Trading Compliance

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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.

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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.

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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.

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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.

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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*.

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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.

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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).

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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.

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(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

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[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.

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(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).

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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.

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(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

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[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.

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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.

[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).

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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).

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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).

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(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

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(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.

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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.

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(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.

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[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.

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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.

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