under the BSA.

(d) Corporate Anonymity and Beneficial Ownership: A "Fifth AML Pillar"

(i) On July 30, 2014, FinCEN proposed a new "customer due diligence" rule that goes beyond the customer identification program currently required of financial institutions under the BSA. The new rule requires a firm to determine the *beneficial owners* of legal entity customers. While there are some entities exempt from the rule, for which no beneficial owner needs to be identified, the exemption *does not apply to hedge funds*. This means that hedge funds and other non-exempt entities will need to provide beneficial ownership information to financial institutions.

(ii) The new rule contains four elements:

(1) Identify and verify the identity of customer (i.e., Customer Identification Program);

(2) Identify and verify the beneficial owners of (i.e., natural persons who own or control) legal entity customers;

(3) Understand the nature and purpose of customer relationships; and

(4) Conduct ongoing monitoring to maintain and update customer identification information and to identify suspicious transactions.

(iii) OFAC's post-*Clearstream*[44] Guidance on Beneficial Ownership

(1) Clearstream, a Luxembourg-based financial institution, maintained an omnibus account at a financial institution in New York through which the Central Bank of Iran ("CBI") held a beneficial ownership in $2,800,000,000 in securities. Clearstream met with OFAC in late 2007 and early 2008 to discuss Iranian clients, ultimately deciding to terminate those clients. In February of 2008, acting on instructions from CBI, Clearstream transferred CBI's securities to a European bank's Clearstream account. The transfers, however, did not change beneficial ownership; the ultimate place of custody remained in the United States. OFAC alleged that a number of Clearstream employees should have known that the European bank was simply acting as a custodian for CBI's securities and that the transfer did not change beneficial ownership, thereby charging it with violations of the Iranian Transactions and Sanctions Regulations. Clearstream paid a $151,900,000 penalty to settle the claims.

(2) Following its settlement with Clearstream, OFAC issued guidance in the area of beneficial ownership and sanctions compliance, outlining the following best practices for firms in the securities industry:

a. Make customers aware of the firm's U.S. sanctions compliance obligations and have customers agree in writing to not use accounts in a manner that would violate U.S. sanctions.

b. Conduct due diligence to identify customers who do business in or with countries or persons subject to U.S. sanctions and enhance due diligence accordingly.

c. Impose restrictions and heightened due diligence on the use of certain products or services by high-risk customers.

d. Understand the nature and purpose of non-proprietary accounts, including information about third parties' assets.

e. Monitor accounts to detect unusual or suspicious activity — unexplained, significant changes in value, volume and types of assets — which may indicate a customer is facilitating a new, unvetted business for third parties.

(e) Recent Federal Court Cases Have Expanded Potential Liability Under the Anti-Terrorism Act

(i) In *Linde v. Arab Bank PLC*,45 297 individual plaintiffs who had family members harmed by terrorist attacks filed a civil complaint against Jordan-based Arab Bank, alleging ATA violations. They asserted that the bank processed and facilitated payments for Hamas and other terrorist organizations, as well as for members of these groups and their families — parties the bank should have known were involved in terrorist activities. A jury in federal court in Brooklyn found the bank guilty of violating the ATA, even after it raised the defense that the electronic funds transfers at issue were screened against OFAC's "specially designated nationals" lists and that it ceased processing funds for the accounts of any party added to that list.

[44] *Clearstream Banking S.A.*, Settlement Agreement No. IA-673090, U.S. Dep't of Treasury (Jan. 22, 2014).

[45] *Linde v. Arab Bank PLC*, No. 1:04-cv-2799 (E.D.N.Y. 2014).

(ii) In *Weiss v. National Westminster Bank PLC*,[46] 200 individual plaintiffs harmed Hamas' violent acts filed ATA claims against National Westminster ("NatWest"), alleging that it financed Hamas' terrorist activities in Israel. One of the bank's account-holders was nonprofit Interpal, which the U.S. government had designated as a terrorist group that had funded Hamas, though British authorities had cleared it of terrorism-related allegations and given the bank permission to hold its accounts. Judge Irizarry in the Eastern District of New York granted summary judgment in NatWest's favor, stating that there was insufficient evidence that the bank had the knowledge that it was financing terrorists, as required by the statute. The plaintiffs appealed to the Second Circuit, which found that Judge Irizarry erred in dismissing the claims. It instead held that the ATA only requires a showing that the bank knew *or was deliberately indifferent to* the fact that its account-holders provided financing to terrorist groups. The conflicting information from U.S. and U.K. regulators was enough to convince the court that NatWest may have had sufficient knowledge of its violations for a guilty verdict. The case has been remanded to the Eastern District of New York for further proceedings.

2. Charges for compliance failures and failures to act are not limited to the AML realm. Regulators are bringing both criminal and civil failure to act claims in an even wider range of circumstances.

   (a) The Principles of Federal Prosecution of Business Organizations expressly direct DOJ to consider "the existence and effectiveness of [a] corporation's pre-existing compliance program" when deciding whether to bring criminal charges against the corporation.

   (b) Rule 206(4)-7 of the Advisers Act makes it unlawful for an investment adviser to provide investment advice without first adopting and implementing written compliance policies and procedures. 206(4)-7 also requires advisers to annually review and, as needed, revise compliance procedures and to designate a CCO to oversee compliance.

3. Recent SEC Enforcement Actions and Settlement Agreements

   (a) *SEC v. Avon Products, Inc.*, No. 14-cv-9956 (S.D.N.Y. Dec. 17, 2014): The SEC alleged that Avon, a global beauty products company, had failed to implement proper controls to detect and prevent payments made by its employees and consultants to Chinese government officials. Company personnel allegedly made $8,000,000-worth of payments to various Chinese officials in order to procure business licenses in the country. Furthermore, the books and records of the company did not reflect these payments. Though an internal audit in 2005 revealed these FCPA violations and management subsequently engaged an outside law firm to reform compliance, no changes were carried out at the Chinese subsidiary. On Dec. 17, 2014, Avon paid $135,000,000 to settle all claims.[47] The settlement agreement also requires the company to retain an outside compliance monitor to review its FCPA compliance program for 18 months and then carry out self-reporting on its compliance efforts for the following 18 months. The SEC noted that the settlement agreement took into account Avon's cooperation with the government and its remedial measures, including improvements to its compliance program and its implementation of FCPA training for employees worldwide.

   (b) *Bruker Corp.,* Exch. Act Rel. No. 34-73835 (Dec. 15, 2014): The SEC charged Bruker, a Massachusetts-based manufacturer of scientific instruments, with FCPA violations stemming

[46] *Weiss v. Nat'l Westminster Bank PLC*, 768 F.3d 202 (2d Cir. 2014).

[47] The total penalties reflect Avon's settlement of the SEC proceeding, as well as a parallel criminal proceeding brought by DOJ. Avon entered into a DPA with the DOJ, in which it pled guilty to FCPA violations. *United States v. Avon Prods., Inc.* (S.D.N.Y. Dec. 17, 2014).

from inadequate oversight of payments. Bruker's lack of internal controls allowed $230,000 paid to Chinese officials to be classified as legitimate business and marketing expenses in corporate records. Bruker agreed to pay $2,400,000 to settle the SEC's claims. The SEC took into account the company's extensive remedial measures, including the fact that it self-reported violations to the SEC and cooperated in the investigation.

(c) *Morgan Stanley & Co. LLC*, Exch. Act Rel. No. 34-73802 (Dec. 10, 2014): The SEC found that the brokerage arm of Morgan Stanley, which offers institutional clients market access through an electronic trading platform, failed to put adequate risk controls in place, thus violating of the market access rule. Morgan Stanley's risk management failures allowed a rogue trader to fraudulently trade in Apple stock. Morgan Stanley's control measures did not prevent this trader from hugely surpassing daily trading limits nor did they stop employees from increasing his limits without performing due diligence. Morgan Stanley agreed to pay a $4,000,000 civil penalty for this violation.

(d) *Bio-Rad Laboratories, Inc*., Exch. Act Rel. No. 34-73496 (Nov. 3, 2014): The SEC alleged that Bio-Rad, a clinical diagnostic and life research company based in California, lacked internal controls, and as a result of this compliance failure, allowed over $7,500,000 to be paid in bribes to officials in Russia, Vietnam and Thailand. Inadequate oversight and compliance resulted in these costs being recorded as legitimate advertising, training and commissions costs in the company's records. In November 2014, Bio-Rad paid $55,000,000 to settle the claims with the SEC, despite self-reporting its FCPA violations and extensive cooperation with the investigation. On the same day that Bio-Rad entered into this settlement agreement, DOJ announced a parallel investigation of the company.

(e) *E*TRADE Securities, LLC*., Exch. Act Rel. No. 34-73324 (Oct. 9, 2014): Broker-dealers, like E*TRADE, can sell unregistered securities if they make a reasonable investigation as to whether the issuer is relying on some exemption from registration. E*TRADE failed to perform this diligence while depositing billions in unregistered, penny stock securities into customer accounts. E*TRADE agreed to settle the SEC's charges, paying $1,500,000 in disgorgement to defrauded customers, plus a civil penalty of $1,000,000.

(f) *Barclays Capital, Inc.,* Adv. Act Rel. No. IA-3929 (Sept. 23, 2014): The SEC brought charges against the financial institution for failing to maintain an adequate internal compliance system when its wealth management division acquired the advisory business of Lehman Brothers in 2008. The SEC alleged that despite the acquisition, Barclays failed to enhance its compliance system to integrate the new business, and did not grow it to reflect the acquisition. Barclays agreed to pay a $15,000,000 penalty to settle the claims. It also agreed to take remedial measures, including hiring an independent compliance consultant to conduct an internal review of its advisory business.

4. Recent FINRA Investigations, Enforcement Actions and Settlement Agreements

(a) *FINRA v. Monex Securities, Inc.*, FINRA Case No. 2011025617702 (Dec. 30, 2014): Jorge Martin Ramos, the President and CCO of Monex, executed an agreement on behalf of Monex with its parent company in Mexico that permitted numerous employees to conduct securities business on Monex's behalf, allowing them to collect client information needed to open accounts, make investment recommendations to clients and transmit orders. Ramos, however, performed no diligence, so he failed to discover that the employee conducting securities transactions on Monex's behalf were not registered in any capacity with FINRA. In December 2014, Monex agreed to pay $1,100,000 in disgorgement and a $175,000 penalty to FINRA for its supervisory deficiencies. Ramos was assessed an individual fine of $15,000 and suspended for 45 days.

(b) *Merrill Lynch Professional Clearing Corp*., FINRA Case No. 20100229712 (Oct. 27, 2014): FINRA alleged that Merrill and its affiliated broker-dealer failed to have adequate supervisory systems in place to monitor traders. This failure in oversight allowed traders to engage in naked short sales in violation of SEC emergency orders. In October 2014, the entities paid $6,000,000 to settle FINRA's claims.

(c) *Goldman Sachs Execution & Clearing, L.P*., FINRA Case No. 2011030761501 (July 1, 2014): FINRA alleged that Goldman lacked proper written policies and procedure to prevent trade-throughs in its proprietary alternative trading system, SIGMA-X. The Order Protection Rule requires that trading centers trade at best-quoted prices. However, FINRA found that for a two-week period in the summer of 2011, nearly 400,000 trades were executed in SIGMA-X at a price inferior to the national standard. Goldman paid an $800,000 penalty to settle the claims.

(d) *Morgan Stanley Smith Barney LLC*, FINRA Case No. 2012032646901 (May 6, 2014): From Feb. 16, 2012 to May 1, 2013, Morgan Stanley sold shares to retail customers in 83 different IPOs without having adequate procedures and training in place to ensure its sales complied with financial regulations. Though regulations require certain discussions and disclosures to occur between employees and clients before sales of securities, Morgan Stanley's written policy used certain key terms for different types of sales offers — which trigger different disclosure obligations — interchangeably. The firm also failed to monitor compliance with the written policy and failed to properly train its sales employees as to their legal obligations. In May 2014, FINRA assessed a $5,000,000 fine against Morgan Stanley for its supervisory failures.

(e) *LPL Financial LLC,* FINRA Case No. 2011027170901 (March 24, 2014): FINRA alleged supervisory failures related to LPL's sale of alternative investments, including non-traded REITs, hedge funds, and oil and gas partnerships. Though these types of illiquid investments are subject to concentration limits imposed by some states and internally by firms (LPL itself had such limits in place), LPL failed to supervise sales to ensure that these limits were abided. LPL first used manual processes plagued by outdated information to review investments, and though it moved to an automated system later, the database was not updated to accurately reflect suitability standards. Lastly, LPL lacked training and supervision processes to ensure alternative investments were properly reviewed. LPL paid $950,000 in fines related to the supervisory failures. FINRA also required the group to conduct a comprehensive review of its compliance system, policies, procedures and training and to remedy any deficiencies it discovered as a result.

(f) *Berthel Fisher & Co. Financial Services, Inc*., FINRA Case No. 2012032541401 (Feb. 24, 2014): FINRA found that the brokerage had inadequate supervisory controls in place to ensure suitability of alternative investments, such as non-traded REITs, inverse exchange-traded funds, managed futures, and oil and gas programs. The firm did not enforce suitability standards, and it failed to train its staff on reviewing alternative investments for suitability. Berthel Fisher paid $775,000 to settle FINRA's claims.

(g) *Brown Brothers Harriman & Co*., FINRA Case No. 2013035821401 (Feb. 5, 2014): FINRA alleged compliance failures, including failure to have an adequate AML program in place to oversee and detect penny stock transactions. FINRA also alleged that Brown Brothers Harriman failed to put any system in place to prevent the distribution of unregistered securities and failed to investigate suspicious activity or file required Suspicious Activity Reports ("SARs"). FINRA imposed a fine of $8,000,000, the highest fine it has ever charged for AML-related violations. Additionally, the bank's former AML compliance officer was fined $25,000 and suspended from his post for one month.

(h) *Banorte-Ixe Securities International, Ltd.,* FINRA Case No. 2010025241301 (Jan. 28, 2014): FINRA alleged that Banorte-Ixe, a New York-based securities firm servicing Mexican clients investing in global securities, had inadequate AML compliance procedures in place. Due to these failures, Banorte-Ixe opened an account for a customer linked to a drug cartel without investigating the customer or the rapid movement of $28,000,000 in and out of his account. FINRA found that the AML program failed in three aspects: (1) there was no system to identify and investigate suspicious activity, in violation of the BSA; (2) given its interaction with Mexican clients, the firm had no procedures in place tailored to its inherent business risks; and (3) the firm failed to register 200 to 400 foreign finders who interacted with its clients. Banorte-Ixe was fined $475,000. In addition, the firm's former AML officer and CCO, Brian Anthony Simmons, was suspended for 30 days.[48]

(i) *Vertical Trading Group, LLC*, FINRA Case No. 2010022017301 (Jan. 10, 2014): FINRA alleged that Vertical's written AML procedures were not tailored to its business-specific risks and were largely unenforced, thereby allowing customers to sell $10,000,000 in unregistered securities. Vertical relied on reports from a clearing firm rather than do its own independent monitoring of suspicious activity. Additionally, although an executive was in charge of monitoring customers' trading, there were no written parameters guiding when review was necessary; the resulting random reviews did not allow for the discovery of suspect trading patterns. Finally, the firm failed to conduct due diligence on correspondent accounts of foreign financial institutions, despite knowing that some of these foreign firms' traders had disciplinary histories. The firm was fined $400,000 and was required to amend its AML compliance program and other internal controls to better suit the risks of its business model. Two executives were also fined, one for $15,000 and the other for $50,000. These executives were also both suspended from association with any FINRA member in a principal capacity for two months.

(j) *Transcend Capital LLC*, FINRA Case No. 2011029039801 (Dec. 18, 2013): FINRA alleged that Transcend, an Austin, Texas-based broker-dealer, failed to adequately monitor, detect and investigate suspicious activity, leading it to provide direct market access to high frequency traders and sell unregistered securities. Though the firm's written procedures included a list of red flags, when certain firm accounts exhibited a variety of red flags, they remained uninvestigated, and no SAR reports were filed. Furthermore, FINRA found that Transcend sold the restricted securities in reliance on attorney opinion letters that the securities would be exempt from registration requirements, although attorneys are prohibited from submitting opinion letters to OTC markets. Transcend paid $200,000 to settle the claims.

(k) *Legent Clearing LLC*, FINRA Case No. 2009016234701 (Dec. 16, 2013): Legent Clearing (now COR Clearing LLC), which provided clearing service for nearly 100 firms, failed to have an AML compliance program tailored to its business model; by processing orders for introducing broker-dealers, Legent's business was highly susceptible to money laundering and the sale of unregistered securities. Legent also failed to respond to red flags; though many of its correspondent firms had been subject to FINRA disciplinary action for AML failures, Legent didn't take extra measures to monitor their transactions. For several months in 2012, Legent's AML surveillance system nearly collapsed, the firm failing to conduct any regular review for

[48] Simmons thereafter left Banorte-Ixe to become the CCO and AMLCO of John Carris Investments LLC, where he also failed to monitor and detect suspicious activity related to penny stock trading. FINRA obtained a temporary cease-and-desist order against John Carris and its CEO in April 2014.

suspicious activity. Lastly, Legent used a "Defensive SARs" program, in which it filed SARs on many transactions without investigating them as a blanket, preemptive defense to AML liability. FINRA fined the firm $1,000,000. The agreement with FINRA also required Legent to retain an independent consultant to conduct a review of its compliance policies and systems.

(l) *BB&T Securities, Inc*., FINRA Case No. 2012033723601 (Dec. 13, 2013): FINRA alleged that BB&T failed to implement an AML program to effectively detect and report suspicious activity, thereby allowing the sale and liquidation of large amounts of unregistered securities. Furthermore, once its AML program identified this suspicious trading, it continued for four months. FINRA also cited a number of oversight and compliance failures; BB&T did not perform proper diligence on issuers, it did not maintain adequate records of its analysts' appearances to monitor their disclosures, and its automated systems suffered from technical deficiencies. BB&T paid $300,000 to settle the claims.

(m) *Argentus Securities, LLC*, FINRA Case No. 2011025621801 (Sept. 23, 2013): FINRA alleged that Argentus, a Dallas-based securities firm, failed to monitor activity in its customers' accounts. For example, the firm processed a significant amount of wire transfers for clients located in South America but failed to investigate these transfers for suspicious activity. Furthermore, the firm did not file any SARs. Stan Russell Hall, Argentus's AMLCO from 2004 to 2012, failed to put adequate supervisory procedures in place; and Argentus did not provide suitable AML training for personnel, failed to conduct audits at one of its branch offices and inappropriately allowed registered representatives to use outside email addresses to conduct securities activity. The firm was censured and fined $150,000 in late 2013. Hall was personally fined $20,000 and suspended from association with any FINRA member in a supervisory capacity for a period of three months.

5. Recent DOJ Enforcement and Settlement Agreements

(a) *United States v. Bank Leumi Group* (C.D. Cal. Dec. 22, 2014); *Bank Leumi USA*, N.Y. Dep't of Fin. Servs. Consent Order (Dec. 22, 2014): DOJ and the New York Department of Financial Services ("NYDFS") both alleged (in separate enforcement actions) that the Israeli bank helped U.S. taxpayers hide assets in unreported accounts around the world, including in Israel, Switzerland and Luxembourg. The bank referred U.S. clients to outside lawyers, who set up and maintained offshore corporations to hold undeclared accounts, hiding their U.S. tax status. It also executed a scheme to hold account statements abroad at foreign banks rather than send them to customers in the United States to help clients evade tax liability. The bank agreed to pay $270,000,000 to resolve criminal charges as part of a DPA with DOJ. It also entered into a settlement agreement with NYDFS in which it agreed to pay $130,000,000 and ban its former CCO and other responsible senior employees from conducting any compliance-related activities. Additionally, the settlement agreement with NYDFS requires the bank to install an independent, NYDFS-appointed monitor to conduct a comprehensive review of its compliance programs and procedures.

(b) *United States v. JPMorgan Chase Bank, N.A*. (S.D.N.Y. Jan. 4, 2014): Since 1985, JPMorgan was the primary bank through which Bernard Madoff ran his Ponzi scheme. Not only did Madoff keep several accounts at the bank, but the bank even appointed a "relationship manager" to in BSA responsibilities for the Madoff account. Over time, red flags about Madoff arose. For example, in the 1990s, another bank filed an SAR with law enforcement and shut down Madoff's account over check-kiting transactions, but JPMorgan continued to service his accounts and even took on the accounts that the other bank had shut down. Additionally, in the late 2000s, the London branch of JPMorgan grew suspicious of Madoff's funds and hired its own diligence staff and filed a report with U.K. regulators. Yet, the U.S. branch failed to take similar actions. On Jan. 7, 2014, the bank entered into a DPA with the government, in which it agreed to pay a $1,700,000,000 penalty to the victims of Madoff fraud, accept responsibility for its conduct, cooperate fully with the government and continue its BSA/AML compliance program. The government agreed to defer prosecution on the criminal charges filed — two felony violations of the BSA — for two years, at which point it will dismiss the charges at a subject to the bank's compliance with the agreement.

6. Pending Enforcement Actions and Investigations for Failures to Supervise and Failures to Act

(a) *U.S. Dep't of the Treasury v. Haider*, No. 14-cv-9987 (S.D.N.Y. Dec. 18, 2014); *Thomas E. Haider*, FinCEN No. 2014-08 (Dec. 18, 2014): Thomas Haider was the CCO and head of the AML Department of MoneyGram International Inc. from 2003 to 2008. Over this time period, he received thousands of complaints from defrauded customers. In 2012, DOJ and MoneyGram entered a DPA in connection with these AML failures, but Haider himself was not prosecuted. Two years later — in December 2014 — FinCEN filed charges against Haider, alleging he *willfully* violated the BSA by failing to implement an effective AML program and file SARs. On Dec. 18, 2014, FinCEN imposed a $1,000,000 fine on Haider. Furthermore, the U.S. Attorney's Office for the Southern District of New York filed a complaint in federal court seeking a *civil injunction* barring Haider from future employment in the financial industry, and asking the court to convert FinCEN's fine into a judgment against Haider. The government's compliant seeking a civil injunction signals a new tool prosecutors will likely use in future cases.

(b) *Wedbush Securities, Inc.*, Adv. Act Rel. No. IA-3971 (Nov. 11, 2014); *Wedbush Securities, Inc.,* FINRA Case No. 20090206344-01 (Aug. 18, 2014): Both the SEC and FINRA, in separate proceedings, alleged that Wedbush, a market access provider, failed to dedicate sufficient resources to risk management and compliance programs, thereby allowing traders to conduct manipulative trades. Wedbush failed to put such programs in place despite knowledge of risks of the market access business, such as disciplinary actions against other market participants and published industrywide notices. In addition to its compliance failures, Wedbush also allegedly paid its employees based on the trading volume of their customers, thus incentivizing them to turn a blind eye to fraudulent trading. FINRA filed a complaint on Aug. 18, 2014 setting forth these compliance failures. The FINRA proceeding is still pending. In November 2014, the SEC settled its own case against Wedbush for a $2,440,000 civil penalty. Two former Wedbush executives also settled SEC charges for a combined total of $85,000 in disgorgement and penalties.

(c) *Thomas R. Delaney II*, Exch. Act Rel. No. 34-72185 (SEC, May 19, 2014): The SEC initiated administrative proceedings against Thomas Delaney (former CCO) and Charles Yancey (former CEO and president) of Penson Financial Services, a clearing firm, in connection with the firm's violation of SEC rules requiring it to deliver shares to a registered clearing agency. The SEC alleged that CCO Delaney knew that the firm was not complying with these regulations yet did nothing to fix procedures or supervise those committing violations. It claimed that CEO Yancey failed to supervise Delaney and others in his firm, despite red flags discovered in audits. The SEC filed an administrative proceeding in May of 2014. The claims against both individuals are still pending.

(d) *Citigroup Inc.*, DOJ & SEC investigations (2014): In February 2014, Citigroup disclosed that its Mexico-based Banamex unit was defrauded by Mexican oil company Oceanografia. Banamex extended $400,000,000 in loans to this company, despite warnings from Citigroup's own bond investors that Oceanografia had been accused of corrupt practices and there were well-documented concerns of Mexican lawmakers and U.S. rating agencies regarding Banamex's poor financial condition. Citigroup's CEO Michael Corbat admitted that the misconduct was a result of poor oversight and self-reporting, stating that Banamex "was allowed to operate as its own fiefdom, with New York employees struggling to get information about how the unit operated." Along with making disclosures, Citibank fired 12 employees, including managing directors. Yet, despite Citigroup's self-reporting, the SEC launched a formal investigation into potential violations of the BSA and AML compliance failures. The U.S. Attorney's Office in Boston and the Federal Reserve Bank of New York also subpoenaed Citigroup.[49]

(e) *Charles Schwab Corp.* (SEC 2014); *Bank of America Corp*. (SEC 2014): Certain accounts of Charles Schwab, a broker-dealer, and Bank of America's Merrill Lynch brokerage arm, had unverified owners, despite BSA regulations that require brokerages to know the identity of customers before allowing them to trade or raise money through their platforms. These unverified owners were allegedly linked to shell companies with fake addresses, which were in turn linked to the funding of Mexican drug cartels. The SEC has initiated investigations into these two entities, probing their AML compliance.[50]

III. EU Marketing Regulations

A. AIFMD and Annex IV Reporting

1. Regulation of EU Marketing Under the Alternative Investment Fund Managers Directive ("AIFMD")

(a) The AIFMD became law across the EU with effect from July 22, 2014 when the last remaining transitional periods in certain EU countries expired.

(b) The AIFMD regulates marketing by alternative investment fund managers ("AIFMs"), or others on their behalf, of investments in alternative investment funds ("AIFs"), regardless of their investment strategy, structure or underlying investments. The marketing restrictions apply whenever an AIF is being offered *on the initiative* of the AIFM, or on its behalf, to an investor domiciled or with a registered office in an EU country.

2. What Remains Outside the Scope of the AIFMD?

(a) Certain services and products remain outside the scope of the AIFMD. These include:

(i) Offers of managed accounts;

(ii) Single investor funds (subject to certain conditions); and

(iii) UCITS funds.

(b) However, some EU jurisdictions (such as Ireland) do not accept that single investor funds are out of scope and the domestic Irish fund rules regulate them as if they are AIFs with AIFM and therefore subject them to AIFMD rules. In contrast, Malta and the United Kingdom treat them as out of scope of the AIFMD.

[49] Dakin Campbell, Citigroup Says Banamex Fraud Cost $165 Million in Quarter, Bloomberg News (May 2, 2014), *available at* http://www.bloomberg.com/news/2014-05-02/citigroup-says-banamex-fraud-cost-165-million-in-first-quarter.html.

[50] Emily Flitter, Exclusive: SEC probes Schwab, Merrill, for Anti-Money Laundering Violations — Sources, Reuters News (May 21, 2014), *available at* http://www.reuters.com/article/2014/05/21/us-sec-brokerages-investigation-idUSBREA4K15S20140521.

3. AIFMD and National Private Placement Regimes

   (a) Each EU member state has amended its private placement regime to incorporate the minimum elements of the marketing regime set out in the AIFMD.

   (b) The AIFMD obligations that are triggered by non-EU AIFMs marketing AIFs in the EU now include obligations to comply with prior and ongoing investor disclosure requirements, regulatory reporting obligations ("Annex IV reporting"), certain disclosures in the AIF's annual accounts, and the private equity provisions in the AIFMD.

   (c) EU AIFMs are however required to Annex IV report whether or not they market their funds in the EU, but marketing in the EU also triggers a further requirement to ensure the AIF appoints a depositary.

4. Different EU Member State Approaches to AIFMD and National Private Placement Regimes

   (a) EU member states are not required to have national private placement regimes, and some member states, have decided not to allow AIFMs who do not have access to the AIFMD marketing passport to market funds in their jurisdiction. Other member states (such as France) have effectively restricted their private placement regimes to offers of closed-ended funds, precluding the marketing of offshore hedge and other open-ended funds.

   (b) EU regulators have taken different approaches to the procedure that must be followed before marketing can occur:

      (i) Some EU regulators (such as the United Kingdom, Luxembourg, Malta and the Netherlands) only require a simple notice to be given that the AIFM proposes to market an AIF;

      (ii) Other EU regulators require not only prior price notice but also that the prior approval of the regulator is obtained before marketing of an AIF occurs (such as Belgium, Finland, Sweden and Norway); and

      (iii) Other EU regulators have gone even further and require that the AIF itself goes through a lengthy registration process before marketing can occur (such as Denmark and Germany, where it can take two to four months to register the AIF). Denmark and Germany have also included additional "gold-plating" by requiring the AIF to appoint a depositary (which is not otherwise required where the AIFM is non-EU).

5. Different EU Member State Approaches to Disclosure and Reporting Have Begun to Emerge

   (a) A degree of variation has also emerged in individual country approaches to the investor disclosure and regulatory reporting requirements of the AIFMD. These include:

      (i) A requirement for an AIFM to produce additional disclosure supplements (such as in Germany);

      (ii) Some EU regulators (such as the United Kingdom) have issued guidance confirming that non-EU AIFMs only need to report feeder-level information with no look-through to the positions of the master fund; and

      (iii) Other EU regulators (such as Germany and Sweden) expect separate Annex IV reports to be submitted in respect of both a feeder fund and the master fund and its investments.

(b) Whilst there are a number of similarities between Annex IV reporting and Form PF, there are also many differences.

(i) Similarities include:

(1) Form PF and Annex IV require similar underlying information — approximately 60 percent of the data required in Form PF can be used in Annex IV;

(2) Similar reporting solutions are available — whether in-house or via a third party; and

(3) Form PF and Annex IV have similar filing frequencies (annual, semi-annual or quarterly).

(ii) Five key differences are:

(1) Annex IV report deadlines are shorter (typically 30 days versus 60 days);

(2) The AUM calculation differs under Annex IV by grossing up derivatives taking the absolute value of the underlying exposures;

(3) Annex IV reports do not allow the use of assumptions and explanations, whereas Form PF does;

(4) Annex IV reports require a special calculation of leverage; and

(5) Annex IV reports have to be filed with multiple regulators (in each EU country where the fund has been marketed), whereas Form PF is only filed with the SEC.

6. Future AIFMD Developments

(a) Looking to the year ahead, the European Securities and Markets Authority ("ESMA") has recently carried out a constitution exercise (as required by the AIFMD) seeking the views of managers, funds, investors and others in the marketplace as to how the marketing of AIFs in the EU under the national private placement regimes has been functioning.

(b) The purpose of this consultation is to guide ESMA when issuing its opinion to the European Commission as to whether the AIFMD marketing passport (currently only available to EU AIFMs in respect of EU AIF) should be made available to non-EU AIFMs and non-EU AIFs.

(c) ESMA is expected to issue its opinion to the European Commission by July 22, 2015. If the AIFMD marketing passport is granted, the likely timing for this is expected to be at the end of this year or early in 2016.

B. New Swiss Regime

1. A new regime governing the distribution of non-Swiss funds to Swiss investors comes fully into force on March 1, 2015, when the current transitional period under the Swiss Collective Investment Schemes Act expires.

2. The new regime segments Swiss investors into three categories:

(a) Unregulated Qualified Investors (pension plans, corporates, family offices, family trusts and high-net-worth individuals);

(b) Regulated Qualified Investors (a more restricted list of Swiss-regulated financial entities, such as banks, securities dealers, fund managers and insurance companies); and

(c) Non-Qualified Investors (effectively retail investors).

Investment managers who expect to be distributing their funds to the first category — unregulated qualified investors — in Switzerland on or after March 1, 2015 must comply with the new requirements by that date. These include, among other things, requirements for the fund to appoint a Swiss-licensed representative and a Swiss bank as a paying agent and for the fund's investment manager to enter into a distribution agreement with the appointed Swiss representative.

3. There is a reverse inquiry exception to the new requirements, but the concept has been very narrowly defined and requires no prior action or contact from the manager. Swiss regulators are also expected to take a conservative approach to implementing the new regime. As a result, managers will find it difficult to rely on this exception.

4. Investment managers should consider whether they want the ability to distribute their funds to unregulated qualified investors and, if so, take steps to comply with the new requirements.

5. The new Swiss regime is much less onerous than the AIFMD regime since it does not require prior notice to or approval from the Swiss regulators; there is no Annex IV reporting; and the disclosure requirements are much simpler.

Investing in the Oil and Gas Sector

I. Introduction

The energy sector has been one of the most active sectors for new investment in recent years. Capital has been in demand, and substantial amounts of capital have been raised in the sector, including through private investment funds. At the same time, the nature of finance in the energy sector is changing. More capital than ever before is being accessed from sources outside of the sector's traditional investor base, and the level of deal activity in the sector has been robust.

As oil and gas prices decline and the availability of reserve-based senior credit becomes increasingly scarce, more and more exploration and production ("E&P") companies are seeking to raise cash in a variety of ways, such as by carving out and selling portions of their working interests to investors. Although the energy story has clearly changed and moved into the distressed part of the cycle, many of the legal issues that require due diligence remain the same.

Whether you're a lender for the development of proven reserves or a purchaser of an overriding royalty interest, or you are entering into a joint development agreement with an operator, you will undoubtedly need to diligence the underlying leases and geology. This includes understanding the types of oil and gas reserves, the types of oil and gas royalty interests, and the intersection of these reserves and interests with the federal securities laws.

II. Private Investment Funds in the Energy Sector

A. Trends in Capital Raising

Capital has been in demand by the energy investment industry, especially in the oil and gas segment. In 2013, $35,000,000,000 was raised for energy-related investment funds, about $24,000,000,000 of that in private equity-style funds. Hedge funds increasingly trade energy stocks and commodities.

Many firms invest in energy through their existing funds. Others have created energy sector funds. Sector funds have a smaller investor audience, and sponsors must be prepared for long fundraising periods. With a sector fund, there may be few places to turn to get out of an investment and diversify the fund's holdings.

Co-investment opportunities in the energy sector are also on the rise. Co-investments are often created by large private equity players undertaking multi-billion-dollar projects, principally in the upstream segment. The co-investment sponsor benefits by reducing downside and concentration risk. Co-investments attract investors that do not traditionally take the lead on deals and enable those investors to leverage off of the resources of the sponsor and gain exposure to the larger E&P plays. Co-investments are frequently offered on a no-fee or reduced-fee basis.

B. Fund Terms

Generally, energy investments fit well in typical hedge fund and private equity fund structures and terms. For hedge funds, special considerations mainly involve tax issues. Investment professionals should be sensitized to tax issues that may surprise them. For example, publicly traded energy interests such as master limited partnerships ("MLPs") and royalty interests may trade like stocks but are subject to different tax treatment. For private equity funds, investment liquidity, exits and the investment cycle are important considerations. Many energy deals have the characteristics of real estate and infrastructure investments, and the long-term hold scenario must be considered — length of the investment period, the fund's term (and how long the management fee is paid), and the flexibility to do follow-on investments, including restructurings.

C. Other Considerations

Many energy investment opportunities will be outside of the United States and in emerging markets. Due diligence may take longer and be more complicated. High-risk issues may include environmental laws, political risk, local business practices (e.g., bribery, which may violate the Foreign Corrupt Practices Act) and typical emerging market risk factors, such as weak legal systems, sub-standard financial reporting and undeveloped and unregulated markets.

III. Types of Oil and Gas Reserves: SEC Definitions

A. Proved Developed Reserves

Proved "developed oil and gas reserves" are oil and gas reserves that can be expected to be recovered: "(i) Through existing wells with existing equipment and operating methods or in which the cost of the required equipment is relatively minor compared to the cost of a new well; and (ii) Through installed extraction equipment and infrastructure operational at the time of the reserves estimate if the extraction is by means not involving a well."[1]

B. Proved Undeveloped Reserves

Proved "undeveloped reserves" are "reserves of any category that are expected to be recovered from new wells on undrilled acreage, or from existing wells where a relatively major expenditure is required for recompletion."[2] "Reserves on undrilled acreage shall be limited to those directly offsetting development spacing areas that are reasonably certain of production when drilled, unless evidence using reliable technology exists that establishes reasonable certainty of economic producibility at greater distances."[3]

"Undrilled locations can be classified as having undeveloped reserves only if a development plan has been adopted indicating that they are scheduled to be drilled within five years, unless the specific circumstances[ ] justify a longer time."[4] "Under no circumstances shall estimates for undeveloped reserves be attributable to any acreage for which an application of fluid injection or other improved recovery technique is contemplated, unless such techniques have been proved effective by actual projects in the same reservoir or an analogous reservoir … , or by other evidence using reliable technology establishing reasonable certainty."[5]

C. Probable Reserves

"Probable reserves" are those where "it is as likely as not that actual remaining quantities recovered will exceed the sum of estimated proved plus probable reserves" when deterministic methods are used, or

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[1] 17 C.F.R. § 210.4-10(a)(6).

[2] 17 C.F.R. § 210.4-10(a)(31).

[3] 17 C.F.R. § 210.4-10(a)(31)(i).

[4] 17 C.F.R. § 210.4-10(a)(31)(ii).

[5] 17 C.F.R. § 210.4-10(a)(31)(iii).

when there is "at least a 50% probability that the actual quantities recovered will equal or exceed the proved plus probable reserves estimates" when probabilistic methods are used.[6]

D. Possible Reserves

"Possible reserves" are those where "the total quantities ultimately recovered from a project have a low probability of exceeding proved plus probable plus possible reserves" when deterministic methods are used, or when there is "at least a 10% probability that the total quantities ultimately recovered will equal or exceed the proved plus probable plus possible reserves estimates" when probabilistic methods are used.[7]

E. Other Considerations

1. Society of Petroleum Engineers: a membership organization serving the upstream oil and gas industry that publishes its own definitions[8]

2. Other Countries Use Different Definitions

3. Discuss with Petroleum Engineers

IV. Oil and Gas Royalties: Types of Carved Out Interests

The "working interest" includes the operating interest under an oil and gas lease.[9] The lessee-owner of the working interest has the exclusive right to explore, drill and produce oil and gas from a specific tract of property.[10] As described below, overriding royalty interests ("ORRIs"), net profits interests ("NPIs") and production payments ("PPs") can be "carved out" of the working interest.

On one side of a carve-out transaction is the investor, who contributes capital in exchange for a financial interest in an oil- or gas-producing property and/or corresponding royalty payments. On the other side is the lessee-owner of the working interest in the property, who receives the investor's capital and subsequently distributes the agreed-upon royalty payments or proceeds to the investor. While carved out interests are all similar in this regard, they differ from one another in certain respects that may prove significant to investors when a lessee-owner becomes distressed.

A. Overriding Royalty Interests

An ORRI is an ownership stake in a percentage of production or production revenues from an oil- or gas-producing property. The investor's stream of payments from an ORRI are consistent in duration with the existing lease or working interest, and they continue for so long as the working interest exists. An ORRI can therefore be indefinite in duration. However, a "term ORRI" with a fixed duration is also possible.

ORRIs are generally not subject to production expenses for the development, operation or maintenance of the property. Production expenses are the costs associated with bringing oil and gas from the

[6] 17 C.F.R. § 210.4-10(a)(18)(i).

[7] 17 C.F.R. § 210.4-10(a)(17)(i).

[8] These definitions can be found at http://www.spe.org/industry/docs/PRMS_Guidelines_Nov2011.pdf.

[9] *See* Howard R. Williams, Charles J. Meyers, Patrick H. Martin & Bruce M. Kramer, Oil and Gas Law (15th ed. 2012) at 1147-48.

[10] *Id.* A working interest is "a percentage of ownership in an oil and gas lease granting its owner the right to explore, drill and produce oil and gas from a tract of property." *Id.* at 1148.

reservoir to the surface, and they commonly include labor, equipment, drilling, pipe and well completion costs. Production taxes may also be excluded for purposes of an ORRI.[11]

While ORRIs are free from production expenses, they are often subject to post-production expenses[12] after the oil or gas is removed from the "wellhead,"[13] which generally refers to the point at the top or "head" of the actual well where the oil or gas is severed or removed from the ground.[14] Post-production costs are the expenses associated with rendering the gas "marketable" and include dehydrating, compressing and transporting the gas to the market, as well as extraction costs resulting from processing.[15]

B. Net Profits Interests

An NPI is similar to an ORRI in that it is carved out of the working interest of an oil- or gas-producing property.[16] But NPIs differ in that that they are measured by, and paid from, the net profits rather than the revenues realized from operation of the property[17] and are generally not free from either production expenses or post-production expenses.

NPI owners are thus subject to a level of operating performance risk that ORRI owners are not. For example, since NPI owners share in the well's drilling expenses, they might assume a proportional share of the costs associated with certain operational risks such as well blowouts. However, though NPI owners share in the costs of production, their liability is generally limited to their invested capital.[18]

C. Production Payments

PPs are a type of ORRI[19] and are likewise carved out of the working interest and paid out free from production expenses, and are also subject to post-production expenses.[20] Additionally, PPs are subject to termination if the lease or working interest expires.[21] The duration of PPs is generally fixed, however, and the PP will terminate once a pre-determined production amount or dollar amount from the sale of production is reached.[22]

PPs that terminate after a specified production amount is reached are called volumetric production payments ("VPPs"), while PPs that terminate after a specified production revenue amount is reached are

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[11] *See* Chesapeake Energy Corp., SEC Staff Comment Letter, 2014 WL 1380751 (March 27, 2014).

[12] *See Martin v. Glass*, 571 F. Supp. 1406, 1414 (N.D. Tex. 1983), *aff'd*, 736 F.2d 1524 (5th Cir. 1984) (stating that "it appears that Texas and Louisiana law are the same; both jurisdictions allow the deduction of post-production cost when royalty is determined 'at the mouth of the well'") (citing *Haynes v. Southwest Natural Gas Co.*, 123 F.2d 1011, 1012 (5th Cir. 1941)).

[13] *See id.*; *see also* Williams & Meyers at 726 (an ORRI is an "interest in oil and gas produced at the surface"). Post-production costs can only be assessed once the oil or gas reaches the wellhead. *See ConocoPhillips Co. v. Lyons*, 299 P.3d 844, 851 (New Mex. 2012) (citing *Ramming v. Natural Gas Pipeline Co. of America*, 390 F.3d 366, 369 (5th Cir. 2004)).

[14] *See* Williams & Meyers at 1133.

[15] *Martin v. Glass*, 571 F. Supp. at 1415.

[16] *See* Williams & Meyers at 647.

[17] *Id.*

[18] "While net profits interest owners are entitled to a percentage of the profits, they are not responsible for any portion of losses incurred in property development and operations. These losses, however, may be recovered by the working interest owner from future profits." *Id.* (citing Charlotte J. Wright & Rebecca A. Gallun, Fundamentals of Oil & Gas Accounting 15 (5th ed. 2008)).

[19] *See* 11 U.S.C. § 101(42A) and (56A), which define "production payment" as a type of term overriding royalty.

[20] Williams & Meyers at 827.

[21] *Id.*

[22] *Id.* (citing *QEP Energy Co. v. Sullivan*, 444 Fed. Appx. 284, 289 (10th Cir. 2011)).

called dollar denominated production payments ("DDPPs"). Since DDPPs give the royalty owner the right to receive a fixed dollar amount generated from the property (usually with a stated rate of interest),[23] DDPPs are generally less correlated with the market risks associated with commodity prices. Whether the property's production output (or the price of oil or gas) rises or falls, a DDPP owner is still contractually owed his or her fixed dollar amount subject to a fixed interest rate.

This structure can create situations in which, if a DDPP owner is entitled to a contractually higher rate of interest for untimely (or missed) payments, he or she may be incentivized to hope for decreased production and/or commodity prices in order to receive slower payments and a higher rate of return. DDPPs are defined as "borrowings" by the Financial Accounting Standards Board ("FASB"), while VPPs are defined as "the transfer of a mineral interest."[24] The FASB considers VPPs not to be borrowings, but rather to be sales in which the entity's obligation is accounted for as an obligation to deliver, free and clear of all expenses associated with operation of the property, a specified quantity of oil or gas to the purchaser out of a specified share of future production.[25]

Characteristics	ORRI	NPI	VPP	DDPP
Carved out of working interest	✓	✓	✓	✓
Subject to pre-production costs	X	✓	X	X
Subject to post-production costs	✓	✓	X	X
Contractually determined termination point	X	X	✓	✓
Greater production volume equals greater profitability	✓	✓	✓*	X
Sensitivity to commodity prices	✓	✓	✓	X**

* Only until the pre-determined quantum of production is reached

** May benefit from decrease in commodity prices

V. Oil and Gas Interests and Securities Laws

A. Are Oil and Gas Interests Securities?

Generally, oil and gas interests will be securities subject to federal securities laws to the extent they are "fractional undivided interest[s] in oil, gas, or other mineral rights" or "investment contracts" as defined by federal statutes.[26]

[23] *See* Ernst & Young, The Revised Revenue Recognition Proposal — Oil and Gas (Feb. 2, 2012), *available at* http://www.ey.com/publication/vwluassetsdld/technicalline_bb2276_revrecoilgas_2february2012/$file/technicalline_bb2276_revrecoilgas_2february2012.pdf?OpenElement.

[24] *See* FASB, FAS 133 Derivatives Implementation, *available at* http://www.fasb.org/derivatives/issueb11.shtml; Securities & Exchange Commission, Technical Amendments to Commission Rules and Forms Related to the FASB's Accounting Standards Codification, *available at* http://www.sec.gov/rules/final/2011/33-9250.pdf; *see also* Ernst & Young.

[25] *See* Ernst & Young.

[26] Federal and state laws may exempt certain interests from registration with state or federal agencies. Those exemptions are beyond the scope of this outline and are not discussed herein. Regardless of whether or not registration is required, anti-fraud provisions will still apply to the extent a security is involved.

Section 2(a)(1) of the Securities Act of 1933 specifically includes in its definition of a "security" a "fractional undivided interest in oil, gas or other mineral rights."[27] Section 3(a)(10) of the Securities Exchange Act of 1934 includes similar language.[28] Even if an oil and gas interest is not a "fractional undivided interest in oil, gas or other mineral right," it may still be a security if it is an "investment contract" included in those same definitions.

B. What Is a Fractional Undivided Interest in Oil, Gas or Other Mineral Rights?

A "fractional undivided interest in oil, gas or other mineral rights" generally arises "when a lessee of mineral rights sells part of its interest in the rights in order to finance the development of the minerals."[29] Courts have interpreted that statutory phrase broadly,[30] finding that it includes working interests (e.g., a fractional undivided leasehold interest), as well as interests in joint ventures and partnerships that invest in oil and gas activities.[31]

However, not every transaction involving the sale of a fractional undivided interest in oil and gas will constitute the sale of a "fractional undivided interest" within the meaning of the federal statutes. The most notable of these exceptions is where a party sells his or her entire interest to another. In such a case, there is no "fractionalizing" and therefore no sale of a "fractional undivided interest."[32] However, as discussed below, such a sale may still involve the sale of a security if the interest is deemed to be an "investment contract."

It is important to note that, as with many other areas of securities law, there are very few truly bright line rules, as many cases turn on the individualized facts of those cases. For example, in one decision, the U.S. Court of Appeals for the Tenth Circuit *declined* to find that the sale of a 50-percent working interest in a well (i.e., a fractional undivided interest) constituted a "fractional undivided interest" under the '33 Act.[33]

C. Application to Different Oil and Gas Interests

There are various types of potential investments in oil and gas, including working and non-working interests, and interests that are carved from those interests, such as NPIs, ORRIs and PPs. Given SEC guidance,[34] and many courts' broad interpretation of the statutory definitions as discussed above, a prudent investor should assume that an interest in oil and gas is a security.

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[27] *See* 15 U.S.C. § 77b(a)(1).

[28] *See* 15 U.S.C. § 78c(a)(10) ("'security' means any … certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease"). Although somewhat different, courts have long held that the definitions are functionally equivalent. *See, e.g.*, *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 847 n.12 (1975). Courts will typically ignore the '34 Act definition.

[29] *Penturelli v. Spector, Cohen, Gadon & Rosen, Attorneys at Law, P.C.*, 779 F.2d 160, 165 (3d Cir. 1985).

[30] *See, e.g.*, *Adena Exploration Inc. v. Sylvan*, 860 F.2d 1242, 1252-53 (5th Cir. 1988) ("if a financial instrument is properly denominated a 'fractional interest in oil and gas' then the instrument is necessarily a security").

[31] *Id.* (buyer of 25-percent working interest held to have bought a "fractional undivided interest"); *Nolfi v. Ohio Kentucky Oil Corp.*, 675 F.3d 538 (6th Cir. 2012) (interests in joint ventures and limited partnerships held to be "fractional undivided interest" under '33 Act definition; investments were "analogous to the working interest in oil … classified as a security under the Act in *Adena Exploration*" and created for the purpose of sale).

[32] *See, e.g.*, *Adena Exploration*, 860 F.2d at 1245 n.5 ("Where the owner of a fractional undivided working interest surrenders his entire interest whole, there is no sale of a 'fractional undivided interest' under the act."); *Woodward v. Wright*, 266 F.2d 108, 112 (10th Cir. 1959) ("If the seller transfers the whole of what he owns, there can be no creation of a fractional undivided interest in oil and gas, and this is so even though what he sold was a fractional interest therein."); *see also* 69 Am. Jur. 2d, Securities Regulation — Federal § 50; 79A C.J.S. Securities Regulation § 24.

[33] *See Ballard & Cordell Corp. v. Zoller and Danneberg Exploration, Ltd.*, 544 F.2d 1059, 1063 (10th Cir. 1976).

[34] *See* SEC Securities Act Release No. 185 (June 30, 1934), 11 Fed. Reg. 10951 ("The ordinary royalty interest which entitles the holder to share in the oil or gas produced from a particular tract of land clearly comes within this definition."); *Adena Exploration*, 860 F.2d at 1244 ("The [SEC] has consistently espoused the view that any fractional undivided interest in oil and gas is subject to regulation under both the 1933 and 1934 Acts … .").

D. Are Working Interests Securities? How About Non-Working Interests?

Working interests, as discussed above, can be securities under both the "fractional undivided interest" and "investment contract" tests for securities. To the extent the purchaser of a working interest has decision-making authority over business strategy, the interest may not be an "investment contract."[35]

Non-working interests, such as royalty interests, are by their nature dependent upon the work of others and would be "investment contracts" to the extent they satisfy the other parts of the *Howey*[36] test (i.e., is there an investment of money; is there a "common enterprise"?). One noteworthy example of an instance where a non-working interest will *not* be an investment contract is where a landowner leases land in exchange for a royalty interest in a drilling operation. In such an instance, there is no sale of a security because there is no "investment of money" — the transfer of the royalty interest is considered to be consideration for the sale of the lease interest.[37]

E. Are Carve-Out Interests Securities?

"Carve-out" interests are those that are derivative of other interests, such as production payments, overriding royalty interests and net profit interests. Because these types of interests typically will depend on the work and labor of others, they are by their nature non-working interests and most likely "investment contracts," if not "fractional undivided interests," and have been found to be securities under both the "investment contract" and "fractional undivided interest" analyses.[38]

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[35] *See Stewart v. Ragland*, 934 F.2d 1033, 1038-39 (9th Cir. 1991) (no "investment contract" because purchasers maintained managerial powers and were sophisticated investors; "the proper focus is upon the managerial powers retained by the non-operators in a given relationship").

[36] *See SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946).

[37] *See, e.g.*, *Graham v. Clark*, 332 F.2d 155 (6th Cir. 1964); *Robertson v. Humphries*, 1978 WL 4096 (10th Cir. 1978); *Fearneyhough v. McElvain*, 598 F. Supp. 905 (C.D. Ill. 1984). This view is premised on the notion that securities laws were not intended to cover oil and gas *leasing* transactions. *See* Peter K. Reilly & Christopher S. Heroux, When Should Interests in Oil and Gas Be Considered Securities?: A Case for the Industry Deal, 34 S. Tex. L. Rev. 37, 53 (1993).

[38] *See, e.g., Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124 (4th Cir. 1970) (holding that broker's sale of production payments constituted sale of an investment contract); *Vale Natural Gas Am. Corp. v. Carrollton Resources 1990, Ltd.,* 795 F. Supp. 795 (E.D. La. 1992) (plaintiff sufficiently alleged that production payment constituted investment contracts under '33 Act); *Nor-Tex Agencies, Inc. v. Jones*, 482 F.2d 1093 (5th Cir. 1973) (royalty interests created for purposes of sale were fractional undivided interests and investment contracts).

Co-Investments and Sidecars: Structuring Opportunities

I. Trends Toward Co-Investments and Sidecars

A. Co-Investments and Sidecars: What They Are

1. A co-investment opportunity is an opportunity to invest alongside (or outside of) a private investment fund in an investment that is too large (or not appropriate) for the private investment fund. These investments are typically less liquid assets.

2. A sidecar is an investment vehicle established to invest in a co-investment opportunity. Sidecars can be structured to invest in one or more co-investment opportunities, can be blind pool or not, and may be established for a single investor or may be offered to multiple investors.

B. Disappearing Side Pocket

1. Historically, hedge funds invested in liquid assets, whereas private equity funds invested in more illiquid assets.

2. A side pocket is a mechanic utilized by a private investment fund to segregate less liquid (or difficult to value) investments from the liquid portion of the fund's portfolio. The side pocketed investment is segregated from the rest of the portfolio, and incoming investors do not participate in existing side pockets. Investors generally are permitted to redeem amounts that are side pocketed only after the side pocketed investment is realized, and typically, performance compensation on the side pocketed investment is not taken until the time of realization. As hedge fund managers started to invest in illiquid assets, the industry saw a trend in the growth of side pockets. Prior to the financial crisis in 2008, managers were launching funds with side pocket thresholds that exceeded 30 percent in some cases and were able to make meaningful illiquid investments.

3. Since the financial crisis in 2008, funds with side pockets have been more difficult to market to prospective investors, and there are far fewer new hedge funds being launched with side pockets as a result. Many managers have eliminated the ability to use side pockets in new (and sometimes even in existing) funds due to investor concerns, which include concerns that: (1) side pockets lack sufficient investor protections; and (2) managers spend too much time managing side pocket assets at the expense of the liquid portion of the portfolio.

4. Some managers have attempted to launch products with side pocket opt-in/opt-out provisions, but the opt-in classes of such products have seen less interest among investors than the opt-out classes.

5. Deferred compensation laws that went into effect at the beginning of 2009[1] have also made structuring performance-based compensation from side pockets in a tax-efficient manner more challenging.

C. Illiquid Investing Without Side Pockets

[1] *See* Section 457A of the U.S. Internal Revenue Code of 1986, as amended (the "Code").

1. The decline of side pockets has created a need for alternative ways to fund illiquid investment opportunities.

2. Co-investments, sidecars and traditional private equity funds are the alternatives available to achieve this.

3. There has been significant manager interest in co-investment opportunities. According to a recent survey, 38 percent of managers have offered co-investment opportunities to investors, and 28 percent would consider or are currently considering offering such opportunities.[2]

4. North America is the leading continent for co-investment appetite among investors. According to a 2012 survey, 44 percent of investors that seek to make co-investments are based in North America, 31 percent in Europe and the remaining 25 percent in Asia and the rest of the world.[3]

D. Common Co-Investment and Sidecar Strategies

1. Activism: Acquiring a significant position in the equity of a public company in order to effect changes in the company's strategy. These funds often need additional assets to make concentrated bets, especially when pursuing tender offers or proxy fights.

2. Distressed Credit: Acquiring securities of a company in bankruptcy or financial distress across the capital structure. These funds may need extra capital to, e.g., take control of the "fulcrum security" in a bankruptcy.

3. Concentrated Versions of Existing Strategies: Vehicles may have position limits, and a manager will structure a sidecar to make co-investments in opportunities to the extent the fund has filled up with its share of an investment.

4. Sector Opportunities: Managers focused on particular industry sectors may, in the course of their public markets investing, become aware of related private market or otherwise illiquid opportunities.

5. Hedge Funds and Private Equity Funds Run Side-By-Side: Strategies that lend themselves to both hedge and private equity vehicles often include investments in illiquid opportunities. Often, these managers will find opportunities that are appropriate for co-investments because their hedge funds have limited capacity for illiquid investments and their private equity funds have position limits.

II. Structuring/Terms

A. Flexibility

1. Since a sidecar is a newly formed vehicle, managers have flexibility to customize the terms and structure to attract capital. In some cases, managers may structure a sidecar with terms that mirror the main fund, and in other cases, investors may seek more private equity-style protections in recognition of the fact that the sidecar is illiquid. For instance, investors may ask that the sidecar be structured to include a key person event concept, a no-fault removal mechanism and back-ended carry structure.

[2] *See* Aksia's 2014 Hedge Fund Manager Survey.

[3] *See* Prequin Special Report: LP Appetite for Private Equity Co-Investments (2012).

2. Tax Structuring

(a) If an asset sought by a sidecar is a United States real property interest,[4] including stocks in certain U.S. corporations that are considered "United States real property holding corporations,"[5] the sidecar or a special purpose vehicle ("SPV") may need to be structured as a U.S. vehicle so as to prevent a U.S. withholding tax from being imposed on such sidecar or SPV upon its disposition of the asset under Section 1445 of the Code,[6] even with respect to U.S. investors who would not otherwise be subject to any U.S. withholding tax on their investments.

(b) For European deals and deals in certain other jurisdictions, "BEPS" (base erosion and profit shifting) proposals[7] may require in the future that the sidecar or an SPV be structured in a jurisdiction (e.g., Ireland) that is more heavily regulated than jurisdictions commonly used today.

(c) Attention should be given to the Foreign Account Tax Compliance Act ("FATCA") and the expanded affiliated group ("EAG") rules.[8] If the sidecar may at some point in time have a majority owner that is a corporation (other than a tax-exempt U.S. entity), a non-U.S. sidecar or a non-U.S. SPV that is not a disregarded entity for U.S. tax purposes may be considered part of such owner's EAG, in which case, such sidecar's or SPV's FATCA-compliant status may be linked to that of the other members of such an EAG (which may include other investment funds unrelated to the sidecar's manager). Failure to comply with FATCA due to being part of such a noncompliant EAG can eventually lead to a 30-percent U.S. withholding tax on U.S. source interest, dividend and similar payments and, starting in 2017, a 30-percent U.S. withholding tax on gross proceeds from the sale or disposition of property that may generate U.S. source interest or dividend payments.

B. Fees

1. Fees depend on the rationale for the sidecar.

(a) For higher conviction opportunities that run parallel to a manager's main fund, fees are more likely to mirror the fees in the main fund.

(b) In deals where excess capital is needed from investors in order to close the transaction (e.g., in a control scenario), fees may be lower or, in some cases, zero, if the bargaining power lies more with the investor than the manager.

(c) When capital is used to enhance a strategy (e.g., an activist co-investment), fees are typically lower than as compared to the main fund, but the discount is usually smaller than the opportunities where capital is required to consummate a transaction.

2. Netting of P&L for Fee Purposes

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[4] As defined in Section 897(c)(1) of the Code.

[5] *See* Section 897(c)(2) of the Code.

[6] Foreign Investment in Real Property Tax Act ("FIRPTA").

[7] *See, e.g.*, Part 1 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries (July 2014), *available at* http://www.oecd.org/tax/tax-global/part-1-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf and Part 2 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries (Aug. 13, 2014), *available at* http://www.oecd.org/ctp/tax-global/part-2-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf.

[8] *See, e.g.*, Sections 1471(d)(1) and (e)(2) of the Code.

(a) In general, netting of profits and losses across investments within a fund is common within blind pool vehicles, but less common where investors have discretion over whether to invest in a deal.

(b) Some managers that have investors below water in their main fund also offer netting arrangements for opt-in co-investment opportunities.

(c) In such arrangements, the investor's high-water mark in the main fund would count toward the fees charged to that investor in the sidecar vehicle, and the sidecar would not charge separate fees until the losses in the main fund are recouped.

3. Management fees for co-investments may be charged on capital commitments or capital contributions. Sidecars structured to invest in multiple co-investment opportunities may accept capital commitments from investors and charge fees on those commitments. Sidecars that make a single investment are more likely to charge on contributed capital (or net asset value), even if investors make capital commitments instead of a one-time contribution.

4. Performance fees and allocations with respect to co-investments vary on a case-by-case basis, but they often take the form of a back-ended private equity carry structure. Such compensation needs to be structured carefully to take into account tax considerations, both from the manager's standpoint and an investor's standpoint. Activist strategies that invest in publicly traded securities that are more easily marked to market may charge an annual incentive allocation based on realized and unrealized gains in the sidecar.

5. Time Sensitivity: Co-investment opportunities often present themselves on a relatively short timeframe, particularly where publicly traded securities are involved (e.g., activism). If a co-investment opportunity is time sensitive and the manager needs to raise co-investment capital quickly, the manager may offer lower fees to attract capital quickly.

C. Expenses that are specific to a particular sidecar vehicle (such as the vehicle's organizational costs) will generally be borne by the investors in such vehicle. If the expenses are common to the sidecar and the main fund (and other funds), each vehicle typically will bear its pro rata share of such common expenses. Expenses attributable to a particular opt-in co-investment opportunity are typically borne by the investors that opt into that particular opportunity.

D. Separate sidecar vehicles may be focused on a single investment or multiple related investments, and they may be organized at the same time or after the main fund is organized.

III. Conflicts and Regulatory Issues

A. Offering Co-Investments to Investors

1. Investors in the main fund (more often in private equity funds) may request the right to participate in co-investment opportunities offered by a manager. Managers should consider contractual obligations, investor relations concerns and fiduciary concerns when determining the allocation of co-investment opportunities across funds and investors.[9]

2. Fund documents typically provide managers with broad discretion to allocate co-investment opportunities and contain the allocation methodology for determining when an investment may be allocated to a sidecar.

[9] *See* Igor Rozenblit's (Co-Head of the Private Funds Unit at the SEC's Office of Compliance Inspections and Examinations) speech at the Compliance Outreach Program Seminar (Jan. 30, 2014).

B. Allocation of Purchases and Sales

1. From a conflicts perspective, it would be ideal to buy and sell assets at the same time in all vehicles — and co-investors often request this — but simultaneous transactions are often not achievable because:

   (a) Funds may have investment restrictions and guidelines in their governing documents that limit potential exposure to illiquid investments. These provisions guide the allocation of purchases of investments. For instance, if a fund has reached its limit with respect to a particular investment opportunity, it may cease purchasing an investment while the sidecar continues to purchase the same investment.

   (b) Differing terms between a fund and a sidecar (e.g., liquidity provisions, investment periods) may result in a manager pursuing different exit strategies, even though both vehicles own the same asset. For instance, a manager may be forced to sell a co-investment in the fund in order to meet withdrawal requests, while the sidecar that holds the same co-investment may not have the same liquidity considerations.

   (c) A manager may sell a co-investment on behalf of a sidecar at the end of its term, while the manager's main fund may not be required to liquidate the position because it is evergreen.

   (d) A manager's main fund may have a cap on follow-on investments, which could lead to an over-allocation of a particular co-investment to a sidecar as compared to the manager's main fund.

   (e) Tax considerations may cause one vehicle to acquire or dispose of the asset at a different time from another and/or delay distributions to investors.

2. Managers often reserve the right to run multiple funds side-by-side and allocate investment opportunities across funds and investors. Managers should have a clearly written allocation policy that describes how such opportunities will be allocated across the manager's funds and investors. In some cases, managers may choose to structure a sidecar outside of the main funds in order to make a co-investment.

C. Confidentiality

1. Managers may offer blind pool co-investment opportunities where the investor does not learn what the target company is. In such cases, the investor does not typically need to sign a nondisclosure agreement to make the investment in the sidecar.

2. In other cases, a manager may disclose the name of the target company to prospective investors. In such case, a confidentiality undertaking from the prospective investors may be important to protect the interests of both the manager's main fund and the sidecar vehicle.

3. When a limited subset of investors from the manager's main fund participate in the sidecar, the manager must consider selective disclosure issues. Investors in a sidecar may receive detailed information about the co-investment opportunity. If that is the case, the manager should consider disclosing the same information to the investors in the main fund to avoid providing some investors with better information about the main fund's portfolio.

D. Regulatory Scrutiny

1. Regulators have focused on the allocation of co-investment opportunities in their examination activities. In particular, regulators have focused their attention on whether the governing documents of a fund address co-investments, noting that governing documents often lack clearly defined protocols for mitigating conflicts of interest associated with co-investments.[10]

2. One area of focus is the allocation of co-investment opportunities to some but not all investors in the main fund without proper disclosure in the governing documents of the main fund.[11]

E. Conclusion

1. The decline of side pockets has resulted in increased use of alternative means of accessing illiquid investments, including one-off co-investments, sidecars and private equity funds.

2. These alternative techniques present new challenges for managers and investors with respect to legal structure, business terms and fiduciary issues.

3. Despite these challenges, co-investments are likely to be an increasingly important component of the offerings of investment managers, even where liquid investments are a primary focus.

[10] *See* Andrew Bowden's (Director of the SEC Office of Compliance Inspections and Examinations) speech at the Private Equity International Private Fund Compliance Forum 2014 (May 6, 2014).

[11] *See* Rozenblit's speech at the Compliance Outreach Program Seminar (Jan. 30, 2014).

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