Schulte Roth & Zabel

21st Annual

Private Investment Funds Seminar

Wednesday, January 18, 2012

Main Program

Welcome Remarks
Paul Roth

Relationships with Institutional Investors
Stephanie Breslow, David Cohen, Josh Dambacher, Kelli Moll, Michael Swartz

Succession Planning
Philippe Benedict, Steven Fredman, David Nissenbaum, Richard Presutti

Mobility of Investment Professionals and Executives
David Efron, Ronald Richman, Holly Weiss

Regulatory and Compliance
Ida Wurczinger Draim, Marc Elovitz, Christopher Hilditch, David Momborquette, Craig Stein, Peter White

What Are Institutional Investors Looking For?
Thomas L. Kempner, Jr.
Davidson Kempner Capital Management LLC

Joel Wittenberg
W.K. Kellogg Foundation

Interviewed by Paul Roth

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Practices

Tax

Philippe Benedict

Philippe Benedict, a partner at Schulte Roth & Zabel, focuses his practice on the tax aspects of investment funds, mergers and acquisitions, international transactions, real estate transactions and financial instruments.

Philippe has been involved in many major transactions involving sales or spinoffs of investment fund managers. He recently advised Gresham Investment Management LLC in its sale of a 60 percent stake to Nuveen Investments and represented ABS Investment Management LLC in Evercore Partners Inc.'s $45 million purchase of a non-controlling stake in ABS. He also advised Secor Asset Management LP in regard to an investment by Babson Capital Management.

A frequent speaker at prominent industry events, Philippe was invited to present on "Structuring the Transaction: Tax, Accounting and Operational Issues" at the Managed Funds Association Hedge Fund Manager M&A Seminar and spoke on "Managing Intellectual Capital: Talent Retention and Compensation in Challenging Business Environments" at Morgan Stanley's 16th Annual Chief Operating & Chief Financial Officer Forum. He also co-authored "New Paradigm in Asset Manager M&A: Financial Institution Alliances with Hedge Fund Managers," which appeared in *The Hedge Fund Journal*.

Philippe attended New York University School of Law, where he was awarded an LL.M. in taxation and a J.D. While attending NYU for 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.

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Practices

Financial Institutions

Hedge Funds

Investment Management

Private Equity

Stephanie R. Breslow

Stephanie R. Breslow is a partner at Schulte Roth & Zabel, where she is also co-head of the Investment Management Group and a member of the Executive Committee. Her practice includes investment management, partnerships and securities, with a focus on the formation of liquid-securities funds (hedge funds, hybrid funds) and private equity funds (LBO, mezzanine, distressed, real estate, venture), 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 represents funds of funds and other institutional investors in connection with their investment activities.

Stephanie is a sought-after speaker on fund formation and operation and compliance issues, and also regularly publishes books and articles on the latest trends in these areas. She co-authored *Private Equity Funds: Formation and Operation* published by Practising Law Institute, contributed a chapter on "Hedge Funds in Private Equity" for inclusion in *Private Equity 2005-2006* (PLC Cross-border Handbooks) and co-wrote *New York and Delaware Business Entities: Choice, Formation, Operation, Financing and Acquisitions* and *New York Limited Liability Companies: A Guide to Law and Practice*, both published by West Publishing Co.

Currently the secretary of the Investment Funds Committee of the International Bar Association, Stephanie is also a founding member and former chair of the Private Investment Fund Forum, a former member of the Steering Committee of the Wall Street Fund Forum and a member of the Board of Directors of 100 Women in Hedge Funds.

Stephanie was named one of *The Hedge Fund Journal*'s 50 Leading Women in Hedge Funds and 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"), *IFLR Best of the Best USA* (Investment Funds), *IFLR Guide to the World's Leading Investment Funds Lawyers*, *IFLR Guide to the World's Leading Women in Business Law* (Investment Funds), *IFLR Guide to the World's Leading Private Equity Lawyers*, *and PLC Cross-border Private Equity Handbook*, among other leading directories.

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.

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Practices

Employment & Employee Benefits

Hedge Funds

Private Equity

Regulatory & Compliance

David M. Cohen

David M. Cohen is a partner at Schulte Roth & Zabel, where his practice focuses on matters related to fiduciary responsibility, the Employee Retirement Income Security Act of 1974 (ERISA) and qualified plans.

David has spoken and written widely on ERISA and benefit fund-related issues, including authoring ERISA compliance guides for broker-dealers for Practising Law Institute and recently presenting "Handling ERISA Issues When Managing a Plan Asset Look-Through Fund" at Financial Research Associates' 13th Annual Effective Hedge Fund Tax Practices Conference. In recognition of his accomplishments, he was selected for inclusion in *The Best Lawyers in America* and in *New York Super Lawyers*, a listing of outstanding attorneys in the New York metro area.

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).

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

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Practices

- Activist Investing
- Financial Institutions
- Hedge Funds
- Investment Management
- Private Equity
- Regulatory & Compliance

Josh Dambacher

Josh Dambacher, a partner at Schulte Roth & Zabel, focuses his practice on corporate, securities and regulatory matters. He primarily represents institutional and entrepreneurial investment managers, financial services firms and private investment funds in all aspects of their business. Josh's experience includes structuring investment management firms, hedge funds, private equity funds, hybrid funds, UCITS funds and funds of funds; and structuring and negotiating seed and strategic investments. He also regularly advises investment management firms and their principals on U.S. and U.K. regulatory compliance, acquisitions and reorganizations of investment management firms, and restructuring proprietary trading desks into independent investment management firms.

Josh is a frequent speaker and author on issues facing the investment management industry including, most recently, discussing "Dodd Frank and the SEC Supervision of UK-based Firms Panel" at the ACA Compliance Regulatory Horizon 2012 conference and presenting "The Evolving Shape of Management Business and Funds" at *HFMWeek*'s Legal Summit. Josh is recognized by *Chambers UK* interviewees as "pragmatic and commercial in his outlook" and "always reachable no matter what." Josh is listed as a leading investment management attorney by *Chambers UK* and *PLC Which Lawyer* and previously led the U.S. Financial Reforms Working Group for the Alternative Investment Management Association.

Josh holds a J.D. from the University of Michigan Law School and an MBA in finance from Purdue University, where he was Phi Beta Kappa. He received his B.B.A. from the University of Missouri, with distinction.

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Practices

Hedge Funds

Investment Management

Regulatory & Compliance

Securities & Capital Markets

Securities Enforcement & White Collar Defense

Ida Wurczinger Draim

Ida Wurczinger Draim is a partner at Schulte Roth & Zabel, where her practice focuses on securities and commodities futures compliance counseling and the representation of securities industry and corporate clients in regulatory investigations and proceedings. Ida is known for her expertise in investment adviser and broker-dealer compliance and her highly effective representation of industry clients before the SEC, NYSE, FINRA, CFTC, NFA and other regulatory authorities. Some of the areas that Ida regularly addresses on behalf of investment adviser clients include conflicts of interest, Form ADV disclosure, third-party marketing arrangements, soft dollar practices, personal trading compliance, principal and agency trades, advertising, and trading restrictions and prohibitions. In the broker-dealer context, Ida deals with Regulations NMS and SHO, best execution, dark pools, prime brokerage functions, institutional and retail sales practices, insider trading and rumors, marketing materials, short sale restrictions and statutory disqualifications, among other issues.

In addition to compliance counseling and regulatory representation, Ida is an active speaker and writer, most recently co-authoring the chapter “Protecting Your Firm Through Policies and Procedures, Training and Testing” from the *Insider Trading Law and Compliance Answer Book*, published by Practising Law Institute. She also recently authored the “Trade Reporting and Compliance” chapter in Complinet’s *Practitioner’s Guide for Broker-Dealers*, and discussed “Proposed CFTC Filing Requirements” at the Hedge Fund CFO Association Membership Meeting.

Ida has experienced securities regulation from both sides. After several years as a securities litigation associate with a Wall Street law firm, Ida joined the SEC, first serving as staff attorney in the Division of Enforcement and then as special counsel to SEC Chairman John Shad. Ida has been a member of the FINRA Board of Arbitrators and Board of Mediators and, for 10 years (ending January 2009), served as a member of the Nasdaq Listing Qualifications Panel. She is also a former Chair of the Corporation, Finance and Securities Law Section of the District of Columbia Bar and is recognized by *The Best Lawyers in America* in the area of securities law.

Ida received her J.D. from Harvard Law School and her B.A., *cum laude*, from Rutgers University.

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Practices

Hedge Funds

Investment Management

Regulatory & Compliance

David J. Efron

David J. Efron is a partner at Schulte Roth & Zabel, where he 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 structures seed capital and joint venture arrangements. David also represents hedge fund managers in connection with SEC regulatory issues and compliance-related matters.

A published author on subjects relating to investment management, David is a sought-after speaker for hedge fund industry conferences and seminars and a frequent guest lecturer at New York-area law schools and business schools. David's recent speaking engagements include a discussion on "Regulatory Developments" at the 2011 Bank of America/Merrill Lynch Hedge Fund Client Conference in addition to discussing "New Whistleblower Rules: The Impact on Fund Managers" and "Ethical Issues Facing In-House Counsel" at recent SRZ events.

David has been recognized by *The Legal 500 United States* as "an extraordinarily capable attorney. He has a mastery of the pertinent matters, but he also brings a pragmatic approach."

David received his LL.M. degree 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.

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Practices

Investment Funds LItigation

Investment Management

Regulatory & Compliance

Marc E. Elovitz

Marc E. Elovitz is a partner at Schulte Roth & Zabel, where he heads up the firm's regulatory compliance work in the private investment funds area. He is a member of the Investment Management, Regulatory & Compliance and Investment Funds Litigation Groups. Marc advises hedge funds, private equity funds and funds of funds on compliance with the Investment Advisers Act of 1940 and other federal, state and self-regulatory organization requirements. He works with fund managers to design and implement compliance programs tailored to the business, operations and risks specific to each manager. He guides clients through the SEC adviser registration process and regularly provides strategic and practical advice to managers undergoing SEC examinations. Marc provides guidance to clients on securities trading matters and represents them in regulatory investigations and enforcement actions, arbitrations and civil litigation.

Recently, Marc has been leading 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. He also regularly leads training sessions for portfolio managers and analysts on complying with insider trading and market manipulation laws.

Marc is a frequent speaker at hedge fund industry conferences and seminars and recently discussed "New Regulatory Filing Requirements" at the Goldman Sachs Annual Hedge Fund Conference, "Identifying and Addressing Conflicts of Interest" at the ACA's Compliance Group Fall Compliance Conference, and "New Registration Rules Applicable to PE and VC Managers" at the American Bar Association's Annual Meeting. He wrote the chapter on "The Legal Basis of Investment Management in the U.S." for the Oxford University Press book *The Law of Investment Management* and co-authored the chapter on "Market Manipulation" in the Matthew Bender treatise *The Securities Exchange Act of 1934*. In addition, he recently co-authored a chapter on "Protecting Your Firm Through Policies and Procedures, Training and Testing" for the *Insider Trading Law and Compliance Answer Book*, published by Practising Law Institute.

Marc is a member of the Steering Committee of the Managed Funds Association's Outside Counsel Forum, the Private Investment Funds Committee of the New York City Bar Association and the American Bar Association's Hedge Funds Subcommittee.

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

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Practices

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

Steven J. Fredman

Steven J. Fredman is a partner and co-head of the Investment Management Group at Schulte Roth & Zabel. 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 has structured and organized private investment partnerships and offshore funds, including general equity, arbitrage, global investment, private equity, distressed company, small cap and funds of funds, and has counseled on issues relating to partnership law, new product development and other matters. He has structured and organized investment advisers and broker-dealers, handled the registration of commodity pool operators and commodity trading advisors, and provided ongoing advice to investment advisers on securities laws, rules, regulations and information. He has also represented clients in connection with the acquisition and sale of investment management firms or their assets.

Steve is a frequent speaker, having most recently discussed “Current Issues in Trading Fixed Income Securities” at SRZ’s Investment Management Hot Topics Seminar and “Alternative Asset Manager Acquisitions” at Goldman Sachs’ 14th Annual Hedge Fund Conference. He also recently co-authored “Alternative Asset Manager Acquisitions: Addressing the Human Paradigm in the Integration Process,” which was published in *The Hedge Fund Journal*. He is 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 was awarded his J.D. from Georgetown University Law Center, where he was an editor of *Law and Policy in International Business*, and earned his B.A. from Columbia University, where he was Phi Beta Kappa.

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Private Investment Funds Seminar

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Practices

Financial Institutions
Hedge Funds
Investment Management
Regulatory & Compliance

Christopher Hilditch

Christopher Hilditch is a partner and the head of the London office at Schulte Roth & Zabel. He advises a wide range of institutional and entrepreneurial managers on structuring and establishing investment funds, especially hedge funds and funds of hedge 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.

Chris is a frequent speaker on hedge fund and related topics and a regular contributor to a variety of industry publications. He co-authored "Hedge Funds – A European Perspective" published in *The Asset Growth Guide* and "Hedge Fund Structure – Some Key Legal Considerations," which appeared in *A Guide to European Hedge Funds*. He also contributed to *Investment Management: Law and Practice*, published by Oxford University Press. He speaks on topics including "Regulatory Environment, Fund Stimulus, Planning for 2010," "The Ongoing Challenges of a COO: Changing Regulatory Environment, Safety of Assets etc.," "Current Issues for Hedge Funds" and "Liquidity Issues," and most recently he participated in the opening panel at The Lawyer Funds Summit and participated in the "Update on UK and US Insider Trading" webinar presented by SRZ.

Listed as a leading hedge fund lawyer in *Chambers UK*, *The Legal 500 UK*, *PLC Cross-border Investment Funds Handbook*, *IFLR Best of the Best*, *The International Who's Who of Private Fund Lawyers* and *Who's Who of Professionals*, Chris is a member of the Legal Experts Group of the Financial Services 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 has participated in a number of ad hoc industry committees.

Chris graduated with an M.A., with honors, from Oxford University and attended law school at the College of Law, Guildford.

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Practices

- Hedge Funds
- Investment Management
- Private Equity
- Regulatory & Compliance

Kelli L. Moll

Kelli L. Moll is a partner at Schulte Roth & Zabel, where her areas of concentration include the formation and ongoing operation of hedge funds and private equity funds, and counseling investment advisers. Kelli has represented numerous hedge funds and their managers in connection with fund formations, compensation and vesting arrangements, spin-offs of proprietary trading groups, the acquisition of trading groups, seed capital arrangements, private equity co-investments and registration and compliance under the Investment Advisers Act of 1940.

Kelli lectures extensively on hedge funds. As the first speaker in a new InterLinks podcast series targeting the financial services industry, Kelli presented on "U.S. and E.U. Proposed Legislation: New Regulation Requirements and Assessing Systemic Risk." She was invited to discuss product development issues at Campbells Cayman Fund Focus Conference, hedge fund regulations at Practising Law Institute's Investment Management Institute and establishing a framework of internal policies, practices and controls at an American Conference Institute event. Kelli has also authored numerous articles on issues affecting investment funds and their managers.

After obtaining a B.S. in finance from the University of Illinois at Urbana-Champaign, Kelli received her J.D. from Loyola University Chicago School of Law, where she was both a staff editor of *The Business Lawyer* and case editor of the *Loyola Consumer Law Reporter*.

David K. Momborquette

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David K. Momborquette is a partner at Schulte Roth & Zabel, where his practice focuses on complex commercial litigation and regulatory matters primarily for financial services industry clients, including hedge funds, funds of funds and private equity funds. David has substantial experience in both private securities litigation and securities regulatory matters, including class action litigation and investor disputes, as well as investigations by the SEC, the NYSE, FINRA and state attorneys general offices.

David's recent representations include representing an inter-dealer broker in certain arbitrations and related civil actions arising from the hiring of brokers by a competitor, representing an investment manager in connection with a fund wind-down and related regulatory and investor disputes, representing an investment fund in connection with a civil action seeking to enjoin proxy solicitation, counseling a private equity fund in connection with a shareholder action brought to enjoin a proposed merger and counseling a securities firm in connection with a civil action arising from the hiring of a CDO group.

David has written extensively on securities regulation and frequently presents on regulatory compliance and enforcement issues. He recently spoke on "New Whistleblower Rules: The Impact on Fund Managers" at SRZ's Investment Management Hot Topics and discussed "Rule 13h-1 and Form 13H" at Goldman Sachs' Prime Brokerage Regulatory Reporting Overview. He also recently authored the chapter "Big Boy Letters" in the *Insider Trading Law and Compliance Answer Book*, published by Practising Law Institute.

David earned his B.A. from Boston University and was awarded his J.D. from Boston University School of Law, where he was notes editor of the *Boston University Law Review*, a G. Joseph Tauro Scholar and an Edward F. Hennessey Scholar.

Practices

- Complex Commercial Litigation
- Internal Investigations
- Investment Funds Litigation
- Regulatory & Compliance
- Securities & Shareholder Litigation
- Securities Enforcement & White Collar Defense

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Practices

Financial Institutions

Hedge Funds

Investment Management

Private Equity

David Nissenbaum

David Nissenbaum is a partner at Schulte Roth & Zabel, where his practice focuses on corporate, bank regulation and securities matters. He primarily represents institutional and entrepreneurial investment managers, financial services firms and private investment funds in all aspects of their business.

David's expertise is in structuring and advising investment management and financial services firms; structuring and forming hedge, private equity, structured finance and hybrid funds, funds of funds and scalable platforms for fund sponsors. David also counsels principals on firm structures, partner and senior employee terms and regulatory matters, in addition to structuring and negotiating seed and strategic investments, spin-offs, lift-outs and acquisitions; restructures proprietary trading desks into investment management businesses; and counsels on identification and management of conflicts of interest. David advises a diverse group of clients 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.

A member of the Advisory Board of the Alternative Investment Financial Executives Association 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. He authored "Just Like Starting Over: A Blueprint for the New Wall Street Firm" and "Hedge Fund Outlook 2010" for *The Deal*. He has spoken on "Non-Banking Institutions' Growing Influence in the Financial Services Sector" at mergermarket's Financial Services M&A Symposium and discussed "Current and Expected Changes in the Investment Management Business" at an SRZ Breakfast Briefing.

David has been recognized by *The International Who's Who of Private Funds Lawyers*, *PLC Cross-border Private Equity Handbook*, *The Legal 500 United States*, *IFLR Guide to the World's Leading Investment Funds Lawyers*, and *Chambers USA*.

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Practices

- Distressed Investing
- Financial Institutions
- Mergers & Acquisitions
- Private Equity

Richard A. Presutti

Richard A. Presutti, a partner at Schulte Roth & Zabel, practices primarily in the areas of private equity, mergers and acquisitions, leveraged buyouts and alternative asset management transactional matters. Rick received the M&A Atlas Deal of the Year award for his representation of Chrysler in its sale to the Fiat-led group.

Rick regularly advises parties involved in private equity M&A transactions, recently representing Cerberus Capital Management in its sale of Chrysler Financial to TD Bank Group, Levine Leichtman Capital Partners in its acquisition of Revenew International, and Red Pine Advisors in its sale to Houlihan, Lokey, Howard & Zukin. He also counsels clients involved in investment adviser M&A deals, including representing FrontPoint Partners in its spin-off from Morgan Stanley, representing Montrica in its sale to TPG-Axon, and representing Level Global Investors in the sale of a minority interest to Goldman Sachs' Petershill Fund.

Rick writes and speaks on business transactions topics, co-authoring "Taking Stakes in Hedge Funds" for *The Daily Deal*, and presenting "Negotiating the Agreement: Pricing, Governance, Marketing and Investor Consent" at the Managed Funds Association Hedge Fund Manager M&A Seminar.

Rick received his B.A. from Bentley College and his J.D., *cum laude*, from Tulane University Law School.

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Practices

Alternative Dispute Resolution

Employment & Employee Benefits

Investment Funds Litigation

Mergers & Acquisitions

Restrictive Covenants

Ronald E. Richman

Ronald E. Richman is a partner, co-head of the Employment & Employee Benefits Group at Schulte Roth & Zabel 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, nonsolicit, 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. Ron also represents employers (particularly hedge and private equity funds), employees and partners with respect to executive compensation and partnership issues.

Ron frequently speaks and writes on employee benefit and employment topics. He recently presented "The Last Case Standing: What Every Non-ERISA Litigator Should Know About ERISA Stock-Drop Cases" at the Federal Bar Council ERISA Litigation Conference and discussed "Restrictive Covenant Issues for Investment Managers" at an SRZ conference.

Ron has been recognized by *The Best Lawyers in America* as a leading labor and employment litigation attorney and 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.

Ron received a B.S. from the Industrial and Labor Relations School at Cornell University and a 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.

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Private Investment Funds Seminar

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Practices

Investment Management

Mergers & Acquisitions

Regulatory & Compliance

Paul N. Roth

Paul N. Roth is a founding partner of Schulte Roth & Zabel and chair of the Investment Management Group. Paul's extensive private investment funds practice, an area in which he has more than 40 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 serves as a special adviser to the Board of Directors of the Managed Funds Association and as an adviser to the Alternative Investment Management Association and is a former member of the Legal Advisory Board to the National Association of Securities Dealers. 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 has been recognized as a leading fund lawyer by *The Best Lawyers in America*, *Chambers Global*, *Chambers USA*, *The Legal 500 United States*, *IFLR Best of the Best USA* (Investment Funds), *IFLR Guide to the World's Leading Investment Funds Lawyers*, *IFLR Guide to the World's Leading Private Equity Lawyers*, *IFLR 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 was also named to *HFMWeek*'s 2010 list of the 50 most influential people in hedge funds.

Paul is a member of the Boards of Directors of the NAACP Legal Defense and Educational Funds 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 and a trustee of the Harvard Law School Alumni Association of New York City.

Paul received his A.B., *magna cum laude* and Phi Beta Kappa, from Harvard College, and received his J.D., *cum laude*, from Harvard Law School, after which he was awarded a Fulbright Fellowship to study law in The Netherlands.

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Private Investment Funds Seminar

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Practices

Regulatory & Compliance

Structured Products & Derivatives

Trading Agreements

Craig Stein

Craig Stein, a partner at Schulte Roth & Zabel and co-head of the Structured Products & Derivatives Group, focuses his practice on swaps and other derivative products, prime brokerage and customer trading agreements, and structured finance and asset-backed transactions. He also represents issuers, underwriters and portfolio purchasers and sellers in public and private structured financings, including collateralized loan obligations (CLOs).

A sought-after speaker for hedge fund industry conferences, Craig is also the author of articles on advanced financial products for such publications as *Credit* magazine, *Loan Market Week*, *Pratt's Journal of Bankruptcy Law* and the *Journal of Derivatives*. He co-authored "Dodd Frank — One Year On" for the *International Financial Law Review* and "On the CLO Horizon — Regulations Expected to Impact CLOs," which appeared in *The International Comparative Legal Guide to: Securitisation 2011*.

Craig is a member of the American Bar Association, the New York State Bar Association and the ISDA Credit Derivatives Market Practice Committee. He has been recognized by the prestigious legal directory *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.' "

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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Practices

Alternative Dispute Resolution

Antitrust

Complex Commercial Litigation

Investment Funds Litigation

Litigation — General

Professional Liability

Securities & Shareholder Litigation

Securities Enforcement & White Collar Defense

Michael E. Swartz

Michael E. Swartz is a partner at Schulte Roth & Zabel, where he focuses his practice on complex commercial, securities and business litigation and antitrust, particularly as it relates to mergers and acquisitions. His litigation practice includes fund litigation, class actions, proxy contests and other corporate-control disputes, accountant's liability, international litigation and arbitration. Michael's antitrust practice involves the representation of companies across a wide range of industries, including private equity firms, financial services firms, rating agencies, defense industry companies and auto manufacturers, among others.

Michael recently authored the chapter on "Information Sharing with Market Professionals" in the *Insider Trading Law and Compliance Answer Book*, published by Practising Law Institute. His work has been recognized by his peers and clients in *Benchmark Litigation* and *New York Super Lawyers* in the area of business litigation, and he is the Regional Vice Chair for the Mid-Atlantic Region of the Lawyers' Committee for Civil Rights Under Law.

A former law clerk to the Hon. Irving R. Kaufman, Circuit Judge for the U.S. Court of Appeals for the Second Circuit, Michael obtained his J.D. from Columbia Law School, where he was editor of the *Columbia Law Review*, and his B.A., *magna cum laude*, from the University of California, Los Angeles, where he was elected to Phi Beta Kappa.

Holly H. Weiss

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Practices

- Alternative Dispute Resolution
- Employment & Employee Benefits
- Hedge Funds
- Internal Investigations
- Restrictive Covenants

Holly H. Weiss is a partner at Schulte Roth & Zabel, where she focuses her practice on the representation of employers in all aspects of employment law and employee relations. Holly 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 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, a recent example of which, "Alternative Dispute Resolution in the Executive Employment Context," appeared in BNA's Executive Compensation Library on the Web. Holly is 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*. A much sought-after speaker, she addressed an MFA General Counsel Forum on "Employment Issues — What Could Go Wrong? Avoiding Common Pitfalls," and spoke on "Drafting Severance Agreements — A How-To" at the New York State Bar Association Labor and Employment Law Section's annual meeting.

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

Schulte Roth & Zabel

Private Investment Funds Seminar

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Practices

Alternative Dispute Resolution

AML, OFAC, FCPA

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Complex Commercial Litigation

Financial Institutions

Internal Investigations

Investment Funds Litigation

Professional Liability

Regulatory & Compliance

Securities & Shareholder Litigation

Securities Enforcement & White Collar Defense

Peter H. White

Peter H. White, a partner at Schulte Roth & Zabel, concentrates his practice on representing corporations and executives in criminal and related civil and administrative matters, including grand jury investigations, internal investigations, SEC enforcement proceedings, False Claims Act and qui tam lawsuits, and shareholder class actions. Pete has litigated disputes involving accounting and securities fraud, Foreign Corrupt Practices Act violations, government program fraud, false claims and statements, antitrust violations, public corruption, tax evasion, insider trading, environmental violations, and other claims. A former assistant U.S. attorney for the Eastern District of Virginia and the District of Columbia, Pete has served as lead counsel in over 80 federal and local jury trials and many more bench trials.

A recipient of the Department of Justice Director's Award for Superior Performance as an Assistant U.S. Attorney, Pete has performed with comparable skill as a private practitioner. Among the many publications that have recognized him as a leading litigator are: *The Best Lawyers in America* (white collar criminal defense; corporate governance & compliance law), *Ethisphere: Attorneys Who Matter*, *Washington, D.C. Super Lawyers*, *Washingtonian Magazine* (white collar defense) and *The Washington Post* ("Their Own Defense," June 18, 2007).

Pete regularly speaks and writes on regulatory compliance topics, recently authoring the chapter on "Civil and Criminal Enforcement" in the *Insider Trading Law and Compliance Answer Book*, which was published by Practising Law Institute, and co-authoring "Government Launches FCPA Inquiry into Investments by Sovereign Wealth Funds in U.S. Banks and Private Equity Firms" for the *Financial Fraud Law Report*. He also spoke on "Best Practices to Prevent Insider Trading" at the Managed Fund Association's Regulatory Compliance conference and participated in an SRZ webinar titled "Update on UK and US Insider Trading."

Pete obtained his B.A., with high honors, from the University of Notre Dame and his J.D. from The University of Virginia School of Law, where he was Order of the Coif and on the Management Board of the *Virginia Law Review*. Upon graduation, he had the distinction of serving as a law clerk to The Honorable Richard L. Williams of the Eastern District of Virginia.

Thomas L. Kempner, Jr. | Guest Speaker

Executive Managing Member
Davidson Kempner Capital Management LLC

Thomas L. Kempner, Jr. is the executive managing member of Davidson Kempner Capital Management LLC. Tom joined Davidson Kempner in December 1984. Tom became a managing member of Davidson Kempner in January 1986 and was appointed executive managing member in January 2004.

Prior to joining Davidson Kempner, he was a vice president of First City Capital Corporation, where he traded a fixed-income portfolio. From April 1981 to February 1983, Tom was a vice president of Loeb Partners, where he traded a bond arbitrage portfolio and headed the firm's money-market department. From June 1978 to February 1981, he was an associate at Goldman, Sachs & Co.

Tom is presently the chairman of the Board of Trustees of the Central Park Conservancy, a member of the Board of Trustees of The St. Bernard's School in New York, a member of the Board of Trustees of Harlem Village Academies, a member of the Board of Dean's Advisors of the Harvard Business School and a member of the Board of Directors of Harvard Management Company. Tom also serves on the board of the USA Cycling Development Foundation and on the investment committee of the Howard Hughes Medical Institute.

Tom graduated from the Harvard Business School in 1978, with distinction, and from Yale College in 1975, *magna cum laude*.

Joel Wittenberg | Guest Speaker

Vice President and Chief Investment Officer
W.K. Kellogg Foundation

Joel Wittenberg is vice president and chief investment officer at the W.K. Kellogg Foundation of Battle Creek, Mich.

Joel serves on the Foundation's executive staff and is responsible for both Kellogg Foundation and Kellogg Trust investments, as well as the operations of the Kellogg Trust. The foundation is the fourth largest in the United States with more than $7 billion in assets.

Prior to joining the Foundation, Joel spent nine years as corporate vice president at the Kellogg Company, serving as treasurer as well as heading up investor relations.

Before joining the Kellogg Company, he was vice president and treasurer with Armstrong World Industries in Lancaster, Penn., and he held several key treasury roles with the Dow Chemical Company of Midland, Mich.

Joel earned his B.S. in accounting and finance at Michigan State University's Eli Broad Graduate School of Management and his M.B.A. from the University of Michigan's Stephen M. Ross School of Business.

The W.K. Kellogg Foundation, established in 1930, supports children, families and communities as they strengthen and create conditions that propel vulnerable children to achieve success as individuals and as contributors to the larger community and society. Grants are concentrated in the United States, southern Africa, Latin America and the Caribbean.

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Relationships with Institutional Investors

Stephanie Breslow

David Cohen

Josh Dambacher

Kelli Moll

Michael Swartz

Notes:

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Schulte Roth & Zabel

Succession Planning

Philippe Benedict

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Regulatory and Compliance


Ida Wurczinger Draim


Marc Elovitz


Christopher Hilditch


David Momborquette


Craig Stein


Peter White

Notes:

Schulte Roth & Zabel

Regulatory and Compliance

Notes:

Schulte Roth & Zabel

What Are Institutional Investors Looking For?

Paul Roth

Thomas L. Kempner, Jr.
Guest Speaker

Davidson Kempner
Capital Management LLC

Joel Wittenberg
Guest Speaker

W.K. Kellogg
Foundation

Notes:

Schulte Roth & Zabel

What Are Institutional Investors Looking For?

Notes:

Relationships with Institutional Investors

I. Increasing demands of institutional investors

A. Manager considerations

1. In the current capital-constrained environment, large institutional investors are increasingly able to demand customized terms, including requiring standalone vehicles

2. Managers evaluating these requests should consider how an institutional investor's demands may affect an existing fund structure and investment approach, including the impact on existing MFN relationships and liquidity issues within the fund

3. If accepting capital from a significant institutional investor into an existing fund under special terms, managers need to consider the feasibility of adding on additional classes of interests that are tailored to the institutional investor's needs and whether such terms will become available to all investors in that fund. ERISA considerations will also need to be addressed if the institutional investor is an ERISA plan or ERISA covered fund-of-funds

4. If establishing a managed account or "fund of one" arrangement, consider the fiduciary issues involved in the structuring of the liquidity and transparency of such relationships. For example, if a manager is running a fund and a managed account for an institutional investor with substantially similar investment mandates, and if the institutional investor is demanding more frequent liquidity, an analysis should be made as to the effect on the parallel fund, including its performance and liquidity of its positions

B. New demands regarding the incentive allocation/fee

1. Certain institutional investors are requesting that hurdles be implemented before a manager is paid incentive compensation. Such hurdles can either be "soft," meaning the manager is entitled to a "catch up" if the hurdle is met or "hard," meaning the manager is only entitled to share in profits above the hurdle

2. The higher the hurdle rate, the more likely a "catch up" will be permitted, with a LIBOR or other "money market" like hurdle often being structured without a manager "catch up"

3. Managers may be faced with requests that the hurdle be cumulative from year-to-year as opposed to "resetting" each year. These requests make it more difficult to catch up and receive incentive compensation if a manager has large losses in a single year

4. Certain institutional investors have requested that incentive compensation be calculated over a multi-year period

   (a) If such arrangements are structured as an incentive allocation, the manager will be allocated income in each year and should negotiate to receive tax distributions in respect of such income allocations

   (b) Negotiations also arise over which party, the manager or the institutional investor, should receive the performance accruing on any incentive allocation that remains invested in the fund until the end of the multi-year measurement period

   (c) Managers often seek to require that an institutional investor's liquidity match the term of the multi-year incentive allocation (for example, if the allocation is to be measured over a three-year period, the institutional investor would be locked-up for a three-year period)

(d) Tax issues can arise in structuring incentive fees over a multi-year period and careful attention must be paid to ensure that such arrangements do not cause an impermissible fee deferral subjecting a manager to a 20% additional tax on its income. In managed accounts forfeiture provisions may be implemented to seek to address these deferral issues

5. Clawback arrangements

(a) Certain institutional investors are seeking clawback arrangements on incentive compensation. These arrangements are often part of a multi-year compensation formula

(b) If the incentive compensation is in the form of an allocation, the manager should seek a clawback arrangement that is on an after-tax basis since it will be allocated income in the previous year

(c) If the incentive compensation is in the form of a fee, it may be possible to structure a pre-tax clawback arrangement. Under such scenario, as long as the incentive fee is paid by Dec. 31 of the following year, a "year one" incentive fee may be offset with losses in "year two" and, therefore, clawed back. As long as the year one incentive fee is paid, or forfeited through the clawback, by Dec. 31 of the following year, no tax is paid by the manager and the full amount (i.e., pre-tax) is available for the institutional investor. In order to implement such arrangements the manager would be required to calculate year two performance on an estimated net asset value since valuation often would not be finalized by the time payment is required under this arrangement

6. Preferential transparency

(a) Providing preferential transparency to certain investors can raise fiduciary issues

(b) While use of a "fund of one" may ameliorate this problem, it is not a full solution if the portfolio of the "fund of one" and that of parallel funds will substantially overlap

II. Issues relating to sovereign wealth funds and state government plans

A. Sovereign wealth funds and state government plans may be able to claim sovereign immunity. Thus, it may be difficult for the fund and/or the manager to sue such investors

1. Generally such investors will include a provision in their side letters whereby the fund and manager acknowledge that the investor reserves all immunities, defenses, rights or actions to which it is entitled arising out of its status as a sovereign

2. Provision will also provide that no provision of the subscription document, limited partnership agreement (if applicable) or side letter shall be construed as a waiver or limitation of any such immunities, defenses, rights or actions

3. Do not concede that sovereigns are immune from suit

4. The Foreign Sovereign Immunities Act ("FSIA") contains certain delineated exceptions to immunity, a key exception being when the sovereign acts in a commercial capacity and that activity has a relationship to the United States, either because it is carried out in the United States or is performed elsewhere but has a direct effect in the United States

See, e.g., *Argentina v. Weltover*, 504 U.S. 607 (1992) (finding a "direct effect" in the United States when a payment was to be made in the United States); *Cruise Connections Charter Mgmt I, LP v. Attorney General of Canada*, 600 F.3d 661 (D.C. Cir. 2010) (finding that sovereign's termination of contract had "direct effect" in the United States because the U.S. company was unable to consummate fully negotiated multimillion-dollar subcontracts with other U.S. companies)

5. U.S. state government entities are immune from suit under the 11th Amendment to the U.S. Constitution. Generally, however, state entities are willing to waive sovereign immunity with respect to contracts to which they are parties

6. Certain states may provide that state entities can only be sued within the courts of that state

7. Such courts may be inconvenient for the fund and the manager and may favor the state entity

   (a) Agree to venue in such state only for suits against the investor

   (b) Provide for a more convenient, and more neutral, venue for suits against the fund and the manager

   (c) Unless the venue is "exclusive" for certain types of suits, it is possible that suits will be permitted in other venues as well

B. Sovereign wealth funds and state government plans may claim that they have no authority to indemnify the manager, the fund and their affiliates

Generally, such investors will state that they have no obligation to make any indemnification payments under the subscription document and, if applicable, the limited partnership agreement

1. Include an acknowledgement that such investors' shares or capital accounts will bear their pro rata share of indemnification obligations

2. The fund should retain all other rights to bring claims against the investor for breach of any representations, warranties, covenants and other obligations in the subscription document and limited partnership agreement (if applicable)

C. Sovereign wealth funds and state government plans may be required to disclose information regarding their investment and the fund to government officials or pursuant to the Freedom of Information Act ("FOIA") or state "sunshine" laws

1. The fund and the manager can seek to limit the information that can be disclosed by the investor

   (a) The fund and the manager can, for example, agree that disclosures made pursuant to a FOIA request or similar law of the amount invested, the value of such investment and the amount of management fees and incentive compensation paid by the investor would not be considered to be a breach of the confidentiality provision in the fund documents. (*Note*: You may not be able to limit the scope of information that can be disclosed if the investor is a sovereign wealth fund)

   (b) Permit the disclosure only of information that the investor is required by law to disclose (which, if the investor is a sovereign wealth fund, may be everything)

   (c) The fund and the manager can require that they be notified of any request for information by a government office or pursuant to the relevant law

2. It may not be practicable for the investor to provide prior notice of such request

3. The fund and the manager should seek the agreement of the investor to consult with and reasonably cooperate with them regarding their response to the request and the assertion of any available defenses

4. The fund and the manager can also require that disclosures by the investor be subject to confidentiality provisions

   (a) Note that sovereign wealth funds in certain jurisdictions (e.g., China) cannot and will not agree to this request

   (b) Also, disclosures made pursuant to a FOIA or similar request will not be treated as confidential by the party requesting such disclosure

D. Sovereign wealth funds and state government plans will generally seek to have the governing law be that of its "home" jurisdiction

1. Generally, it is preferable to have the governing law be that of the state of Delaware or the state of New York

(a) Both jurisdictions have a well-developed body of law

(b) The law of the investor's "home" jurisdiction may favor the investor

2. If the investor insists that certain issues (e.g., confidentiality, sovereign immunity, etc.) must be governed by the laws of its "home" jurisdiction, limit the application of such laws to such issues

E. Side letters with sovereign wealth funds may contain an arbitration clause

1. Arbitration versus litigation

(a) Sovereign wealth funds may have strong preference for arbitration since it is a common mechanism for resolving international disputes

(b) Arbitration may provide a more neutral forum

(c) Arbitration proceedings are generally more confidential than court proceedings

(d) Litigation may be preferable in situations where the fund expects to be able to rely on express contractual rights provided in side letter. If not in the sovereign's home jurisdiction, courts are more likely to dismiss actions early for purely legal reasons

2. Arbitration clauses should be reviewed closely. Frequently overlooked, they can have significant consequences should an arbitration be brought

(a) Consider a pre-arbitration consultation requirement to avoid formal arbitration

(b) Any arbitration should occur in "neutral" jurisdiction

(c) Any arbitration should apply recognized and well-established standards

(d) At least one arbitrator, preferably the chairperson, should be a "neutral" (i.e., not a citizen or resident of the jurisdiction of either the investor or manager)

(e) Proceedings should be conducted in English

3. Expressly provide that proceedings should be confidential, to the extent possible

III. Considerations when courting ERISA and public plan investors

A. ERISA plans and public plans as an ever increasing source of hedge fund investments

ERISA covered and public defined benefit pension plans are an ever growing source of hedge fund investments. They want and need to make up for losses incurred in 2008, and low interest rates exponentially increase their liabilities, while diminishing the returns available from their traditional fixed income investments

B. Implication of ERISA and public plan investment in hedge funds

1. Under ERISA, if less than 25% of each class of equity interest in a hedge fund is held by "benefit plan investors" (i.e., U.S. private pension plans and individual retirement accounts), the hedge fund will not be subject to regulation under ERISA. If ERISA investors own 25% or more of a class of equity interests in a hedge fund, the hedge fund will be subject to ERISA and the investment manager of the hedge

fund will be subject to the fiduciary responsibility and prohibited transaction rules of ERISA. This is because ERISA provides a look-through in this scenario and treats each investing benefit plan investor as having an ownership interest in each of the hedge fund's assets and a direct fiduciary relationship with the hedge fund's investment manager

2. When corporate pension plans invest in such a non-plan asset fund, they do not typically make extensive ERISA-focused demands. Side letter requests will generally focus on obtaining assurances that the hedge fund will remain under 25% plan assets and that the hedge fund manager is counting correctly when determining that benefit plan investors own less than 25% of each class of equity interest in the hedge fund

3. Taft-Hartley (i.e., union) plans investing in non-plan asset hedge funds may request the manager of the hedge fund to accept ERISA fiduciary status even though the hedge fund is not a plan asset fund, or to commit to managing the fund under the ERISA prudent expert standard of care that is otherwise not applicable to the hedge fund. Agreeing to such a demand sets up a situation in which the hedge fund manager is subject to different standard of care (and concomitantly, different standards for measuring liability) vis-à-vis the various investors in the hedge fund

4. Although the rules are different in each of the 50 states and many local governments have their own additional rules, the look-through concept found in ERISA generally does not appear in state laws. Nonetheless, certain public plans may demand that the investment manager of a non-plan asset hedge fund treat the public plan as an ERISA investor and accept ERISA fiduciary status even though the hedge fund is not a plan asset fund, or to commit to managing the fund under the ERISA prudent expert standard of care that is otherwise not applicable to the hedge fund nor the public plan

5. Even when making such demands, the public plans typically concede the point that the manager of the hedge fund need not count the public plan as a benefit plan investor for purposes of determining whether benefit plan investors own less than 25% of each class of equity interest in the hedge fund

6. Where an ERISA covered plan invests in a plan asset look-through fund, the manager of the fund will be subject to ERISA regardless of the existence of a side letter. Public plans investing in plan asset look-through hedge funds may demand to be treated as an ERISA investor for these purposes regardless of the fact that public plans are not subject to ERISA and the lack of any look-through provision in the governing state or local law

7. Where an ERISA investor is going to invest a large sum with a particular manager, it may require the manager to establish a separately managed account or fund of one for the plan. In this scenario, the manager will be an ERISA fiduciary and the assets subject to ERISA. In the fund-of-funds space the separately managed account or fund of one translates into a "custom" fund exclusively for the fund-of-funds manager's clients, and the manager of the custom fund will be an ERISA fiduciary if the fund-of-funds has brought enough ERISA assets to the table

8. Although many states lack plan asset look-through rules, where a hedge fund manger establishes a separately managed account or fund of one for a public plan, state and local laws and/or regulations often require the manager to accept an ERISA fiduciary like standard of care

C. An overview of items to consider when managing plan assets

1. The manager is subject to the prudent expert standard when managing the assets

2. As a corollary, the manager is no longer indemnified for negligence, because a prudent expert would not be negligent

3. Although the prudent expert standard will not typically change the way in which the manager manages the assets entrusted to him or her, it makes it more likely that the manager will have to absorb any trade errors because simple negligence violates the prudent expert standard

4. The assets have to be diversified so as to avoid large losses, but only within the manager's stated investment style and strategy
5. The use of soft dollars must fall within the Section 28(e) safe harbor
6. Incentive compensation must be computed based on realized and unrealized gains and losses, functionally removing the manager's ability to create side pockets and get paid only upon a realization event
7. All assets must be independently priced, the manager cannot set its own compensation by valuing the assets
8. Locks in excess of one year will typically be problematic
9. The manager cannot cross trades with an ERISA account, cannot enter into principal trades with its ERISA accounts and cannot cause an ERISA account to transact with any of the manager's affiliates
10. The manager cannot charge the account for salaries, overhead and overhead like expenses. Those expense must be paid from the fixed management fee or the manager's incentive compensation

Succession Planning

I. Introduction

A. "Succession planning" is planning for the continuity of a firm when a succession event occurs (e.g., the death, disability or retirement of a founder or a monetization event)

B. Succession planning has emerged as the hedge fund industry continues to mature, founders begin considering retirement and the industry becomes more institutionalized. It has also been catalyzed by investors, particularly institutional investors, placing greater importance on or demanding succession plans

C. The implementation of a succession plan can create value for a firm

D. A succession plan becomes part of the firm structure and involves aspects of governance and economics

II. Benefits of succession planning

A. Service partnerships, such as hedge fund management businesses, are fragile because they depend on keeping the key people satisfied and incentivized. A succession plan can provide predictability and, therefore, stability for the firm

B. The predictability and stability of a succession plan creates franchise value, which can increase the firm's valuation and, therefore, the price that a buyer is willing to pay for the firm

C. A succession plan protects the founder's heirs. In the event the founder dies or is incapacitated, a succession plan avoids a situation where the founder's widow or widower, family members or estate and the prospective successors have to negotiate over the survival of the firm

D. Creating a stable firm will help ensure that a founder's tail economic interest will have value

III. Triggers for succession

A. Succession can be triggered under several scenarios, with or without warning, and a plan should be in place to deal with all circumstances

B. The goal is to prevent or reduce any disruption to the business through the use of succession planning

IV. Succession plan — governance aspects

A. There is no one right way — it depends on a firm's particular business and people

B. A threshold issue is identifying whether a firm has potential successors in the ranks, or whether it needs to make additional hires

C. It is vital to involve the prospective successors in management decisions prior to a succession event. This will involve sharing knowledge of the business with them, providing additional training and, perhaps, increasing their decision-making authority and responsibility

D. There are various options for succession management, including passing the business to a single "CEO/ managing partner" successor, establishing management or other committees and/or formalizing organizational lines of authority

E. Authority can be given to one or more committees, such as management and investment committees, or can be implemented through an institutionalized style of governance with risk committees, operations committees and the like

F. Committee size and governance, including the appointment of members, the replacement of members, whether the committee is self-perpetuating or members are chosen by shareholder vote, and committee-member voting, should be part of the succession plan

G. The founder or his heirs can also continue to have some control, influence or role post-succession

H. These factors provide an opportunity to see how potential successors function in a business decision-making context

I. Pre-succession, the founder can refine or change the governance plan

V. Succession plan — economics among the founder and partners

A. Founders

1. A buyout option is not ideal because it may require cash up front and burdens the firm with a liability regardless of future cash flows, which of course may be unpredictable. Moreover, a buyout is not tax efficient for the remaining partners since the cash payment is not currently deductible

2. The better and more typical option for a firm is a "sunset" whereby the founder's economic interest decreases over time. The founder remains a partner during the sunset period, and the other partners are not taxed on his continuing economics

3. To the extent the firm has existing deferred fee arrangements with the funds it manages, tax issues can arise as a potential tax consequence from a founder's departure, but these may be addressed if the founder can continue to provide the business with part-time substantive consulting services

B. Successors

1. The founder must: (1) free up economics for the successors; and (2) incentivize the successors. This is accomplished through granting ownership interests to the successors (i.e., interests in profits and equity, the right to participate in sale proceeds)

2. In order for a grant of an equity interest in the firm to be tax free to the recipient, the firm should be valued at the time of the grant, and the recipient should participate only in future increases in the firm's value. Accordingly, the earlier the successors receive these economics the better

3. If a founder is sunsetting, the reassignment of his economics during the sunset period must also be addressed

4. Vesting is often used to create additional incentives for successors to ensure their continued participation in the business over the vesting period. Vesting can be structured in various ways, such as using different vesting for profits versus equity interests or using different vesting timetables

5. Requiring successors to reinvest funds into the firm or funds on an after-tax basis provides additional incentives and is an important component of the plan

C. The economic rights are flexible so that adjustments can be made over time, pre- and post-succession

VI. Clear communication with investors over extended period of time

A. Investors must become comfortable with the successors. Founders should find opportunities to present successors to investors, such as at investor meetings or through letters to investors

B. Gradual communication with investors over an extended period of time is vital for successful succession planning

C. Founders should communicate the successors' track records (but will want to avoid giving the successors too much leverage pre-succession)

D. Some possible key points to communicate

1. Who the potential or expected successors will be

2. The founder has no plans to leave in the near future, if true

3. The founder is maintaining an economic interest in the firm after succession. Investors want founders to still have "skin in the game" which shows founders' confidence in successors

4. The successors have been incentivized as owners (i.e., have economic interests in the firm as partners and will also have skin in the game)

Mobility of Investment Professionals and Executives

I. Introduction

Non-compete agreements and other restrictive covenants are becoming increasingly important to employers. There are a number of important issues that arise in the context of drafting and attempting to enforce non-compete and other restrictive covenant agreements, including: (1) the duration of non-competes; (2) the scope of non-competes; (3) the doctrine of inevitable disclosure; (4) choice-of-law provisions; and (5) the unclean hands defense

II. Summary of non-compete law

The law with respect to covenants not to compete varies from state to state. Some states, like California, have laws that prohibit or severely limit an employer's ability to impose and enforce non-competes. In addition, the law with respect to issues that can become crucial in the non-compete arena (e.g., blue pencil provisions) varies widely from state to state. Accordingly, it is important to review the law of the relevant state (which is generally the state in which the employees work) when drafting restrictive covenants

In general, restrictive covenants may be used to protect an employer's legitimate business interests including trade secrets, confidential customer information, unique or extraordinary employee services, and, in some situations, customer relationships. To be enforced, restrictive covenants must be reasonable in duration, scope and geography. The case law concerning restrictive covenants is highly fact specific

New York courts historically have been reluctant to enforce restrictive covenants in light of the strong public policy in favor of free competition and against restricting an individual's ability to earn a livelihood. Nonetheless, "properly scoped noncompetition agreements are enforceable to protect an employer's legitimate interests so long as they pose no undue hardship on the employee and do not militate against public policy." *Int'l Bus. Mach. Corp. v. Visentin*, No. 11 Civ. 399 (LAP), 2011 WL 672025, at *8 (S.D.N.Y. Feb. 16, 2011) (citing *BDO Seidman v. Hirshberg*, 93 N.Y.2d 382 (1999))

A. Enforceability

Traditionally, restrictive covenants in New York will be enforced only:

1. To the extent necessary to prevent a former employee from engaging in unfair or illegal competition through the disclosure or use of trade secrets or confidential information; or

2. When the employee's services are unique or extraordinary

See Reed, Roberts Assoc., Inc. v. Strauman, 40 N.Y.2d 303, 307, 353 N.E.2d 590, 593, 386 N.Y.S.2d 677, 679 (1976); *Ivy Mar Co. v. C.R. Seasons Ltd.*, 907 F. Supp. 547, 554 (E.D.N.Y. 1995)

B. Trade secrets

A court will consider the following factors in determining whether an employee possesses a trade secret

1. The extent to which the information is known outside of the employer's business

2. The extent to which it is known by employees and others involved in the employer's business

3. The measures the employer takes to guard the information's secrecy

4. The value of the information to the employer and its competitors

5. The amount of money or effort that the employer expended in developing the information

6. The ease or difficulty with which the information could be properly acquired or duplicated by others

Ivy Mar, 907 F. Supp. at 554

A New York federal court recently addressed the extent of trade secret protection in a case in which the court denied IBM's attempt to restrain one of its former executives, Giovanni Visentin, from working for an IBM competitor, HP, for one year. *Visentin*, 2011 WL 672025. The court ruled that IBM had not shown sufficient evidence that Visentin's new job made it inevitable that he would disclose protectible IBM trade secrets. At the time of his resignation, Visentin was the general manager of IBM's Integrated Technology Services Group, which provides clients with IT infrastructure and cloud computing services. Visentin had executed a noncompetition agreement with IBM, agreeing not to become employed by any competitor for one year following the termination of his employment

On Jan. 18, 2011, HP made Visentin an offer to serve as its senior vice president, general manager, Americas, for its HP Enterprise Services Group, which oversees three business segments, one of which provides clients with similar IT infrastructure and cloud computing services. Visentin accepted HP's offer and gave notice to IBM of his resignation. Although Visentin volunteered to stay at IBM for a transition period, IBM escorted him out, took his laptop computer from his home, and immediately filed a complaint seeking a preliminary injunction to prevent his employment with HP

In seeking a preliminary injunction, IBM alleged that Visentin had acquired trade secrets, including strategic initiatives in cloud computing, acquisition plans, pricing strategies, operational finances, the identity of troubled accounts, competitive strategies with HP, and client "pipeline" information. The court addressed each of IBM's alleged trade secrets and found that Visentin only had generalized information and that IBM had failed to provide any specific examples of how Visentin's generalized knowledge could be used at HP to IBM's detriment

The court also ruled that IBM had provided no evidence that Visentin's new role at HP inevitably would require the disclosure of IBM's trade secrets. The court found that HP's agreement provided a safeguard against the disclosure of confidential information by limiting the scope of Visentin's new position for the first year of employment. The court also found that Visentin's new position was significantly larger in scope and only shared a "slight overlap" with his prior position. In short, the court found no evidence that any specific protected information that Visentin possessed would inevitably be disclosed to carry out his new role at HP

The lesson for employers from the *Visentin* case is that, to prevail, they will need to explain specifically the precise trade secret information at issue and the adverse impact that disclosure of that information will have on the employer's business[1]

C. Investor relationships

Most states, including New York, recognize customer relationships as a legitimate resource deserving protection. *See, e.g., Mercator Risk Svcs., Inc. v. Girden*, No. 08 Civ. 10795, 2009 WL 466150 at *7 (S.D.N.Y. Feb. 23, 2009) ("[a] 'legitimate business interest' is found when: (1) because of the nature of the business, the customers' relationships with the employer are near-permanent and the employee would not have had contact with the customers absent the employee's employment"); *GFI Brokers, LLC v. Santana*, Nos. 06 Civ. 3988, 06 Civ. 4611, 2008 WL 3166972 (S.D.N.Y. Aug. 8, 2008) (citing *Ticor Title Ins. Co. v. Cohen*, 173 F.3d 63, 72 (2d Cir. 1999)) (an employer has a "sufficient interest" to enforce a restrictive covenant against a broker or sales agent when "the employee's relationship with the customer is such that there is a substantial risk that the employee may be able to divert all or part of the business" to a competitor). Case law suggests that New York is shifting to include customer relationships as a legitimate employer interest worthy of protection by utilizing the "unique" employee rationale

[1] *Visentin* stands in sharp contrast to *IBM Corp. v. Papermaster*, 08 Civ. 9678, 2008 WL 4974508 (S.D.N.Y. Nov. 21, 2008), which involved the same non-compete provision as *Visentin*. In *Papermaster*, IBM successfully enjoined a former executive from joining Apple for one year because the executive had detailed technical knowledge of IBM's microprocessor development. 2008 WL 4974508, at *8. Because the executive was going to work on an analogous technology at Apple, the court determined that disclosure of trade secrets would occur

In a seminal case, the New York Supreme Court upheld restrictive covenants to protect an employer's customer relationships. In *Maltby v. Harlow Meyer Savage, Inc.*, the court enjoined several brokers from competing with their employer for a period of six months. 166 Misc. 2d 481, 633 N.Y.S.2d 926 (Sup. Ct. N.Y. Co. 1995). The restrictive covenants were part of employment agreements, which provided the brokers with base salaries in excess of $100,000, plus bonuses. Each broker had the opportunity to consult with counsel before signing the agreements. The court held that the brokers "all have unique relationships with the customers with whom they have been dealing that have been developed while employed at HMS and, partially, at HMS expense." 166 Misc. 2d at 486, 633 N.Y.S.2d at 930. The court found the restrictive covenants reasonable upon the condition that the brokers continue to be paid their salaries during the period of the non-compete. *Id.* The Appellate Division affirmed the court's decision in *Maltby* relying upon the fact that the brokers were to receive their base salaries during the period of the non-compete and upon a finding that the services provided by the brokers were "unique." *Maltby v. Harlow Meyer Savage, Inc.*, 223 A.D.2d 516, 517, 637 N.Y.S.2d 110, 111 (1st Dep't 1996). *See also Contempo Commc'ns, Inc. v. MJM Creative Serv., Inc.*, 182 A.D.2d 351, 354, 582 N.Y.S.2d 667, 669 (1st Dep't 1992) (enforcing covenant to protect "special relationship" between employer's clients and defendant employees rendering employees' services unique); *Giller v. Harcourt Brace & Co.*, 166 Misc. 2d 599, 601, 634 N.Y.S.2d 646, 647 (Sup. Ct. N.Y. Co. 1995) (enforcing restrictive covenant against representative of bar review course whose influential relationships were unique)

D. Unique employees

Courts have consistently held that a restrictive covenant may be enforced against an employee whose services are unique or extraordinary. *See Reed Roberts*, 40 N.Y.2d at 307, 353 N.E.2d at 593, 386 N.Y.S.2d at 679; *Tricor Assoc., Inc. v. Harris Corp.*, 27 F. Supp. 2d 175, 184 (E.D.N.Y. 1998). Although often cited as a basis for enforcing a restrictive covenant, until recently, courts rarely have relied upon the unique employee exception for enforcing a covenant. The unique employee exception is rooted in cases concerning disputes involving performers and musicians — individuals who were irreplaceable because of their extraordinary or "unique services." *See McCall v. Wright*, 198 N.Y. 143, 154-55, 91 N.E. 516, 519-20 (1910)

The Southern District of New York upheld a six-month restrictive covenant against a highly compensated title insurance salesman. *See Ticor Title Ins. Co. v. Cohen*, Case No. 98 Civ. 4001 (JSM), 1998 WL 355420 (S.D.N.Y. July 1, 1998). In *Cohen*, Cohen, a highly compensated title insurance salesman in a regulated industry in which customers are well known, was held bound by the six-month restrictive covenant. Relying upon *Maltby*, the court determined that Cohen's client relationships were special in an industry where "[m]aintaining current clients and wooing new ones from an established group becomes important." The court held that these relationships placed Cohen's employment in the unique services category. To the extent that New York case law held that a salesman is not a unique employee, the court held that *Maltby* overruled such precedent. The court rejected the concept that an employee should be paid during the period of his non-compete, finding that Cohen's substantial salary and commissions from his former employer and the substantial bonus received from his new employer would sustain him until he could return to work. *See also Triconic Assoc., Inc. v. Harris Corp.*, 27 F. Supp. 2d 175, 184-85 (E.D.N.Y. 1998) (following *Cohen* and *Maltby* determining that exploiting client relationships developed at former employer's expense may be enjoined)

The Second Circuit affirmed the district court's decision. *See Ticor Title Ins. Co. v. Cohen*, 173 F.3d 63 (2d Cir. 1999). On review for abuse of discretion, the Second Circuit agreed that the relationships that salesmen develop with their customers, *at the employer's expense*, may be the basis for finding that a particular employee is unique. For example, the court found it noteworthy that Cohen had spent $208,000, at Ticor's expense, in a little over one year to entertain clients.[2] *See also BDO Seidman v. Hirshberg*, 93 N.Y.2d 382

[2] The *Cohen* court, however, disregarded countervailing case law in the Southern District of New York, which affirms New York's traditional requirements for enforcing restrictive covenants. In *Bijan Designer For Men, Inc. v. Katzman*, the court denied an injunction against a high-level clothing salesman, who left his employer to start a competing business. 96 Civ. 7345, 1997 WL 65717 (S.D.N.Y. Feb. 7, 1997). In *Bijan*, the defendant developed close business and personal relationships with the plaintiff's customers and sought to use those relationships to further a competing business. *Id.* at *2-3. The court rejected the plaintiff's application for an injunction, stating that non-competes are enforceable only to the extent necessary to protect trade secrets. *Id.* at *6-7. The court held that customer relationships do not provide an independent basis for enforcing a restrictive covenant, even if such relationships are highly valuable. *Id.* at *6-7

(1999) (enforcing covenant to restrict former employee from the competitive use of client relationships which his employer enabled him to acquire)

E. Effect of employer-initiated termination

Generally, if an employer materially breaches an employment contract, the employer will be barred from enforcing a restrictive covenant contained in the contract. *See Michael I. Weintraub, M.D., P.C. v. Schwartz*, 131 A.D.2d 663, 516 N.Y.S.2d 946 (2d Dep't 1987) (employer breached contract by not providing timely notice of whether employee would be offered partnership and, therefore, the restrictive covenant in the contract was unenforceable). Nevertheless, an employer-initiated termination of an employee's employment will not necessarily bar the employer from enforcing the employee's non-compete

For example, when an employee is discharged by his employer for cause, his non-competition covenant may still be enforced (in large part because the employee chose to engage in the cause act). *See, e.g., Gismondi, Paglia, Sherling v. Franco*, 104 F. Supp. 2d 223 (S.D.N.Y. June 22, 2000), rev'd, in part, on other grounds at 206 F. Supp. 2d 597; *MTV Networks v. Fox Kids Worldwide, Inc.*, No. 605580/97, 1998 WL 57480 (Sup. Ct. N.Y. Co. Feb. 4, 1998) (termination of employee for cause did not render covenant unenforceable). The United States District Court for the Southern District of New York has reaffirmed New York's general rule that terminations for cause do not vitiate the impact of a non-compete clause. *See Franco*, 104 F. Supp. 2d at 233. In *Franco*, the employer brought an action to enforce a non-compete that prohibited defendant (whose employment had been terminated by the employer for cause) from "the practice of medicine" within a 15-mile radius of certain Westchester towns. The employee argued that non-competes are unenforceable against terminated employees regardless of whether they were terminated with or without cause. The court rejected defendant's argument and found for the employer. The court opined that accepting the employee's argument would lead to perverse results. According to the court, to do so "would permit employees to avoid reasonable non-compete agreements simply by 'creating' cause for their dismissal." *Id.* at 234

F. Consideration

Signing a restrictive covenant at the inception of employment will provide sufficient consideration to support the covenant. *See, e.g., Mallory Factor, Inc. v. Schwartz*, 146 A.D.2d 465, 536 N.Y.S.2d 752 (1st Dep't 1989). Continued employment also provides sufficient consideration to support a restrictive covenant if discharge is the alternative or if the employee remains with the employer for a substantial period of time after the covenant is signed. *See Zellner v. Stephen D. Conrad*, *M.D., P.C.*, 183 A.D.2d 250, 589 N.Y.S.2d 903 (2d Dep't 1992)

G. Blue pencil rule

In New York, a court may modify and enforce an overbroad or unreasonable covenant. *See, e.g., Muller v. New York Heart Ctr. Cardiovascular Specialists P.C.*, 656 N.Y.S.2d 464, 466 (3d Dep't 1997) (partially enforcing the geographic terms of a covenant). *See also EarthWeb, Inc. v. Schlack*, 71 F. Supp. 2d 299, 313 (S.D.N.Y. Oct. 27, 1999) (courts may "blue pencil" non-competes to make them shorter and enforceable); *Misys Int'l Banking sys., Inc. v. TwoFour Sys., LLC*, No. 650101/2004, 2004 WL 3058144 (Sup. Ct. N.Y. Co. Nov. 23, 2004) (holding the period of non-compete provisions for key employees "blue penciled" down from 18 months to 12 months to match period contained in chief executive officer's covenant). Courts may also interpret a covenant appropriately when a restrictive covenant contains no geographic limitation. *See Deborah Hope Doelker, Inc. v. Kelly*, 87 A.D.2d 763 (1st Dep't 1982) (limiting the covenant to the same geographical area as the employer's business, which was confined to New York City). *See also Greystone Staffing, Inc. v. Goehringer*, 836 N.Y.S.2d 485 (Sup. Ct. Nassau Co. 2006) (court rejected 50-mile restriction and replaced it with one-year restriction on soliciting business of clients of former employer that the former employee dealt with while employed)

Courts may decline to blue pencil, however, when there is overreaching. *See Visentin*, 2011 WL 672025 at *24 (partial enforcement not available when employer could not show a "good faith" effort to protect a legitimate business interest); *Scott, Stackrow & Co. v. Skavina*, 780 N.Y.S.2d 675, 676 (3d Dep't 2004) (partial enforcement denied when employer had used superior bargaining position in conditioning employment on employee's execution of overbroad non-compete); *Leon M. Reiner & Co.*, 929 F. Supp. 154, 161 (S.D.N.Y. 1996) (although courts applying New York law have the power to modify covenants that are unreasonable as drafted and enforce them as modified, "the infirmities [of the non-compete at issue] are simply too patent for this type of restructuring. To bring [this non-compete] into conformity with the law would require this Court essentially to rewrite the entire section, an exercise not appropriate here"). Similarly, courts are hesitant to award relief beyond what is provided for in the express terms of the agreement at issue. For example, the court in *Southerland Global Serv. v. Crowley*, 21 Misc. 3d 344 (Sup. Ct. Monroe Co. 2008), declined to exercise its broad equitable powers to add to the length of the term of the restrictive covenant until after full discovery could be had

It is important to be aware that state law varies significantly with respect to blue pencil rules. Some states either refuse to blue pencil (e.g., Virginia) or will do so only when the offending provision is neatly severable (e.g., Maryland)

III. Key areas of non-compete law

A. Sale of business

Whereas restrictive covenants in employment agreements are rigorously examined because they can result in the loss of an individual's livelihood, "[r]easonable restrictive covenants ancillary to the sale of a business 'are routinely enforced' to protect the goodwill paid for by the purchaser . . . ." *Dar & Assoc., Inc. v. Uniforce Serv., Inc.*, 37 F. Supp. 2d 192, 196-197 (E.D.N.Y. 1999). Accordingly, in the sale of business context, courts are often willing to enforce restrictive covenants of far longer temporal scope than in the traditional employment context. *See, e.g., Sager, infra*, (enforcing 10-year non-compete ancillary to sale of business)

1. Covenant not to compete

In 1999, three businessmen (the "former partners") entered into a merger agreement to combine their accounting firm with Weiser and become Weiser Partners. The former partners signed the Merger Agreement and the Weiser Partnership Agreement ("WPA"). *Weiser, LLP v. Coopersmith*, 859 N.Y.S.2d 634 (1st Dep't 2008). The latter agreement included a restrictive covenant and a liquidated damages provision. In 2005 the former partners gave their notice of withdrawal from Weiser and stated their intent to continue to service the clients they brought to the firm, clients referred to them by these clients, and clients from referral services used prior to the date of merger. Weiser filed suit claiming breach of the restrictive covenant and seeking damages under the liquidated damages provision. The Appellate Division held that Weiser established a prima facie case for enforcing the restrictive covenant and that it was enforceable because it was "not more extensive than reasonably necessary to protect Weiser's legitimate interest in enjoying the assets and goodwill it had acquired pursuant to the merger." *Id*. at 635

The court reaffirmed the more lenient "sale of business" test for assessing the reasonableness of restrictive covenants as applied to all sellers of a business, including minority partners. Because the restrictive covenants were "ancillary" to the merger agreement, they qualified for review under the "sale of business" test, a test that requires enforcing the covenant if it is not more extensive than reasonably necessary to protect the buyer's legitimate business interest in the assets and goodwill it acquired from the merger. The court stated, however, that the partnership provisions at issue here would pass muster even under the "more exacting test applicable to employment contracts." *Id. See also BDO Seidman v. Hirshberg*, 93 N.Y.2d 382, 393 (1999)

In *Sager Spuck Statewide Supply Co. Inc. v. Meyer*, defendant sold his 84.7 percent interest in Statewide Industrial Equipment Co. to the plaintiff's president, who also acquired the remaining shares of Statewide. 273 A.D.2d 745 (3d Dep't 2000). As a result of the subsequent merger with Statewide, the plaintiff succeeded to Statewide's rights under an agreement not to compete executed by defendant Meyer in connection with the sale of his interest in Statewide. The defendant then became a full-time consultant for the plaintiff, accepting 1,365 shares of preferred stock in the plaintiff in exchange for the cancellation of outstanding debt owed to him by the plaintiff and its president totaling over $191,000 pursuant to the non-compete. Six years after the merger, the defendant resigned his consultant position with the plaintiff and began working as a salesperson for a competitor of the plaintiff. As a result, the plaintiff brought this action alleging that the defendant breached the agreement not to compete, breached the implied covenant not to impair the goodwill of the business he sold and breached his fiduciary duty as a shareholder

The trial court granted a 10-year permanent injunction preventing the defendant (the seller) from competing for 10 years following the date of his signing of the non-compete agreement. The Appellate Division affirmed, reasoning that the non-compete agreement fell "squarely within the category of a covenant not to compete arising out of the express agreement of the seller of a business to refrain from competing with the purchaser, which will be enforced if reasonable in geographic scope and duration." *Id.* at 746. The court also noted that a non-compete need not seek to prevent confidential information in the context of a sale of business. *Id. See also Town Line Repairs, Inc. v. Anderson*, 90 A.D.2d 517 (2d Dep't 1982) (holding that the "only limitation on the enforcement of a covenant not to compete is the reasonableness of the restraint on the seller. A covenant of this type is reasonable when it is not broader in terms of time, scope and area than is reasonably necessary to protect the buyer's interest")

2. Implied covenant not to impair goodwill of business

When the sale of a business involves the transfer of its goodwill as a going concern, an incidental covenant by the seller not to compete with the buyer after the sale will be implied and enforced. This rule is premised on the idea that a buyer of a business should be permitted to restrict his seller's freedom of trade so as to prevent the latter from recapturing the goodwill of the very business that he transferred for value. *See Sager*, 273 A.D.2d at 747 ("The implied covenant, which is narrower than an express covenant and restricts the seller's economic freedom only to the extent that it precludes the seller from soliciting former customers, is a duty 'imposed by law in order to prevent the seller from taking back that which he has purported to sell'; it gives the purchaser a 'vested property right of indefinite duration'") (quoting *Mohawk Maint. Co. v. Kessler*, 52 N.Y.2d 276, 285-86 (1981)); *Kessler*, 52 N.Y.2d at 284-85 ("[T]he right acquired by the purchaser of the 'good will' of a business by virtue of this 'implied covenant' must logically be regarded as a permanent one that is not subject to divestiture upon the passage of a reasonable period of time")

Nonetheless, New York's highest court has held that a business seller may solicit and regain former clients for his new employer without incurring liability under certain circumstances. *Bessemer Trust Co. v. Branin*, 2011 N.Y. Slip. Op. 3307 (Apr. 28, 2011). In *Bessemer*, the court held that certain activities of a seller would not breach the implied covenant, such as general advertisements, providing answers to factual questions, providing information to the employer about former clients and being involved in sales pitches. Similarly, the implied covenant will not be enforced if the business was abandoned, dissolved and no longer exists. *Finelli v. Sica*, 66 Misc. 2d 68, 319 N.Y.S.2d 913 (Sup. Ct. N.Y. Co. 1971)

B. Reasonable duration and geographic scope

1. Reasonable duration

One of the touchstones for enforceability of non-compete agreements has traditionally been whether the temporal restriction is reasonable under the circumstances. *See, e.g., Columbia Ribbon & Carbon Mfg. Co. v. A-1-A Corp.*, 42 N.Y.2d 496, 499, 398 N.Y.S.2d 1004 (1977); *Reed, Roberts Assoc., v. Strauman*, 40 N.Y.2d 303, 307-08, 386 N.Y.S.2d 677 (1976). Depending upon the industry, the length of the non-compete agreement oftentimes has been set for a period of years. With the increasing pace of information technology, courts are looking with increased scrutiny at duration

(a) *DoubleClick, Inc. v. Henderson*

In this unreported New York State Case, DoubleClick, Inc., a provider of advertising services on the Internet, sought an injunction to prohibit two former executives from engaging in competitive business activities. *See DoubleClick, Inc. v. Henderson*, Case No. 116914/97, 1997 WL 731413 (Sup. Ct. N.Y. Co. Nov. 7, 1997). After concluding that a preliminary injunction was warranted, the court grappled with the appropriate remedy. DoubleClick requested that the defendants be enjoined from competing for one year. The court concluded, however, that a period of one year was too long. Noting the "speed" with which the Internet industry changes, the court opined that the defendants' knowledge would lose value "to such a degree that the purpose of a preliminary injunction w[ould] have evaporated before a year was over." The court ultimately granted an injunction for six months

(b) *EarthWeb, Inc. v. Schlack*

Building on *DoubleClick*, a New York federal court held that a one-year restrictive covenant was not reasonable in duration. *See EarthWeb, Inc. v. Schlack*, 71 F. Supp. 2d 299 (S.D.N.Y. 1999)

EarthWeb Inc., a provider of on-line business products and services, brought an action against its former vice president, Mark Schlack, to enjoin him from competing with it. In his former capacity as vice president of EarthWeb, Schlack was responsible for the content of all of EarthWeb's websites. Prior to beginning employment with EarthWeb, Schlack signed a non-compete agreement. The non-compete provided that Schlack would refrain from working in any capacity as a direct competitor with EarthWeb for a period of 12 months

Upon EarthWeb's motion for injunction, the court determined that Schlack's restrictive covenant was *not* reasonable in duration. Relying on "the dynamic nature of this [internet] industry, its lack of geographical borders, and Schlack's former cutting-edge position with EarthWeb," the court determined that six months was adequate

2. Reasonableness in geographic scope

Restrictive covenants, traditionally, must also be reasonable in geographic scope. This requirement arose from the traditional store-front model where a traveling salesperson had a specific territory and established contacts with clients. Upon the salesperson's departure, the courts were required to balance two equities: (1) the salesperson's right to a livelihood; and (2) the employer's right to require that the former employee not solicit its clients. The information age, however, turns these basic considerations on their heads. In the internet age, when many companies and businesses operate on a national or international basis, these rules require re-evaluation. For instance, in *Misys Int'l Banking Sys., Inc. v. TwoFour Sys., LLC*, 800 N.Y.S.2d 350 (Sup. Ct. N.Y. Co. 2004), the court held a covenant restricting competition worldwide did not require reformation because of the international nature of the plaintiff's business. The court held that a decision as to the appropriateness of the geographic scope must await discovery and trial

C. Inevitable disclosure in New York

The inevitable disclosure doctrine initially arose out of non-compete agreements, and is often at issue in trade secret cases. It buttresses the enforceability of a restrictive covenant. The doctrine of "inevitable disclosure" evolved in New York case law to enjoin an employee from working for his former employer's competitor in the absence of a non-compete agreement. The rationale behind this doctrine is that if the lines of business of a former and a current employer are substantially similar, the employee could not help but disclose and/or use confidential information gleaned from his previous employment. More recent case law evinces a hostile attitude towards this doctrine

1. *Lumex, Inc. v. Highsmith*

In a decision by Judge Spatt, the district court held that an employee's confidential knowledge of a former employer's business warranted an injunction precluding the employee from working for a competitor. *See Lumex, Inc. v. Highsmith*, 919 F. Supp. 624 (E.D.N.Y. 1996)

Lumex, a manufacturer of fitness equipment, brought suit against its former marketing manager, Greg Highsmith, to enforce the terms of a non-compete agreement. Shortly after resigning from Lumex, Highsmith accepted a position with Life Fitness, a Lumex competitor. Prior to his start of work with Life Fitness, Lumex sought a preliminary injunction. Lumex contended that Highsmith had confidential and trade secret information that would be "inevitably disclosed" to his new employer. The court agreed that inevitable disclosure was likely, finding that "Highsmith was privy to the top secret Cybex product, business and financial information. He cannot eradicate these trade secrets . . . from his mind." *Id*. at 631. The court granted an order restraining Highsmith from working for Life Fitness for six months

2. *DoubleClick, Inc. v. Henderson*

DoubleClick set forth a high-water mark for the doctrine of inevitable disclosure. *See DoubleClick, Inc. v. Henderson*, Case No. 116914/97, 1997 WL 731413 (Sup. Ct. N.Y. Co. Nov. 7, 1997). Despite the absence of a restrictive covenant, the court enjoined two executives from working for a competitor

In *DoubleClick*, an internet advertiser sought an injunction against two former executives who left to start their own internet advertising business. DoubleClick contended that the former executives had access to highly sensitive information, including revenue projections, plans for future projects, pricing and product strategies, and databases. A non-compete agreement did not exist between the parties. Nonetheless, the court held that the threat of "inevitable disclosure" of confidential information by these employees existed. The court granted an injunction for six months

3. *EarthWeb, Inc. v. Schlack*

The *EarthWeb* court refused to apply the inevitable disclosure doctrine. *See EarthWeb*, 71 F. Supp. 2d 299 (S.D.N.Y. 1999). EarthWeb sought an injunction against its former vice president, Mark Schlack, who had accepted a position with another internet-based company prior to his departure from EarthWeb. Irrespective of the non-compete agreement, EarthWeb argued that Schlack's prospective position made disclosure of its confidential information "inevitable." The court disagreed

Undertaking a lengthy analysis, including discussion of *Lumex* and *DoubleClick*, the court warned that invoking the inevitable disclosure doctrine was akin to "bind[ing] the employee to an implied-in-fact restrictive covenant." Absent evidence of actual misappropriation, the court concluded that inevitable disclosure should only be invoked in rare cases. The court set forth the following factors to consider in weighing the appropriateness of invoking the inevitable disclosure doctrine

(a) The employers in question are direct competitors providing the same or similar services

(b) The employee's new position is nearly identical to his old one

(c) The confidential information is highly valuable

(d) Other case-specific factors, such as the nature of the industry[3]

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[3] Ultimately, the Second Circuit remanded this case to the district court. *See EarthWeb, Inc. v. Schlack*, 205 F.3d 1322 (2d Cir. 2000). While the district court had discussed the problematic nature of inevitable disclosure, it also concluded, without any discussion, that EarthWeb could not make a showing of irreparable harm at all, on the basis of disclosure of confidential information. The Second Circuit requested that the district court set forth the specific reasons for this conclusion

4. *Marietta Corp. v. Fairhurst*

Fairhurst relied, in part, on *EarthWeb* to reverse the Supreme Court's granting of a preliminary injunction to the plaintiff. *See Marietta Corp. v. Fairhurst*, 754 N.Y.S.2d 62 (3d Dep't 2003). In *Fairhurst*, the plaintiff, a hotel amenities supplier, brought action against the defendant Pacific Direct, a competitor, after the competitor hired its former senior vice president, Thomas Fairhurst. The plaintiff sought to enjoin disclosure of confidential information. The Supreme Court reasoned that since it was likely that Fairhurst would "use those secrets — if only unconsciously — in carrying out his duties with Pacific Direct, to [the plaintiff's] unfair advantage," the plaintiff had thus established the required elements for a preliminary injunction. *Id.* at 65

On appeal, the Third Department found the Supreme Court's conclusion unsupported by the evidence. The Appellate Division noted that, like restrictive covenants, New York courts disfavor the doctrine of inevitable disclosure "absent evidence of actual misappropriation by an employee." *Id.* citing *EarthWeb*, 71 F. Supp. 2d at 310. The plaintiff proffered no evidence demonstrating actual misappropriation of trade secrets; such a conclusion would be merely conjectural. Absent any transgression that would constitute a breach under the confidentiality agreement, "mere knowledge of the intricacies of a business is simply not enough." *Id.* at 67

D. Choice-of-law provisions

Choice-of-law provisions are inserted in employment agreements to designate a particular body of law that will govern any litigation that arises out of the agreement. With employers doing business in many jurisdictions and with employees in various locales, choice-of-law provisions have become increasingly commonplace. Employers must be cognizant, however, that a choice-of-law clause does not guarantee that a favored body of law will apply. Employers must draft their agreements considering the law of other forums that may be deemed applicable. Regardless, the most appropriate governing law for most employment agreements will be the law of the state in which the relevant employee works. This can be a hot-button issue for private equity firms. Often, New York-based firms want New York law to govern the contracts of their portfolio companies' employees because that is where the private equity business operates. More often than not, however, the portfolio companies and their employees operate in other states with different laws and rules pertaining to labor and employment

1. *SG Cowen Secs. Corp. v. Messih*

In *Messih*, SG Cowen Securities Corporation ("Cowen") claimed that Robert Messih, a managing director of technology in its San Francisco office, had resigned and taken up employment with Banc of America. *SG Cowen Secs. Corp. v. Messih*, No. 00 Civ. 3228, 2000 WL 633434 (S.D.N.Y. May 17, 2000), *aff'd* 224 F.3d 79 (2d Cir. 2000). Cowen contended that working for Banc of America was in violation of a non-compete provision in Messih's employment agreement. Messih's agreement also contained a choice-of-law provision designating New York as the governing law. Despite the choice-of-law provision, the court determined that California law applied because California contacts predominated the contract: Messih worked in California and had executed the employment agreement there. The New York contacts, in contrast, were more limited: Cowen's headquarters were in New York and some of the negotiations surrounding the agreement had taken place in New York. Determining that California Business and Professions Code Section 16600 generally prohibits covenants not to compete, the court denied the employer's request for injunctive relief to prohibit the employee from working for Banc of America[4]

[4] Out of an abundance of caution, the court also determined that even if, *arguendo*, New York law applied, the non-compete would be found unenforceable. The court did not believe the employee's services were "unique" or "special"

2. *Estee Lauder v. Batra* and New York General Obligations Law Section 5-1401

New York General Obligations Law ("GOL") Section 5-1401 allows contracting parties to choose New York law to apply to their agreements so long as that agreement relates to an obligation in excess of $250,000. The GOL encourages the use of New York courts and the freedom to contract. A carve-out in Section 5-1401(1) for personal services provides that GOL "shall not apply to any contract, agreement, or undertaking (a) for labor or personal services . . . ." New York courts typically construe this "personal services" carve-out to encompass executive employee agreements and apply the "reasonable relationship" test to determine the enforceability of choice-of-law provisions in those agreements. *See, e.g., Woodling v. Garrett Corp.*, 813 F.2d 543, 551 (2d Cir. 1987); *Don King Prods. v. Douglas*, 742 F. Supp. 741, 756 (S.D.N.Y. 1990)

Estee Lauder v. Batra, 430 F. Supp. 2d 158 (S.D.N.Y. 2006), exemplifies a court's recent decision to apply New York law to an executive agreement. There, Estee Lauder sued in federal court to enforce the non-compete in the employment agreement of a global brand manager, Batra, who had worked in California, to prevent Batra from becoming a worldwide general manager of a competitor. The non-compete's choice-of-law provision opted for New York law. In determining the enforceability of the non-compete's choice-of-law provision, the court applied a "substantial relationship" approach: the parties' choice-of-law is applied *unless* the chosen state bears no "substantial relationship" to the parties or "application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state." *Id.* at 30-31. The court enforced the non-compete's choice-of-law provision because New York had the "most significant" contacts based on the totality of the number of contacts in New York and California's interest in the dispute was not "materially greater" than New York's interest

Since a separate, free-standing "restrictive covenant agreement" or "option vesting agreement" is not literally included in Section 5-1401's "personal services" carve-out, parties may want to create separate documents that contain a New York choice-of-law provision other than the employment agreement. Parties may also want to take reasonable measures to ensure that New York bears a substantial relationship to the personal services arising under an employment agreement. Possible measures include, but are not limited to

(a) Negotiate the agreement in New York

(b) Draft the contract in New York

(c) Execute and/or deliver the contract in New York

(d) Have the executive perform the agreement's obligations to the greatest extent practicable in New York (i.e., require the executive to attend meetings and seminars, or participate in telephone conferences, in or arising out of New York)

(e) Include provisions in the employment agreement whereby the executive acknowledges the reasonableness of contacts with New York and sets forth his understanding that his responsibilities will involve a range of contacts/activities in New York

(f) Ensure, again to the greatest extent practicable, that the business enterprise has significant operations in New York

E. The unclean hands defense

It has long been the law that to obtain injunctive relief, the party seeking the relief must come to the court with clean hands. Some courts have refused to enforce non-compete agreements when the employer seeking enforcement argues against enforcement when it is self-serving. For example, the Supreme Court, New York County, in *GFI Securities* denied injunctive relief to petitioner, GFI, based, in part, on judicial estoppel grounds. *See GFI Securities LLC v. Tradition Asiel Securities Inc.*, 873 N.Y.S.2d 511 (Sup. Ct. N.Y. Co. 2008), *aff'd* at 878 N.Y.S.2d 689 (1st Dep't 2009)

GFI involved five arbitrations and an action to determine whether an inter-dealer firm, Tradition, raided GFI's brokers and whether the brokers violated the restrictive covenants in their employment agreements. Tradition allegedly raided 22 of GFI's 80 brokers and this suit and the arbitrations ensued. After first finding that the petitioner did not sufficiently prove the traditional elements for a preliminary injunction under CPLR 6301, the court also denied GFI's injunction request on judicial estoppel grounds. In at least two prior cases involving GFI as the defendant, GFI took the opposing arguments to the instant case. For instance, in one of the cases, GFI argued that services of a junior broker were *not* unique or extraordinary, while here GFI contended that such services *were* unique. Furthermore, in a separate case in which GFI was the defendant, GFI solicited and hired a broker from the plaintiff despite a restrictive covenant. The court ruled in GFI's favor, determining that there was no irreparable harm because of the liquidated damages clause in the employment contract

In strong dicta coming down hard on parties employing such tactics, the court noted that "with alarming frequency, these competing parties are asserting alternative and contrary positions depending on which side of a particular suit they are on. Their interpretation of the relevant case law seems to depend, not on the individual facts of the matters, but rather whether, in each particular instance, they are the party seeking to prevent the alleged misconduct or whether they are defending against the conduct." Consequently, the court held GFI was judicially estopped from asserting arguments that constituted contrary positions advanced by GFI in other actions

IV. Creating enforceable covenants

Employers should consider the following suggestions when drafting restrictive post-employment covenants:

A. Drafting reasonable covenants

1. Limited duration and geographic scope

A restrictive covenant should be limited in duration and geographic scope, covering no greater an area or time period than that which is necessary to protect an employer's legitimate interests. Drafting reasonable covenants in the first instance will prevent later contentions and blue pencil determinations by a court. If a geographic scope limitation is impossible, consider a customer service restriction

2. A defined protected interest

A restrictive covenant should narrowly define the interest the employer is seeking to protect. If a covenant is seeking to protect trade secrets or confidential customer information, it should explicitly state in the contract that trade secrets and confidential customer information exist. If an employer is seeking to protect customer relationships, the covenant should state that it covers current customer relationships. The restriction should be drafted with the goal of infringing as little as possible upon an employee's ability to pursue his or her livelihood

B. Consideration in exchange for covenant

Recent case law addresses restrictive covenants as applied to highly compensated employees whose restrictive covenants were negotiated as part of an entire employment agreement. As these cases suggest, the greater the consideration received in exchange for the non-compete, the more apt a court will be to enforce the covenant

A court may examine whether an agreement was negotiated by both parties and whether the employee consulted with or had the opportunity to consult with an attorney. Therefore, employers should encourage employees to seek the advice of counsel and to negotiate the terms of any employment agreements containing restrictive covenants

C. Ensure that the agreement is fully executed

A case from the Southern District of New York exemplifies the importance of a validly executed non-compete agreement. In *Int'l Bus. Mach. Corp. v. Johnson*, 629 F. Supp. 2d 321 (S.D.N.Y. 2009), IBM brought claims against David Johnson, formerly an IBM vice president, for breach of a non-compete agreement and misappropriation of trade secrets when Johnson resigned to join competitor Dell as senior vice president of strategy. The court held in favor of Johnson based on IBM's failure to establish a likelihood of success on the merits of its breach of contract claim, the significant hardship Johnson would suffer as a result of an injunction and New York's general disfavor of non-compete agreements. *Id*. at 337

In 2005, IBM began requiring senior executives to execute non-compete agreements in exchange for equity grants — grants that these employees received before the implementation of the non-competes. Hesitant to sign the agreement, Johnson returned the form to human resources having purposely signed on the line designated for IBM. In its analysis of whether Johnson and IBM entered into a valid non-compete agreement, the court relied, in part, on the rule that where "an offeree communicates to an offeror an ambiguous acceptance, it is the offeror's reaction to that ambiguous acceptance that controls whether the parties entered into a contract." *Id.* at 330. The court found that IBM's subsequent actions in response to the improperly executed agreement raised serious doubts as to whether IBM believed that Johnson had accepted their offer to a non-compete agreement. After receiving Johnson's agreement with the signature in the improper area, IBM contradicted its internal policy for booking validly signed agreements when it failed to sign Johnson's agreement. In fact, IBM essentially asked Johnson to clarify his intentions by returning the agreement he signed and asking him to re-sign a new copy on the proper signature line. He refused. IBM's general counsel indicated to Johnson that he did not consider the agreement properly executed and suggested that Johnson keep records of IBM's repeated efforts to get him to properly sign the document. *Id.* at 332-32

V. Forfeiture-for-competition provisions

The "employee choice" doctrine is based on the assumption that one who elects to leave an employer makes a knowing, informed choice between forfeiting a certain benefit or retaining the benefit by staying with the employer. "New York courts will enforce a restrictive covenant without regard to its reasonableness if the employee has been afforded the choice between not competing (and thereby preserving his benefits) or competing (and thereby risking forfeiture)." *Lucente v. Int'l Bus. Mach., Corp.*, 310 F.3d 243, 254 (2d Cir. 2002) (holding that the employee choice doctrine can apply to deprive an employee of a future benefit or to recover a benefit already paid to the employee). A forfeiture-for-competition provision does not prohibit competition. Rather, it provides that if the former employee does compete, he will forfeit benefits or payments to which he would otherwise be entitled

It is settled in New York that an employer can rely on the doctrine only if: (1) the employer "can demonstrate its continued willingness to employ the party who covenanted not to compete"; or (2) the employee is not discharged without cause. *Id. See, e.g., Gismondi, Paglia, Sherling, M.D., P.C. v. Franco*, 104 F. Supp. 2d 223, 233 (S.D.N.Y. 2000); *In re UFG Intern., Inc. v. DeWitt Stern Group, Inc.*, 225 B.R. 51, 55 (S.D.N.Y. 1998) ("[A]n employee's otherwise enforceable restrictive covenant is unenforceable if the employee has been terminated involuntarily, unless the termination is for cause"). *See also Post v. Merrill Lynch*, 48 N.Y.2d 84 (1979) (holding forfeiture-for-competition clauses unenforceable in the event of an involuntary "without cause" employment termination)

An employer may want to consider crafting a forfeiture-for-competition clause rather than a traditional restrictive covenant when the employee will be eligible to receive compensation subsequent to the termination of employment that, if forfeited, might be substantial enough effectively to deter the employee from competing

VI. Non-solicitation provisions

Freedom of an employee's decision to leave a job is, in general, balanced against protection of the employer's business interests. Non-solicitation, or non-recruitment, clauses in employment agreements intend to prevent former employees with the knowledge of an employer's current workforce from draining the employer's staff through recruitment efforts. Similarly, in situations involving mergers, acquisitions, litigation or usage of temporary workers, companies may enter into no-hire agreements where one or both agree not to hire the other's employees for a set period of time. Some states that are hostile to non-compete agreements have upheld non-solicit clauses (e.g., California, Georgia, Louisiana). *See, e.g., Loral Corp. v. Moyes*, 174 Cal. App. 3d 268 (1985) (holding the obligation not to solicit former employees as not interfering with employee relationships and allowing a former employer to stabilize its workforces and maintain its business). *But see Edwards v. Arthur Andersen LLP*, No. B178246, 2008 WL 5255805 at *6 (Dec. 18, 2008) (affirming the invalidity of the non-competition agreement and the non-solicit clause within the agreement on the narrow ground that since former employer was no longer in business, sufficient consideration was not given for the non-solicitation agreement). Not all states, however, distinguish an employee non-solicitation clause from a non-compete agreement. Because employees often leave without any prompting or influence from former employees, additional restrictions on departing employees such as non-compete and customer non-solicit provisions further protect an employer's business interests by limiting the post-employment conduct of these former employees in other ways. In this respect, non-recruitment clauses complement other more direct restrictions to the extent they prohibit former employees from causing a current employee to sever his or her employment relationship. Courts may uphold, for example, a non-solicitation clause that prohibits recruiting customers or investors by the former employee. *See Natsource LLC v. Paribello*, 151 F. Supp. 2d 465, 469 (S.D.N.Y. 2001) (upholding a non-solicitation clause that prohibited a former employee from soliciting former employer's customers within the non-solicit period (120 days) because to hold otherwise would render the former employer irreparably harmed. The court noted that the former employer, a brokerage firm of energy-related commodities, "expends substantial resources to help its brokers develop customer relations, and the brokers are introduced to established customers")

Employers should structure such non-solicitation clauses to avoid over-reaching or ambiguity. A non-solicitation clause should include a time limit on non-solicit obligations that relates to an underlying business justification

Regulatory and Compliance

I. Introduction

The hedge fund industry is in the midst of major regulatory changes. The majority of U.S.-based fund managers, and many non-U.S.-based managers, will be SEC registered by March 30, 2012. There are extensive new fund-related disclosures in the ADV Part 1, including information about the types of investors in each fund, the service providers for each fund and the percentage of each fund's assets valued by an unrelated party. Registered advisers will be subject to the SEC's new standardized National Examination Program. The SEC has hired industry specialists to aid in its examinations of hedge fund managers, and specialists in structured products and quantitative trading strategies already have gotten involved in examinations

In addition to registration, there is a new world of reporting. The first Form 13H filings were due in early December, and by April all U.S. registered broker-dealers will be required to provide the SEC, upon request, with trading data associated with individual fund managers. The first Form PF filings will be due in late August and the amount of information required will be significant. While the stated purpose of the PF reporting is to aid the Treasury Department in assessing systemic risk, the SEC anticipates using the wealth of information supplied by the forms in connection with its examination and enforcement programs

Unprecedented enforcement in the area of insider trading continues, with the U.S. Attorneys Office and the SEC aggressively pursuing hedge fund managers and personnel. The U.K. regulator and criminal authorities also have been aggressive in this area. Beyond insider trading, the government has pursued managers for valuation fraud, misleading investor communications and market manipulation

Protection of customer assets is again at the center of attention for many in the industry, following the events at MF Global. Other areas, such as derivatives regulation, "pay to play" prohibitions, and potential CFTC registration also demand attention

II. U.S. broker-dealer and U.K. investment firm prime broker insolvency risk management

A. Strategies in advance of liquidation proceedings

1. Select prime broker carefully

(a) Applicable law — where the prime broker is located and what laws govern the prime broker entity (e.g., U.S. law, U.K. law, German law) affect what protections clients receive, including protections as to the treatment of client assets entrusted with the prime broker and protections in a liquidation of the prime broker. For example, a prime broker that is a U.S. broker-dealer may be subject to a liquidation under the Securities Investor Protection Act of 1970, as amended ("SIPA"), but a non-U.S. prime broker may not liquidate under SIPA

In the U.K., new Special Administration Regime ("SAR") may be invoked in the event of the insolvency of an investment firm prime broker. The SAR is governed by the Investment Bank Special Administration Regulations 2011 ("SAR Regulations") supplemented by the Investment Bank Special Administration (England and Wales) Rules 2011 ("SAR Rules") which came into force on June 30, 2011. The SAR Regulations apply to U.K. firms and where the U.K. firm is part of a wider group of companies, it will not apply to any non-U.K. affiliate

The SAR is currently being applied, for the first time, in the insolvency of MF Global U.K. Limited. The SAR aims to address perceived deficiencies in the U.K. insolvency regime in the case of the collapse of an investment bank and highlighted by the collapse of Lehman Brothers in 2008 such as ascertaining which assets are client assets and which firm assets, interpreting the effect of, and the interrelationship between, various contracts and master agreements such as prime brokerage, stock lending and ISDA master agreements and determining and allocating any shortfalls in client omnibus accounts

(b) Prime broker's credit — to the extent information is available, research and consider the prime broker's credit quality and assess the likelihood of its remaining a solvent entity going forward

(c) Diversify brokers — to the extent possible, maintain brokerage accounts at multiple prime brokers to diversify risk

2. Limit risk in prime broker agreement

(a) Identify the prime broker — all prime broker agreements should identify explicitly the name of the party acting as prime broker. Ideally, the prime broker should be singularly identified as the U.S. broker-dealer or as a U.K. investment firm that is providing prime broker services to the fund under the prime broker agreement and should not be defined as a collection of entities. In the event that the prime broker agreement specifies a main entity who is also contracting on behalf of its affiliates, such affiliates should be limited to the applicable prime brokerage relationship and they should be clearly identified in the agreement to enable the fund to clearly identify the counterparty risk attributed to such contractual relationship

(b) Limiting the transfer of assets — the ability of the prime broker to transfer assets from the prime broker account to affiliates of the prime broker or to any agent or sub-custodian of the prime broker should be limited. Also, affiliates of the prime broker should not have an unrestricted right to issue entitlement orders or any similar transfer instructions with respect to assets held in the prime broker account. Otherwise, assets could be moved to entities that are not subject to the same laws and regulations as those applicable to the prime broker and customer protections may be weakened as a result

(c) Limit the minimum net equity level — in relation to a U.S. prime broker, do not permit the prime broker to establish minimum net equity levels in its sole discretion. To the fullest extent possible, limit the fund's minimum net equity level to the minimum amount established by applicable rules and regulations (e.g., the 1994 SEC No Action Letter, applicable to U.S. broker-dealers). Limiting this minimum net equity level will decrease the amount of assets the fund would need to maintain with the prime broker and thus decrease the minimum exposure the fund would have to the prime broker

(d) Ensure your ability to remove assets — some prime broker agreements contain provisions stating that the prime broker has the right to hold all assets until the satisfaction of all obligations to the prime broker and its affiliates across all agreements. Any such language restricting the ability of the fund to move assets out of the prime broker account should be limited only to satisfaction of obligations under the prime broker agreement. Ideally, all prime broker agreements should permit the fund to move assets out of the prime broker account quickly if the prime broker's credit becomes a concern

(e) Limit prime broker's right to transfer its obligations — try to limit the ability of the prime broker to transfer its obligations under the prime broker agreement without the fund's prior written consent to avoid assuming the credit risk of any successor prime broker. If a prime broker requires the ability to transfer its obligations to any affiliate or any third party, consider limiting this right of transfer to another U.S. broker-dealer or U.K. investment firm or bank, governed under the same regulatory, legal and tax regime as the prime broker

3. Custody accounts

(a) In the U.S., consider holding securities (especially securities that are posted to the prime broker as margin or collateral) in custodial accounts at third-party banks or trust companies[1] to avoid having assets entangled in a broker liquidation proceeding. Custodial accounts provide some measure of added protection to the customer's assets because, among other things, banks and trust companies, unlike brokers, are prohibited from using or otherwise rehypothecating customer securities held in such accounts. In the U.K., assets held in custody by a U.K. prime broker will be subject to the FSA's custody rules. These ensure, in relation to non-cash assets, that such assets are held separately from the prime broker's own assets. In the event of the prime broker's insolvency, such assets should not be available to the prime broker's general creditors. There are exceptions to the custody rules and the fund should note that where the ownership of an asset is transferred to the prime broker for the purpose of securing the fund's obligations (i.e., as collateral), such assets will not be subject to the custody rules' protections. Also, where assets are rehypothecated by the prime broker, such assets will not be subject to the protection of the FSA custody rules.[2] In relation to assets held by a non-U.S. or non-U.K. sub-custodian, such asset would be subject to local law, rules, and regulations which might be substantially different from the protections applicable in the U.S. or in the U.K. Additionally, where the assets are subject to law or market practice outside the U.K., assets might be registered in the name of the prime broker or in the name of the sub-custodian. As a consequence, the assets might not be segregated from the prime broker's or the sub-custodian's assets and in the event of their insolvency, recovery of such assets might be subject to a delay (e.g., due to a counter-claim by a sub-custodian or due to record reconciliation issues, as we have seen in the case of LBIE) and at worst, the fund may rank as an unsecured creditor for those assets. Therefore it is important that the fund is able to obtain information from its prime broker as to the jurisdiction in which its assets are located and the identity of the sub-custodian holding them

(b) Rehypothecation in the U.K. — there is currently no regulatory limit on a U.K. prime broker's rehypothecation rights under a U.K. prime broker agreement. This means that if a contractual limit is not negotiated into a prime broker agreement with a U.K. prime broker, that such prime broker may have an unrestricted right to withdraw and transfer title to the majority or potentially all of the fund's non-cash assets. As in the U.S., the fund will be at risk of becoming an unsecured creditor in relation to the portion of assets withdrawn but not yet returned to the custody account upon the prime broker's insolvency. It is therefore highly important to negotiate a contractual rehypothecation limit in the prime brokerage agreement in the U.K. The advantage of a contractual rehypothecation limit is that an established manager might have sufficient negotiation leverage to agree to a low limit in its agreement thereby benefiting from a greater protection than it might have in relation to a non-U.K. prime broker. Conversely, a start-up fund with low negotiation leverage may not achieve a similar contractual rehypothecation limit

4. Account management

(a) Monitor account balances — require each prime broker to provide a daily account summary of assets in custody. For risk analysis purposes, such statement should identify at a minimum:

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[1] In the event of insolvency of the bank or trust company, the customer's securities would not be subject to the claims of other bank creditors and should be returned to customers. While securities properly identified in custodial accounts at banks should be deemed to be customer property and returned to customers, the FDIC (which governs bank liquidations), in view of its purpose to maximize the return of cash (not securities) to depositors, has broad powers as receiver or conservator

If a customer deposits securities in one or more custodial accounts at banks, the accounts should be clearly labeled. Nonetheless, there is a slight risk that such securities will be aggregated with other bank customers' securities, which could result in litigation regarding the treatment of such securities. Note, however, that cash held with the bank is not similarly protected. If a fund has deposited money with the bank (e.g., has excess cash balances arising from its securities transactions), these funds are at risk in the event of the bank's insolvency (to the extent the balance exceeds FDIC/FSLIC limits and there is not excess insurance in place)

[2] In the U.K., since title to rehypothecated assets is transferred to the prime broker, the fund would rank as an ordinary unsecured creditor with respect to its contractual claim for their return

(1) what assets are held by sub-custodians and agents; (2) the identity of each such sub-custodian and agent; (3) what assets are held directly with the prime broker; (4) what assets are held by affiliates of the prime broker; and (5) the identity of each such affiliate. The fund should be particularly aware of, and try to limit the following with respect to sub-custodians and agents: (1) cash held by U.S. banks (because cash in excess of FDIC limits is not protected); (2) cash and securities held by non-U.S. banks and trust companies (because such assets may not be protected under applicable law); and (3) cash and securities held by non-U.S. broker-dealers (because such assets may not be protected under applicable law). The fund should monitor its accounts on a daily basis to confirm the prime broker's compliance with applicable laws, rules, and regulations, as well as the prime broker agreement

(b) Minimize cash balances — under SIPA in the U.S., a client's net equity claim for cash will be recognized to the extent the cash is deposited for the purpose of purchasing securities. If cash in a client's account is deposited for another purpose, the client will only have a general unsecured claim to the cash, which could have a lower likelihood of recovery. The status of cash in a client's account will be a fact-based inquiry. Minimize cash balances in the prime broker account to avoid the risk of a court characterizing a claim to the cash as a general unsecured claim. To the extent cash is in the prime broker account, consider investing the cash in highly liquid, short-term securities (e.g., Treasury securities) that would be considered customer property subject to heightened liquidation priority in a liquidation proceeding. Alternatively, consider entering into a sweep agreement providing that cash would be regularly swept into highly liquid, short-term securities. In relation to a U.K. prime broker, the fund should note that its cash will be held by the prime broker in its general accounts and may be used by the prime broker in the ordinary course of its business. Additionally, cash transferred to the prime broker as collateral will not be subject to regulatory protections. In the event of the prime broker's insolvency, the fund will rank as an unsecured creditor in relation to the cash. The fund should therefore consider requiring, as a contractual obligation in its prime broker agreement that the prime broker holds its cash balances subject to the FSA's client money protections rules which means that cash must be deposited into a separate account and not mixed with the prime broker's own cash

III. Summary of the U.K. special administration regime

A. The SAR Regulations set out three special objectives for the special administrator under the new regime

1. Ensuring the return of client money or assets as soon as is reasonably practicable

2. Ensuring timely engagement with market infrastructure bodies and authorities such as The Bank of England, HM Treasury and the FSA

3. Either rescue the investment bank as a going concern, or wind it up in the best interest of the creditors

The U.K.'s FSA can, in certain circumstances, direct the administrator to prioritize one or more of the objectives, if it is necessary to do so in order to maintain public confidence in the stability of the financial markets in the U.K.

The SAR Regulations set out the means by which an administrator under the SAR may seek to achieve the above objectives. For example, the special administrator has the power to set a bar date for claims to client assets to help expedite the return of client assets. The SAR Regulations provide that where there is a shortfall in client assets which are held in an omnibus account, that shortfall will be shared pro rata between the clients claiming those assets. This avoids having to address complex issues under trust law as to the allocation of losses. The SAR Regulations also contain provisions relating to the continuity of supplies for a limited period so as to assure the administrator of continued access to key services such as data feeds, network services and the like, the absence of which might disrupt the identification and return of client assets

B. The SAR Rules supplement the SAR Regulations and set out some of the mechanics behind the SAR Regulations, such as who is entitled to attend creditors meetings (all clients of the investment bank, as a separate class of creditors, as well as all creditors in the ordinary course) and how they operate, and provide, among other things, that the costs of returning client assets will be paid for out of the client assets

IV. Summary of SIPC proceeding

A. Return of customer-name securities

The trustee will, as promptly as possible after the commencement of a SIPA proceeding, return all customer-name securities (i.e., securities held by the broker-dealer for the customer's account as of the date of the SIPA filing and which, as of the SIPA filing date, were registered or in the process of being registered in the name of the customer (not including securities registered in the name of the customer and in negotiable form)). As a practical matter, most securities are not customer-name securities, but are held by the broker-dealer in "street name"

B. Determination of net equity claim and pro rata distribution

1. From a customer's perspective during a SIPA liquidation, the critical determination is the customer's net equity claim. This is the net amount owed to a customer, excluding customer name securities, calculated by determining the net amount the broker-dealer owes to the customer (generally, the amount of cash and the value of securities held in the account minus any debit balances owed by the customer to the broker-dealer) as of the date that the SIPA liquidation commences

2. If the SIPA trustee determines that he or she does not have sufficient cash and/or securities to pay all net equity claims in full, then all holders of customer net equity claims will share pro rata in the aggregate pool of "customer property" held by the broker-dealer.

   "Customer property" means any cash and securities (except customer name securities delivered to the customer) at any time received, acquired, or held by or for the account of a debtor from or for the securities accounts of a customer, and the proceeds of any such property transferred by the debtor, including property unlawfully converted

C. SIPC fund distributions

If the customer's net equity claim still has not been satisfied in full after receiving customer-name securities and a pro rata share of customer property, the customer will be entitled to receive a distribution from the SIPC fund of up to $500,000, of which $100,000 may be compensation for a cash shortfall. If there is a shortfall in the securities owed to the customer, the SIPA trustee will try to purchase such securities for ultimate delivery to the customary, using SIPC funds, up to the statutory limit

The aggregate amount that the customer receives from the SIPC fund and his or her pro rata share of customer property may not exceed the customer's net equity claim

D. General creditor status

If a customer of a failed broker-dealer still is not whole after receiving customer name securities, sharing pro rata in customer property, receiving advances from the SIPC fund, and sharing in any recovery of transfers the SIPA trustee obtains, the customer becomes a general creditor of the broker-dealer

V. Pay to play laws

"Pay to play" legislation prohibits the giving of campaign contributions and related payments to certain state or local officials or candidates for their offices for purposes of influencing the awarding of government (typically pubic pension plan) advisory business

A. Overview

1. Rule 206(4)-5 issued by the Securities and Exchange Commission ("SEC Rule")

2. State and local pay to play laws

3. Pension plan internal pay to play procedures

B. SEC Rule

1. Limits on political contributions

(a) An adviser and its "covered associates" are prohibited from making "contributions" to any "official" with authority or influence regarding a public plan's selection of an adviser or investment pool

"Contributions" include a gift, subscription, loan, advance, deposit of money, or anything of value made for the purposes of influencing the election for a federal, state or local office, including any payments for debts incurred in such an election

(b) "Covered associates" are an adviser's general partner/managing member/executive officer, any other individuals with similar status or function, any employee who solicits public plan clients or investors and any person who supervises, directly or indirectly, such employee, and any political action committee ("PAC") controlled by the adviser or its covered associates

(c) The SEC Rule defines "official" for purposes of the triggering contribution provisions as "any person (including an election committee for the person) who was, at the time of the contribution, an incumbent, candidate or successful candidate for elective office of a government entity, if the office: (1) is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity; or (2) has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity

(d) The SEC Rule applies only to contributions made on or after March 14, 2011

2. Exception for covered associates only: covered associates may contribute up to $350 per election per candidate for whom the contributor is entitled to vote and up to $150 per election per candidate for whom the contributor is not entitled to vote without triggering the SEC Rule

3. Analysis of potential political contributions

(a) Office currently held by candidate

(b) Office candidate is running for

(c) Public plan board members

(d) Public plan "investment committee" members

(e) PAC which specifically supports any of the above

(f) State or local political party which specifically supports any of the above

4. Pre-clearance form example

(a) Have you[, your spouse or members of your immediate family][3] made any contributions to any

[3] The SEC Rule expressly references only the "covered associate" however, it also prohibits doing indirectly what you cannot do directly. Therefore, some firms also track the contributions of spouses and immediate family members

U.S. federal, state or local government elected officials (or candidates for such a position), state or local political parties or political action committees ("PACs") on or after ________. Yes ____ No ____

(b) If you answered *Yes*, please provide the following information:

(i) Name of elected official/candidate, state or local political party or PAC;

(ii) Office held (if applicable);

(iii) Office being sought (if applicable);

(iv) Amount contributed; and

(v) Date of contribution

5. Placement agents

(a) Advisers are prohibited from providing or agreeing to provide, directly or indirectly, "payment" to any third-party to solicit public plan clients for investment advisory services on its behalf, other than SEC-registered broker-dealers or advisers that are themselves subject to pay to play regulation ("regulated persons")

The SEC Rule defines "payment" as any gift, subscription, loan, advance, or deposit of money or anything of value

(b) The adviser's employees, general partner, managing member or executive officers are not included in such prohibition against hiring unregistered persons to solicit public plans

(c) The adviser will not be considered to have violated the SEC Rule for payments made to unregistered third-parties to solicit public plan business prior to June 13, 2012

6. Solicitation or coordination of contributions

(a) The adviser and its covered associates are prohibited from "soliciting" or organizing other persons or PACs to make contributions to officials in a position to influence the selection of the adviser, or to political parties in the state or locality where the adviser is providing or seeking public plan business

(b) The SEC Rule defines "soliciting" as any communicating, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment

7. Indirect attempts around the SEC Rule

(a) The adviser and its covered associates are prohibited from doing anything indirectly which, if done directly, would violate the SEC Rule

(b) The adviser and its covered associates are prohibited from using third-party solicitors, attorneys, family members or companies affiliated with the adviser to make contributions that would violate the SEC Rule

8. New hires or promotions

The adviser is prohibited from hiring a new employee or promoting an existing employee from non-covered to covered associate if the employee's job functions:

(a) Include solicitation of advisory business and such employee has made a prohibited contribution two years before being hired or promoted; or

(b) Do not include solicitation of advisory business and such employee has made a prohibited contribution within six months before being hired or promoted

9. Penalties: two-year time-out

   (a) If the adviser or any of its covered associates violate these political contribution prohibitions or limitations, the adviser will be prohibited from receiving compensation for advisory services from such public plan for two years after such prohibited contribution

   (b) The adviser may have a fiduciary duty to continue providing advisory services to the public plan until such time as the public plan is able to replace the adviser

10. Possible exceptions to the two-year time-out

   (a) If a covered associate has made a contribution that inadvertently triggered the two-year time-out and: (1) the contribution was $350 or less per election and was made to an official for whom the contributor was not entitled to vote; (2) the adviser discovered the contribution within four months of it having been made; and (3) within 60 days of discovery, the contributor obtained the return of the contribution

   (b) The adviser is prohibited from claiming this exemption more than two or three times per 12-month period, and no more than once for each covered associate regardless of time period. "Larger advisers," defined as any adviser who has reported in response to Item 5.A on its most recently-filed Form ADV, Part 1A that it has more than 50 employees, may claim the exception three times per 12-month period

   (c) The adviser will not be considered to have violated the SEC Rule if the SEC has waived the two-year time-out provision under circumstances where the adviser has discovered contributions after they were made and has provided persuasive objective evidence that no "pay to play" was intended

11. Record keeping requirements

   (a) The adviser is required to maintain records as to: (1) the names, titles, businesses and residential addresses of its covered associates; (2) contributions made by the adviser and its covered associates to government officials (including candidates), state or local political parties and PACs; and (3) public plan clients and investors in pooled investment vehicles to which the adviser has provided advisory services within the past five years

   The adviser is not required to look back for the five years prior to March 14, 2011 to identify former public plans the adviser has advised

   (b) The adviser is required to maintain records of the compensation that it has paid to SEC-registered broker-dealers and advisers, for the solicitation of public plan clients or public plan investors in pooled investment vehicles managed by the adviser

   The adviser is not required to keep records of the regulated persons that solicited government clients for investment advisory services on the adviser's behalf prior to June 13, 2012

12. Subadvisers

   (a) The SEC Rule's restrictions on political contributions also apply to contributions made by the adviser's subadvisers

   (b) However, a contribution by an adviser or subadviser that triggers the two-year time-out will not prevent the adviser or subadviser, as applicable, that did not make the contribution from receiving compensation, unless it was a means of doing indirectly what could not be done directly

13. Fund-of-funds

    (a) Advisers are not required to look through an investing fund unless the investment was made in that manner as a means for the adviser to do indirectly what it could not do directly

    (b) If, however, the investing fund is a fund-of-one or has a majority investor, in either case, that is a state plan with investment discretion, the adviser must treat the state plan as if it were a direct investor

C. State and local pay to play

1. General

    (a) In addition to the SEC Rule, the adviser must ensure it is in compliance with any laws, rules or regulations in the state or municipality in which a public plan is located

    (b) Potential considerations

        (i) Pay to play political contribution limitations (in addition to general contribution limitations) prior to, during and/or after the termination of the advisory contract, or during the term of the office holder

        (ii) General, contractor-specific or investment advisor-specific pay to play laws

        (iii) Placement agent restrictions, fee disclosure or contingent compensation prohibition

        (iv) Gift restrictions

        (v) Possible exceptions for request for proposals process

        (vi) Penalties

        (vii) Growing and changing legal climate

2. New York City pay to play — Local Law 34

    (a) Advisers soliciting or currently engaged in contracts with New York City, including contracts for investment advisory services, and certain covered persons are prohibited from giving contributions in excess of $400 to each candidate per year for city-wide races, $320 for borough-wide races, and $250 for city council races

    (b) Covered persons include principal officers (CEO, CFO and COO), individuals who own or control 10% or more of the contracting entity, and senior managers who have substantial discretion and high level oversight regarding the solicitation, letting or administration of any contract with New York City

3. Potential penalties

    (a) Fines and penalties

    (b) Criminal sanctions (including prosecution and jail terms)

    (c) Termination of advisory contract

    (d) Time-out period or permanent bar from future contracting

4. Comparison to SEC Rule

    (a) The SEC Rule may be more or less restrictive with respect to recipients, donors, contribution limits, look back periods and penalties

(b) Advisers must be in compliance with both federal and state or local pay to play laws and must follow the most restrictive requirements of the applicable laws

5. State plan internal policies

(a) The adviser must be in compliance with any internal guidelines or requirements of the public plan itself which relate to pay to play practices

(b) Many state plans provide for an outright ban on the use of third-party placement agents

6. CalPERS

Disclosure requirements

(a) Individuals or entities seeking an investment relationship with CalPERS must submit a written disclosure of any campaign contributions aggregating $250 or more and any gifts aggregating $50 or more in value that the individual or entity has made during the preceding calendar year to any CalPERS board member, officer or employee. The disclosure must be made before any transaction is considered

(b) Requires advisers to disclose any retention of placement agents, the compensation paid, the services performed, information about key employees of the placement agent, including whether they are registered lobbyists in any state or the federal government, and any other details about the engagement

(c) All placement agents hired by managers of CalPERS funds must be SEC or FINRA registered broker-dealers and registered lobbyists

D. Takeaway

Before pursuing the business of any state or local retirement plan, an analysis must be made with respect to the SEC Rule, the applicable state or local pay to play laws and the government plan's internal policies

VI. Recent U.S. insider trading investigations

A. Recent prosecutions

1. Galleon prosecutions are near completion

(a) Guilty pleas or cooperators versus trial defendants — clear demonstration of "trial penalty"

(b) Longer than 10-year sentences for main trial defendants are the longest in history for insider trading

(c) Remaining trial — Gupta

2. Expert networks cases — working up the food chain

(a) PGR consultants — completed

(b) Corporate insiders — completed

(c) Hedge fund analysts — started

(d) Hedge fund principals — open question

B. Aggressive investigatory tactics work

1. Wiretaps — recordings appear to have been the deciding factor for many of the *Raj* jurors

2. Search warrants and grand jury subpoenas

3. Use of cooperating witnesses

   (a) By the DOJ — bottom to top of pyramid

   (b) By the SEC — new authority

C. The prosecuted conduct is not the standard

1. Prosecutions to date involve egregious conduct or home run information

   (a) Material non-public information from corporate or temporary insiders about M&A transactions and earnings announcements

   (b) Much less egregious conduct raises civil, regulatory and even criminal liability risk

2. Prosecutors and regulators are not finished — less egregious conduct is likely to be prosecuted as well

D. Scrutiny of hedge funds will only increase

1. Hedge funds are inviting targets

2. Prosecutors emboldened by results/reactions, and civil/criminal investigations will increase

3. Areas likely to receive heightened scrutiny

   (a) Use of experts and consultants

   (b) Communications with suppliers, vendors, distributors and customers

   (c) Buy-side and sell-side communications

   (d) Investment banker meetings

   (e) Manipulative trading

E. The mosaic theory remains viable

1. Protects insight gained from piecing together disparate pieces of information *but* no tile in the mosaic can constitute material nonpublic information obtained in breach of duty

2. Public information

   (a) For information to be "public" it must be "widely disseminated" in the marketplace

   (b) Widespread rumors are not equivalent to credible data from an insider

   (c) Widespread awareness of information by other traders is not enough

3. Congress, courts and prosecutors recognize the importance of information gathering

   (a) "There is nothing inherently wrong or bad about hedge funds or expert networking firms or aggressive market research, for that matter." – Preet Bharara, U.S. Attorney, SDNY

   (b) "Analysts can provide a valuable service in sifting through and extracting information that would not be significant to the ordinary investors to reach material conclusions . . . . We do not intend, by Regulation FD, to discourage this sort of activity." (17 CFR 240, 243, and 249 (2000))

(c) "It is commonplace for analysts to 'ferret out and analyze information .... [A]nalysts remain free to obtain from management corporate information for purposes of "filling in the 'interstices in analysis'. . . ." (*SEC v. Dirks*, 463 U.S. 646, 658 & n. 17 (1983))

4. Distributor and supplier communications

(a) Mosaic theory should protect most supply chain communications, which serve a very useful purpose, but have their limits

(b) There is a large gap between some analysts' views and practices and regulators' view of the law of insider trading

(c) Retention of "expert consultants" does not mitigate problems

F. What are prosecutors looking for?

1. Are you paying for the information?

2. Are you contemplating an investment in the company where the contact works?

3. Is the contact likely breaching a duty to his employer or to a business partner?

4. What is the relationship between the contact and the public company?

5. Did the communication involve specific data or generalized statements regarding the business?

G. Key takeaway: compliance is critical

1. Legal and compliance must have a thorough ongoing understanding of

(a) The sources analysts use for research

(b) The nature of the information gathered from those sources

2. Effective compliance is the best way to minimize enterprise liability in this area

3. "I trust that many of you share the appreciation that, to be effective, compliance and ethics programs cannot exist in silos. Instead, I believe they need to be ingrained in the DNA of the organization and the decision-making framework of the organization. They need to be imbedded in the business process and at the table when strategic decisions are being made and new products are being developed. They need to be an integral part of performance measurement and management processes. And, they need to be part of the way business is done. After all, compliance programs and the work that you do every day add tremendous business value. They protect the business, they enhance the brand, they ensure that reputation is protected and that reputation risk is managed." – Carlo V. di Florio, Director, SEC Office of Compliance Inspections and Examinations

VII. U.K. insider trading and market abuse

A. Insider trading

1. Applicable law

(a) Insider trading is a criminal offense under Part V of the Criminal Justice Act 1993 ("CJA"). This implements the EU Insider Dealing Directive and so broadly similar provisions apply across the EU

(b) The enforcement agency is the U.K. financial regulator, the Financial Services Authority ("FSA"). The FSA also has power to prosecute the criminal offense of market manipulation under Section 397 of the Financial Services and Markets Act 2000 ("FSMA")

(c) Under Section 52 CJA, an offense is committed if:

  (i) An insider deals in price-affected securities when in possession of inside information;

  (ii) An insider encourages another to deal in price-affected securities when in possession of inside information;

  (iii) An insider discloses inside information otherwise than in the proper performance of his employment, office or profession

  The offense can only be committed by an individual but a company or other entity could be guilty of conspiracy or aiding and abetting an offense under CJA

(d) Under Section 57(1) CJA, a person has information as an insider if and only if it is, and he knows that it is, inside information and he has it, and he knows that he has it, from an inside source

(e) A person has information from an inside source if he has it through:

  (i) Being a director, employee or shareholder of an issuer of securities;

  (ii) Having access to the information by virtue of his employment, office or profession; or

  (iii) The direct or indirect source of his information is a person within (i) or (ii)

(f) Under Section 56(1) CJA, "inside information" means information which:

  (i) "Relates to particular securities or to [a] particular issuer[s] or securities and not to securities or issues of securities generally;

  (ii) Is specific or precise;

  (iii) Has not been made public; and

  (iv) If it were made public, would be likely to have a significant effect on the price of any securities"

(g) Section 58 CJA sets out a non-exhaustive list of what "made public" means; this includes information which can only be obtained if further steps are taken (e.g., the exercise of diligence or expertise or the payment of a fee)

(h) Part V CJA applies to shares, debt securities, warrants, depository receipts, options, futures and CFDs, which are listed, dealt or quoted on an EEA exchange or regulated market. There must, however, be a U.K. connection — either the offense was committed in the U.K. or the relevant market is in the U.K.

(i) Section 53 CJA provides various defenses

  (i) No expectation of profit

  (ii) Information widely enough disclosed

  (iii) No expectation of dealing (this only applies to the disclosing offense — see (c)(iii) above)

(j) There are additional defenses for market makers, for those with market information and for certain price stabilization activities

(k) Penalties on conviction of up to seven years in prison and/or unlimited fines

B. Enforcement

1. Since 2009, the FSA has secured 10 convictions for insider trading, with seven of those convicted as a result of providing inside information to a family member

2. The FSA has 16 additional prosecutions under way. Two high profile cases are due to commence in February and April. The biggest case has seven defendants, involved a 21-month investigation, 35 FSA investigators, the review of 200,000 files, 130 trading accounts and 250 written statements

3. In terms of gathering evidence, the FSA cannot use wire taps but

(a) All trades placed and received by a U.K.-authorized firm (i.e., including U.K. brokers) by phone must be recorded. Effective Nov. 14, 2011, this requirement extended to mobile phones. In practice, most firms record all calls. The FSA has access to these recordings

(b) All trades are entered (by market participants) into the FSA's transaction reporting system, ZEN, which monitors reports for suspicious transactions

(c) ARROW II visits, a type of regulatory audit, may include reviews of trading patterns and systems to monitor/detect insider trading

(d) With court consent, the FSA can conduct "dawn raids"

(e) The FSA has recently started cold calling traders and conducting telephone interviews with no notice

(f) Where a criminal prosecution is envisaged, the FSA will interview suspects "under caution" (i.e., a warning that anything they say may be used in evidence against them and that they cannot rely on anything they do not say). There is no protection from self-incrimination

(g) The FSA has limited powers to grant immunity from prosecution for cooperation and/or to plea bargain

C. Policies

1. In July 2007 and June 2008, the FSA published its findings from a thematic review it had undertaken in relation to insider dealing. Included with the latter were some principles developed by an industry working group. These are not FSA principles or formal guidance but are indicative of approved good practice. They cover

(a) Policies and procedures

(b) Awareness and training

(c) "Need to know" and other information needs

(d) Passing price sensitive information to third parties

(e) IT security

(f) Personal dealing policies

D. Market abuse

1. Applicable law

(a) Market abuse is a civil offense under Part VIII FSMA. This implements the EU Market Abuse Directive, albeit with additional, more onerous provisions, and so broadly similar provisions apply across the EU

(b) The civil market abuse regime is wider than the criminal insider dealing regime. Since 2008, however, the FSA has been committed to making greater use of its criminal prosecution powers so as to be a "credible deterrent"

(c) There are seven primary offenses under Section 118 FSMA

  (i) Insider dealing

  (ii) Tipping off

  (iii) Abuse of information

  (iv) Manipulating transactions

  (v) Manipulating devices

  (vi) Dissemination

  (vii) Misleading behavior and market distortion

(d) In addition to the primary offenses, there is a secondary offense of requiring or encouraging market abuse (Section 123 FSMA)

(e) The legislation covers transferable securities, units in collective investment undertakings, money market instruments, financial futures, forward interest rate agreements, interest rate, currency and equity swaps, options on any of the above and derivatives or commodities as well as certain related investments ((c)(i) and (ii) only) such as OTC swaps

(f) With the exception of OTC swaps (which must relate to one of the other investments), the investment must be admitted to trading on a prescribed market — any market operated by

  (i) London Stock Exchange (i.e., including AIM)

  (ii) LIFFE

  (iii) LME

  (iv) ICE

  (v) EDX

  (vi) PLUS Markets

(g) There are several safe harbors

  (i) Acting in compliance with other rules (e.g., the Takeover Code)

  (ii) Certain buy-back programs and financial stabilization

  (iii) Public authorities in respect of monetary or exchange rate policies

(h) Section 123 FSMA provides defenses

  (i) The relevant individual believed on reasonable grounds that his behavior did not amount to one of the primary offenses or the secondary offense

  (ii) The relevant individual took all reasonable precautions and exercised all due diligence to avoid engaging in one of the primary offenses or the secondary offense

(i) Under Section 119 FSMA, the FSA is required to issue a code providing guidance as to whether or not certain behavior constitutes market abuse. To the extent the Code describes behavior which, in the FSA's opinion, does not constitute market abuse, it is conclusive (i.e., no offense will have been committed)

2. Enforcement

(a) The FSA is the enforcement agency

(b) Although it is a civil offense, the standard of proof is higher than "on the balance of probabilities" and is closer to the criminal standard "beyond reasonable doubt"

(c) However, as a civil offense, the penalties do not include imprisonment. They are

(i) Unlimited financial penalty

(ii) Public censure

(iii) Restraining or freezing orders

(iv) Restitution

(v) Payment of compensation

3. Future developments

(a) In October 2011, the European Commission set out proposals to overhaul the pan-European market abuse regime. These will be implemented in a new Market Abuse Directive (which will need to be implemented into national laws) and a Market Abuse Regulation (which will have direct effect)

(b) Commodities and their related derivatives will be brought within the scope of the regime

(c) Regulators will be given new powers to obtain evidence

(d) Member states will be required to criminalize inciting, aiding and abetting insider dealing as well as insider dealing itself where there is evidence of intent

VIII. Market manipulation

A. General concepts

1. The federal securities laws contain a number of provisions designed to prohibit manipulative activity in the securities market

See, e.g., Section 17(a) of the Securities Act of 1933, and Sections 9, 10(b), and Rule 10b-5 promulgated thereunder, 14(e), 15(c)(1), and 15(c)(2) of the Securities Exchange Act of 1934

2. Definition of "manipulation"

(a) "Manipulation" generally refers to the intentional interference with the free market forces of supply and demand

(b) Courts frequently describe market manipulation as a "term of art" that is a short-hand description for "intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." *See, e.g.*, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976). Specifically, "[t]he gravamen of manipulation is deception of investors into believing that prices at which they purchase and sell securities are determined by the natural interplay of supply and demand, not rigged by manipulators." *Gurary v. Winehouse*, 290 F.3d 37, 45 (2d Cir. 1999)

Typical examples are so-called "wash sales" or "matched orders," trades that result in no real change in beneficial ownership of the securities in question

(c) The requirement that the conduct at issue be done with the requisite intent to control or artificially affect securities prices acts to narrow the category of conduct prohibited as manipulative. Specifically, a defendant's primary intent in entering into the transaction at issue must be price manipulation

See Schreiber v. Burlington Northern, Inc., 472 U.S. 1, 12-13 (1985); *Ernst & Ernst*, 425 U.S. at 199

(d) As a consequence, liability will not be imposed with respect to acts that have only the effect of manipulating the price of a security, but were not so specifically intended by a defendant

Nanopierce Technologies, Inc. v. Southridge Capital Mgmt. LLC, 2004 WL 2754653, 7 (S.D.N.Y. 2004); H.R. Rep. No. 1383, 73d Cong., (2d Sess. 1934) ("If a person is merely trying to acquire a large block of stock for investment, or desires to dispose of a big holding, his knowledge that in doing so he will effect the market price does not make his action unlawful."). In other words, activity done with a legitimate business or economic purpose will not be deemed manipulative, while the same activity performed with the specific intent to control or artificially affect the price of securities is prohibited. *See General Foods Corp. v. Brannan*, 170 F.2d 220, 231 (7th Cir. 1948); *Commodity Futures Trading Comm'n v. Enron Corp.*, 2004 U.S. Dist. LEXIS 28794, 16 (S.D. Tex. 2004) ("whenever a buyer . . . intentionally pays more than he has to for the purpose of causing the quoted price to be higher than it would otherwise have been . . . the resultant price is an artificial price not determined by the free forces of supply and demand . . . .") (quoting *In re Henner*, 30 A.D. 1151, 1198 (Agric. Dec. 1971)

B. Open market transactions

1. However, courts are split as to whether an arms-length transaction with an unaffiliated third-party constitutes manipulation based solely on the state of mind of the trader. In other words, some courts have found such transactions to be manipulative even in the absence of any affirmative false or misleading information being injected into the marketplace

Compare, *In re Amaranth*, 587 F. Supp. 2d 513, 534 (S.D.N.Y 2008) ("A legitimate transaction combined with an improper motive is commodities manipulation."); *SEC v. Kwak*, 2008 WL 410427 (D.Conn. Feb. 12, 2008) (purpose for trades was to prevent the stock from being delisted and/or to create an illusion that stock price was more stable than it really was.); *SEC v. Masri*, 523 F.Supp.2d 361 (S.D.N.Y. Nov. 20, 2007) (concluding that if a transaction would have been conducted for investment purposes or other economic reasons, and regardless of the manipulative purposes, then it can no longer be said that it is "artificially" affecting the price of the security. The trades must be executed with the sole intent to affect the price of securities and not for some investment purpose.), *with*, *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 205 (3rd Cir. 2001) (concluding that manipulative intent standing alone is not sufficient to render open-market transactions illegal)

2. The SEC has taken the position that open market transactions coupled with manipulative intent can give rise to Section 10(b) liability

See, e.g., *In re Koch*, Securities Exchange Act Release No. 64337 (April 25, 2011) (involving scheme to mark-the-close of certain thinly traded securities held in various accounts of investment adviser's clients); *In re Kirlin Securities Inc*., Securities Exchange Act of 1934, Rel. No. 61135 (Dec. 10, 2009) (Commission noted that it "has consistently held that an applicant's scienter renders his interference with the market illegal"); *In re Newbridge*, Administrative Proceeding before the SEC, No. 380, File No. 3-13099 (June 9, 2009) (SEC stated that "a finding of manipulation does not depend on the presence or absence of any particular device usually associated with a manipulative scheme.); *SEC v. Georgiou*, 09-cv-616 (E.D.Penn. Feb. 12, 2009) (alleging that "marking-the-close" is a form of market manipulation that involves attempting to influence the closing price of a security by executing purchase or sale orders at or near the close of normal trading hours)

C. Takeaways

1. Trading strategies that impact price may draw regulatory scrutiny
2. GC/CCO must become familiar with trading patterns of their respective firms
3. Training investment professionals is critical

Compliance Spotlight

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David has spoken and written widely on ERISA and benefit fund-related issues, including authoring ERISA compliance guides for broker-dealers for Practising Law Institute and recently presenting “Handling ERISA Issues When Managing a Plan Asset Look-Through Fund” at Financial Research Associates’ 13th Annual Effective Hedge Fund Tax Practices Conference. In recognition of his accomplishments, he was selected for inclusion in *The Best Lawyers in America* and in *New York Super Lawyers*, a listing of outstanding attorneys in the New York metro area.

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).

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In addition to compliance counseling and regulatory representation, Ida is an active speaker and writer, most recently co-authoring the chapter "Protecting Your Firm Through Policies and Procedures, Training and Testing" from the *Insider Trading Law and Compliance Answer Book*, published by Practising Law Institute. She also recently authored the "Trade Reporting and Compliance" chapter in Complinet's *Practitioner's Guide for Broker-Dealers*, and discussed "Proposed CFTC Filing Requirements" at the Hedge Fund CFO Association Membership Meeting.

Ida has experienced securities regulation from both sides. After several years as a securities litigation associate with a Wall Street law firm, Ida joined the SEC, first serving as staff attorney in the Division of Enforcement and then as special counsel to SEC Chairman John Shad. Ida has been a member of the FINRA Board of Arbitrators and Board of Mediators and, for 10 years (ending January 2009), served as a member of the Nasdaq Listing Qualifications Panel. She is also a former Chair of the Corporation, Finance and Securities Law Section of the District of Columbia Bar and is recognized by *The Best Lawyers in America* in the area of securities law.

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Recently, Marc has been leading 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. He also regularly leads training sessions for portfolio managers and analysts on complying with insider trading and market manipulation laws.

Marc is a frequent speaker at hedge fund industry conferences and seminars and recently discussed "New Regulatory Filing Requirements" at the Goldman Sachs Annual Hedge Fund Conference, "Identifying and Addressing Conflicts of Interest" at the ACA's Compliance Group Fall Compliance Conference, and "New Registration Rules Applicable to PE and VC Managers" at the American Bar Association's Annual Meeting. He wrote the chapter on "The Legal Basis of Investment Management in the U.S." for the Oxford University Press book *The Law of Investment Management* and co-authored the chapter on "Market Manipulation" in the Matthew Bender treatise *The Securities Exchange Act of 1934*. In addition, he recently co-authored a chapter on "Protecting Your Firm Through Policies and Procedures, Training and Testing" for the *Insider Trading Law and Compliance Answer Book*, published by Practising Law Institute.

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- Securities Enforcement & White Collar Defense

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David K. Momborquette is a partner at Schulte Roth & Zabel, where his practice focuses on complex commercial litigation and regulatory matters primarily for financial services industry clients, including hedge funds, funds of funds and private equity funds. David has substantial experience in both private securities litigation and securities regulatory matters, including class action litigation and investor disputes, as well as investigations by the SEC, the NYSE, FINRA and state attorneys general offices.

David's recent representations include representing an inter-dealer broker in certain arbitrations and related civil actions arising from the hiring of brokers by a competitor, representing an investment manager in connection with a fund wind-down and related regulatory and investor disputes, representing an investment fund in connection with a civil action seeking to enjoin proxy solicitation, counseling a private equity fund in connection with a shareholder action brought to enjoin a proposed merger and counseling a securities firm in connection with a civil action arising from the hiring of a CDO group.

David has written extensively on securities regulation and frequently presents on regulatory compliance and enforcement issues. He recently spoke on "New Whistleblower Rules: The Impact on Fund Managers" at SRZ's Investment Management Hot Topics and discussed "Rule 13h-1 and Form 13H" at Goldman Sachs' Prime Brokerage Regulatory Reporting Overview. He also recently authored the chapter "Big Boy Letters" in the *Insider Trading Law and Compliance Answer Book*, published by Practising Law Institute.

David earned his B.A. from Boston University and was awarded his J.D. from Boston University School of Law, where he was notes editor of the *Boston University Law Review*, a G. Joseph Tauro Scholar and an Edward F. Hennessey Scholar.

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Practices

Financial Institutions

Hedge Funds

Investment Management

Regulatory & Compliance

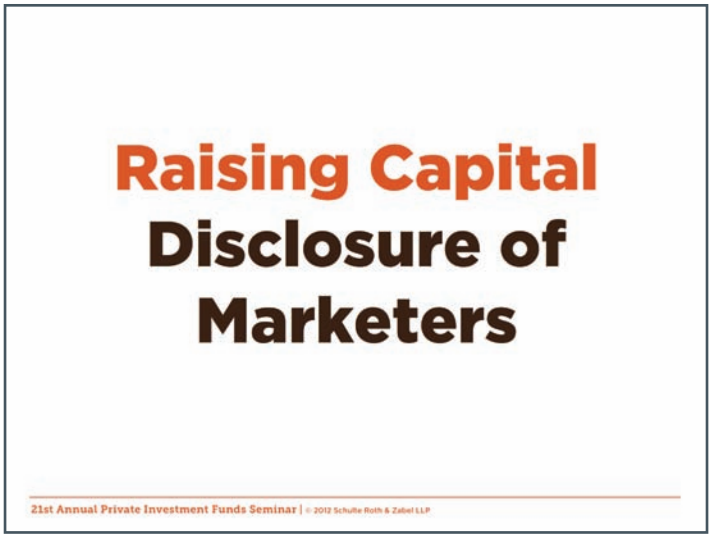
Neil Robson

Neil Robson, a senior associate at Schulte Roth & Zabel, has extensive experience providing regulatory advice to funds and managers regarding Financial Services Authority (FSA) authorization and compliance; cross-border issues in the financial services sector, market abuse, anti-money laundering and regulatory capital requirements; formations and buyouts of financial services groups and structuring and marketing of investment funds; agreements with customers, custodians and service providers; and outsourcing arrangements. Neil provides non-contentious regulatory advice and assistance to banking, investment management, brokerage and other clients to ensure that they remain compliant with FSA rules and U.K. regulation. He also advises on a wide range of other U.K. financial services regulatory and M&A matters.

Neil is a frequent writer, co-authoring "The Impact of Asymmetric Information, Trade Documentation, Form of Transfer and Additional Terms of Trade on Hedge Funds' Trade Risk in European Secondary Loans" for *The Hedge Fund Law Report* and "Proposed Changes to Europe's Derivatives Regulatory Structure: EMIR & MiFID II" for *Bloomberg Law Reports — UK Financial Services Law*. He speaks frequently at conferences attended by attorneys and financial services professionals on developments in U.K. financial services regulation, including MiFID, short selling and market abuse. He recently presented "Distressed Investing: European Bank Debt and Claims — Before You Say 'Done'" at an SRZ conference and participated in an SRZ webinar titled "Update on UK and US Insider Trading."

Neil graduated from BPP Law School and earned an M.A. and B.A. from University College London, as well as a diploma from Birkbeck College at the University of London.

Compliance Spotlight



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Raising Capital
SEC Focus on Materials

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Insider Trading
Industry Response

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Counting
Still Important

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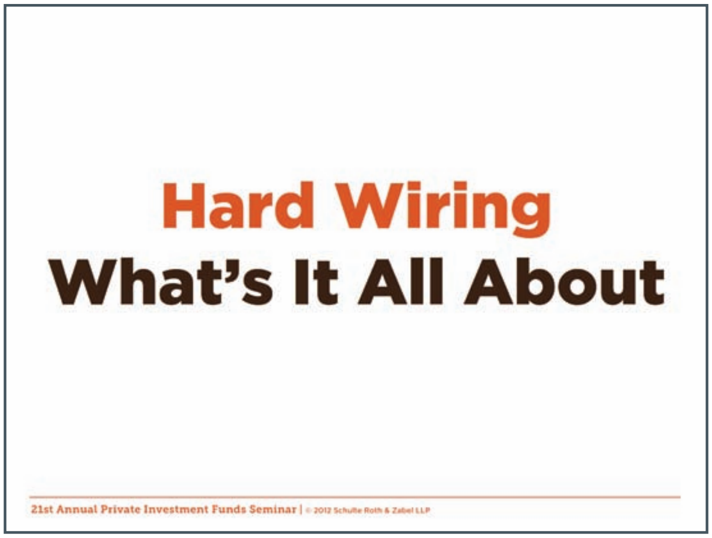

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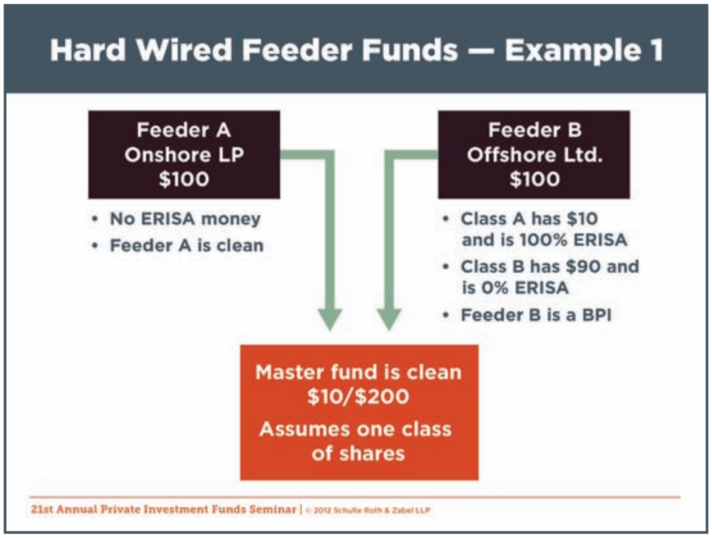

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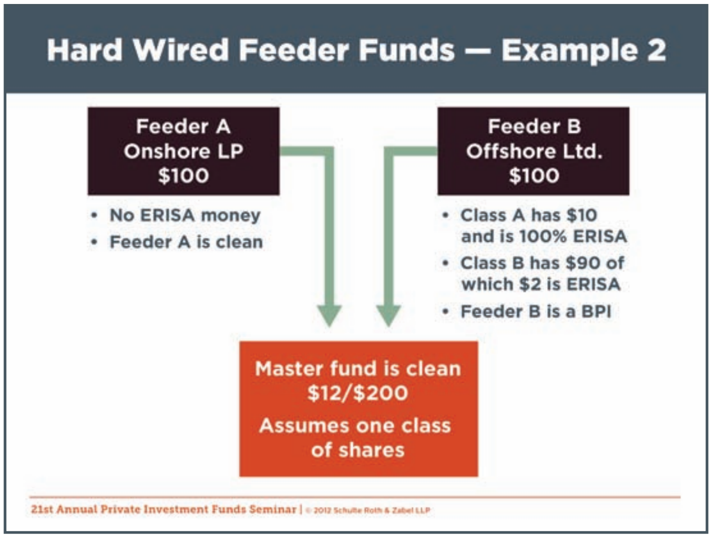

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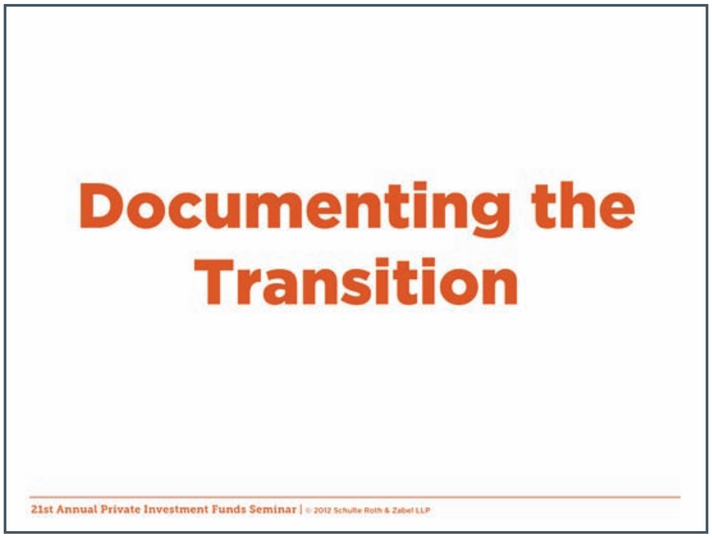

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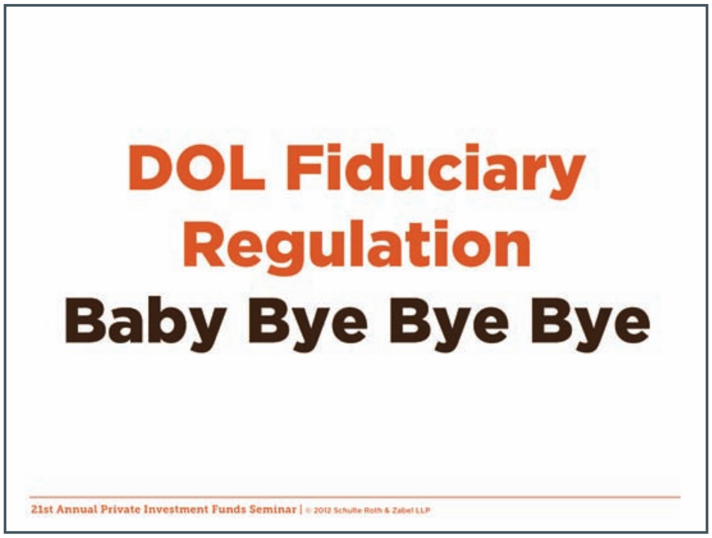

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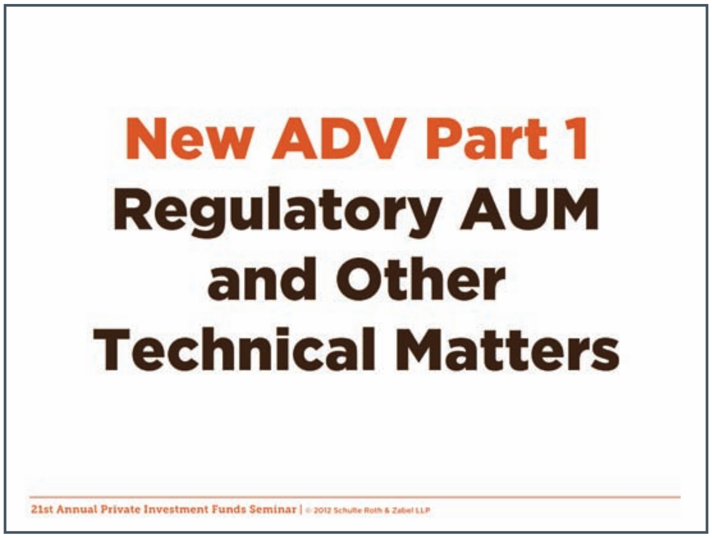

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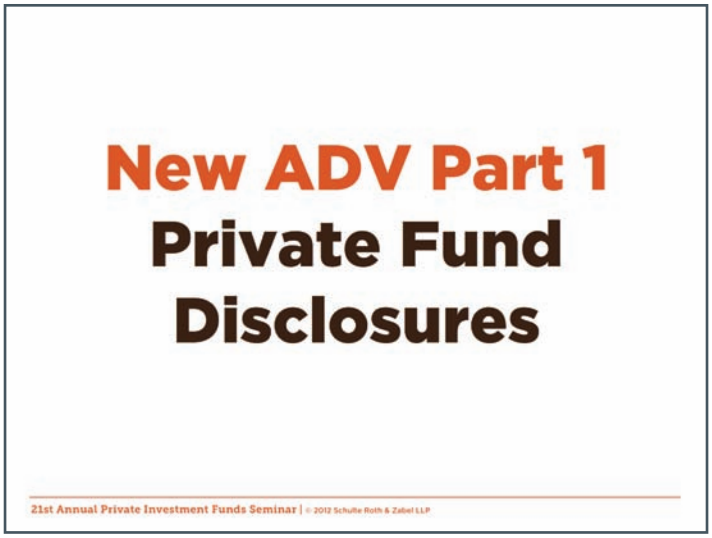

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Compliance Spotlight

I. Raising capital in today's regulatory environment

A. New disclosures regarding marketers

1. New Form ADV questions

Form ADV now requires that SEC-registered advisers publicly disclose whether they have made Regulation D filings with respect to the offering of private fund investment units, the identity of third parties that are used to market their private funds, where such marketers are located and whether they are registered with any regulatory authority

Part 1A, Schedule D, Section 7B

Private offering

21. Does the private fund rely on an exemption from registration of its securities under Regulation D of the Securities Act of 1933?

22. If yes, provide the private fund's Form D file number (if any)

Marketers

28. (a) Does the private fund use the services of someone other than you or your employees for marketing purposes?

You must answer "yes" whether the person acts as a placement agent, consultant, finder, introducer, municipal advisor or other solicitor, or similar person

If the answer to 28(a) is "yes," respond to questions (b) through (g) below for each such marketer the private fund uses. If the private fund uses more than one marketer, you must complete questions (b) through (g) separately for each marketer

(b) Is the marketer a related person of your firm?

(c) Name of the marketer: ______________________________

(d) If the marketer is registered with the SEC, its file number (e.g., 801-, 8-, or 866-): _____________ *and CRD Number (if any)* ______________

(e) Location of the marketer's office used principally by the private fund (city, state and country):
____

(f) Does the marketer market the private fund through one or more websites?

(g) If the answer to 28(f) is "yes," list the website address(es): _________________

Part 2A, Item 14B:[1]

Item 14 client referrals and other compensation

B. If you or a related person directly or indirectly compensates any person who is not your supervised person for client referrals, describe the arrangement and the compensation

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[1] Item 14 specifically references "clients" as opposed to "investors" and hence appears to require disclosure of the terms of arrangements with solicitvors of separately managed accounts, but not arrangements with placement agents for private fund units

Note: If you compensate any person for client referrals, you should consider whether SEC rule 206(4)-3 or similar state rules regarding solicitation arrangements and/or state rules requiring registration of investment adviser representatives apply

2. Lobbyist registration and reporting

   (a) California

      (i) Registration — advisers and employees of an adviser who solicit California plan business are required to register within 10 days of qualifying as such

         (1) A "lobbyist" is: (1) any individual who receives $2,000 or more in economic consideration in a calendar month, other than reimbursement for reasonable travel expenses, or whose principal duties as an employee are, to communicate directly with any elective state official or state plan official for the purpose of influencing the award of state plan advisory business; and (2) a placement agent

      (ii) Reporting — lobbyists must file quarterly reports disclosing information on lobbying efforts and lobbing expenses

      (iii) Training — lobbyists must complete ethics training within 12 months of registration

      (iv) Two possible exemptions to registration

         (1) The "one-third exception" — an individual who is an employee, officer, director, equity-holder, partner, member, or trustee of an external manager and who spends one-third or more of his or her time, during a calendar year, managing the securities or assets owned, controlled, invested, or held by the external manager. Portfolio managers can often fall under this exception

         (2) The "competitive exception" — this exception is for employees, officers, or directors of an adviser, or of an affiliate of the adviser, if the adviser: (1) is registered as an investment adviser or broker-dealer with the SEC (or if exempt from SEC registration is registered with appropriate state regulator); (2) was selected through competitive bidding process; and (3) has agreed to a fiduciary standard of care. With respect to clause (2), SRZ understands that the "competitive bidding process" element is narrowly construed to apply only where a formal RFP has been issued by the public plan

      (v) Under the California lobbying laws, individuals and entities soliciting business from local plans are required to comply with any applicable requirements imposed by the plan's local government. Numerous California cities and counties have their own set of lobbying laws (e.g., Los Angeles, San Francisco, San Diego)

   (b) New York City

      (i) (Registration — requires placement agents (including registered broker dealers), other third parties, advisers and their employees who attempt to influence investment decisions made by New York City pension plans to register as lobbyists if marketing compensation and expenditures attributable to solicitation of such plans is expected to exceed $2,000 in the coming year. Registration is required by Dec. 15 of the present year if compensation and/or expenditures for lobbying in the coming year are expected to exceed $2,000. In all other cases a lobbyist must file within 15 days of being retained, but no later than 10 days from actually incurring or receiving reportable compensation and expenses

      (ii) Reporting — lobbyists must submit bi-monthly reports disclosing the compensation and expenditures made for lobbying activities during the reporting period, as well as one annual report summarizing all such information for the reporting year

(iii) Any person soliciting New York City retirement plan business must also register under New York state's lobbyist registration system

(iv) There are no similar California exceptions

(c) New York state

(i) Registration — requires placement agents, other third parties and adviser employees who attempt to influence investment decisions made by New York state or local pension plans to register as lobbyists if marketing compensation and expenditures attributable to solicitation of such plans is expected to exceed $5,000 in the coming year. Advisers are registered as clients or principal lobbyists

(ii) Reporting — lobbyists must submit bi-monthly reports disclosing the compensation and expenditures made for lobbying activities during the reporting period. Advisers must submit semi-annual reports

(iii) There are no similar California exceptions

B. Increased regulation of marketing arrangements

1. SEC Rule: Section 275.206(4)-5 (political contributions by certain investment advisers)[2]

(a) Prohibitions — as a means reasonably designed to prevent fraudulent, deceptive or manipulative acts, practices, or courses of business within the meaning of Section 206(4) of the Act (15 U.S.C. § 80b-6(4)), it shall be unlawful

(i) For any investment adviser registered (or required to be registered) with the Commission, or unregistered in reliance on the exemption available under Section 203(b)(3) of the Advisers Act (15 U.S.C. § 80b-3(b)(3)) or any of the investment adviser's covered associates:

To provide or agree to provide, directly or indirectly payment to any person to solicit a government entity for investment advisory services on behalf of such investment adviser unless such person is a regulated person or is an executive officer, general partner, managing member (or, in each case, a person with a similar status or function), or employee of the investment adviser

(b) Definitions — for purposes of this section

(i) Regulated person means

(1) An investment adviser registered with the Commission that has not, and whose covered associates have not, within two years of soliciting a government entity:

a. Made a contribution to an official of that government entity, other than as described in paragraph (b)(1) of this section; and

b. Coordinated or solicited any person or political action committee to make any contribution or payment described in paragraphs (a)(2)(ii)(A) and (B) of this section

(2) A "broker," as defined in Section 3(a)(4) of the Securities Exchange Act of 1934 (15 U.S.C. § 78c(a)(4)) or a "dealer," as defined in Section 3(a)(5) of that Act (15 U.S.C. § 78c(a)(5)), that is registered with the commission, and is a member of a national securities association registered under Section 15A of that Act (15 U.S.C. § 78o-3), provided that:

[2] The prohibitions relating to regulated persons will become effective on June 13, 2012

a. The rules of the association prohibit members from engaging in distribution or solicitation activities if certain political contributions have been made; and

b. The commission, by order, finds that such rules impose substantially equivalent or more stringent restrictions on broker-dealers than this section imposes on investment advisers and that such rules are consistent with the objectives of this section

(3) A "municipal advisor" registered with the Commission under Section 15B of the Exchange Act and subject to rules of the Municipal Securities Rulemaking Board, provided that:

a. Such rules prohibit municipal advisors from engaging in distribution or solicitation activities if certain political contributions have been made; and

b. The Commission, by order, finds that such rules impose substantially equivalent or more stringent restrictions on municipal advisors than this section imposes on investment advisers and that such rules are consistent with the objectives of this section

2. Restrictions and prohibitions on payment of contingent compensation[3]

(a) California state lobbyist regulations

Section 86205(f) of the California Political Reform Act of 1974

"No lobbyist or lobbying firm shall accept or agree to accept any payment in any way contingent upon the defeat, enactment, or outcome of any proposed legislative or administrative action"

(b) New York City lobbyist regulations

New York City Administrative Code, Title 3 Elected Officials, Chapter 2 City Council and City Clerk, Subchapter 2 Regulation of Lobbying Section 3-218 Contingent Retainer — no client shall retain or employ any lobbyist for compensation, the rate or amount of which compensation in whole or part is contingent or dependent upon legislative, executive or administrative action where efforts by a lobbyist to influence such action are subject to the jurisdiction of the city clerk, and no person shall accept such a retainer or employment

3. Renewed focus on marketing materials and disclosure

(a) *In the Matter of Aletheia Research and Management, Inc. et al.* (Admin. Proc. File No. 3-14374 (May 9, 2011))

In this settled SEC proceeding, a registered adviser and its two principals were alleged, *inter alia*, to have disseminated proposals ("RFP responses") to clients and potential clients, over a several-year period, that failed to disclose material information regarding prior SEC examinations and deficiency letters. The adviser was fined $200,000 and each principal was fined $100,000

The SEC alleged that in 10 RFPs, between 2005 and 2008, clients and prospective clients asked whether Aletheia had had any "findings," "deficiencies" or "corrective actions required" in connection with SEC examinations. In response, Aletheia either: (1) stated that "there were no significant findings" in its most recent SEC examination; (2) did not answer the question; (3) referred to its affiliated broker-dealer ("ASI") when answering the question in the negative; or (4) provided a copy of the deficiency letter and reply for ASI rather than for Aletheia

The SEC found that Aletheia's responses were materially misleading in that as of its 2005 SEC examination, Aletheia received a seven-page letter reporting six deficiencies and that its principals

[3] The regulations in this section are provided as examples of bans on contingent compensation and do not purport to be a comprehensive list of all state or local bans of a similar type

knew or should have known of the examination results and the abovementioned RFP responses. The SEC further found that Aletheia violated the antifraud provisions of the Advisers Act and that its principals aided and abetted those violations

(b) *Axa Rosenberg Group, LLC, et al.* (Admin. Proc. File No. 3-14224 (Feb. 3, 2011))

In this settled SEC proceeding, two affiliated registered investment advisers specializing in quantitative investment strategies were alleged to have concealed from potential and existing managed account clients a material error in the computer code underlying the advisers' portfolio risk management controls. The advisers were ordered to pay approximately $216.8 million to compensate clients for losses incurred by them during the period that the computer code was malfunctioning, to retain an independent compliance consultant to review various aspects of their compliance program, including their disclosures relating to the abovementioned computer code, and to pay a $25 million civil penalty

The SEC alleged that in mid 2009, an employee discovered a malfunction in the operation of the advisers' risk model — one of three components of their flagship quantitative strategy, and informed a senior official and other employees. For several months, the senior official allegedly concealed the malfunction from the advisers' global chief investment officer ("CIO"), chief executive officer ("CEO") and board of directors, as well as clients who expressed concerns relating to the performance of their accounts. After disclosure to the CIO, CEO and board in late 2009, the advisers commenced an internal investigation and then contacted the SEC. Clients were informed of the malfunction in April 2010. The SEC found that after discovery of the malfunction in June 2009, the advisers made material misrepresentations and omissions in communications with and presentations to clients concerning the reasons for the underperformance of their portfolios and also concerning the advisers' internal control processes and procedures. The SEC found that the advisers thereby violated the antifraud provisions of the Securities Act and Advisers Act, as well as the Compliance Rule, 206(4)-7

II. AIFM Directive update

A. Recap

1. The Alternative Investment Fund Manager's Directive is a new EU law that will become applicable in all 27 countries of the EU from July 22, 2013

2. The AIFM Directive will regulate

(a) All EU-based managers of alternative investment funds ("AIFs")

(b) Any non-EU manager managing an EU AIF

(c) Any non-EU manager (including U.S. advisers) marketing a non-EU AIF into the EU

B. Current state of play

1. July 1, 2011 — final text of Level 1 Directive published

2. July 2011 — European Commission ("Commission") requests technical guidance on Level 2 Measures from European Securities and Markets Authority ("ESMA")

3. Nov. 16, 2011 — ESMA publishes technical guidance (part one of two)

4. Now — Commission assessing ESMA technical guidance, and ESMA drafting part two of the guidance

5. Expected July 2012 — Commission to publish finalized Level 2 Measures

6. Between July 2012 and July 2013 — national governments and national regulators to implement Level 1 Directive and Level 2 Measures into national law of each EU country

7. July 22, 2013 — AIFM Directive comes into force across EU

C. Marketing rules from July 22, 2013

1. At present — national private placement rules and exemptions (“NPPRs”) must be used

2. From 2013 to 2015

(a) NPPRs must be used

(b) Cooperation and information-sharing agreement must exist between the SEC and the regulator of the EU country into which the marketing is to take place

(c) The third country where the fund is established must not be listed as a non-cooperative state by the Financial Action Task Force

(d) The fund must publish an annual report and make the appropriate disclosures to investors and regulators, as is required by the AIFM Directive (the three together, the “third country requirements”)

3. From 2015 to 2018, either:

(a) NPPRs must be used, and the third country requirements must be satisfied; or

(b) The U.S. adviser becomes registered with or authorized by the regulator of the EU country in which it intends to conduct the majority of its marketing and can thereby gain a pan-European passport; the U.S. adviser would have to comply with the full AIFM Directive regime; the third country requirements must be satisfied; and the third country where the fund is established must have signed an agreement with the EU country where the marketing is to take place as regards the sharing of information for tax matters

4. From 2018 there is potential for the NPPRs to be abolished, leaving only the registration and passport regime as the sole option for non-EU advisers to market their fund(s) into the EU

III. Insider Trading

A. Regulatory environment one year ago

1. Criminal prosecutions arising from the use of paid consultants

2. SEC investigations arising from the use of paid consultants

3. Negative press coverage

4. Investor redemptions

5. General confusion in industry as to where the line is between permissible and impermissible conduct

B. Industry response: both positive and negative

1. Some firms eliminated use of paid consultants altogether

2. Most firms conducted a critical review of their use of paid consultants

(a) Strengthened applicable policies and procedures

(b) Revised firm’s policies regarding disclosure of regulatory inquiries

(c) Expanded compliance training

3. Other firms misinterpreted the Galleon prosecutions

   The lesson is not to simply compare your conduct to Raj's and the other co-conspirators — much less egregious conduct still raises civil, regulator and even criminal liability

4. Some firms did nothing at all

C. Areas of improvement

1. Monitoring for compliance with policies and procedures, especially with respect to the handling of confidential information

   (a) How do you know that employees are complying with the applicable rules and regulations?

   (b) Standard is not strict liability, but rather, reasonableness

2. Channel checking activity

   (a) Large gap between industry practice and regulators' view of the law in this area

   (b) Some wrongly assume that such activity does not raise insider trading risks

   (c) Some wrongly assume that you can use paid consultant to obtain information from distributors or suppliers that you could not obtain directly yourself

3. Mosaic theory

   (a) The mosaic theory is still a viable doctrine

   (b) However, while the mosaic theory protects your insight, it will not permit you to trade while aware of MNPI simply because you have performed a lot of other legitimate information gathering and analysis

4. Subscription services

   Raises compliance issues similar to the ones raised in use of paid consultants and channel checking

5. Personal securities transaction reporting

   (a) Most managers have some sort of written policy requiring reporting of personal securities transactions and submission of a "negative report" if no personal securities transactions occurred during relevant period

   (b) Some managers are lax in enforcing these reporting requirements

   (c) Other managers are not adequately documenting that they have received the necessary information

6. Preclearance requirements

   (a) Rule 204A-1(c) of the Investment Adviser Act requires that registered investment advisers' code of ethics include procedures for an access person to obtain pre-approval for the acquisition of a beneficial ownership in any security purchased in an IPO or in a limited offering

   (b) Some firms require preapproval of all personal trades

(c) Similar to the enforcement of personal securities transaction reporting requirements, some managers are lax in enforcing preclearance requirements and/or adequately documenting enforcement of such rules

7. Restricted lists

(a) Although no formal rule or regulation mandates the maintenance of a restricted list, best practice is to maintain both a restricted and watch/gray list

(b) Some managers do not keep their restricted list up to date — tendency is to keep securities on list longer than is necessary and sometimes even after trading in such securities has been approved and
is occurring

(c) Some managers do not provide enough detail regarding the reason that a stock has gone on the restricted list and/or reason it has come off the restricted list

(d) Some managers also are inconsistent with respect to when such lists are distributed internally

D. Looking over the horizon

1. Scrutiny of hedge funds will continue

2. Areas likely to receive heightened scrutiny

(a) Use of experts and consultants will continue

(b) Communications with suppliers, vendors, distributors and customers

(c) Communications with congressional staffers and agency employees

(d) Buy-side communications

(e) Sell-side communications

(f) Meetings with investment bankers

(g) Manipulative trading

IV. Short-selling in the EU

A. Pan-EU short-selling regulation

1. New harmonized and unified pan-European short-selling regime expected to come into force on Nov. 1, 2012. Short-selling rules will be the same in all EU countries

2. Disclosure requirements would be the same as those already in France and Italy etc., requiring the holder of a net short position in a European listed stock exceeding 0.2% of the relevant company's capital to report that position to the regulator with further disclosures at additional 0.1% thresholds. The regulator will make the report public where the position exceeds 0.5%. Downward disclosures also required when a net short position is decreasing

3. National regulators will still be permitted to impose a short-term ban on short-selling in domestic markets, but would significantly also give the European Securities and Markets Authority ("ESMA") the power to impose a ban on short-selling across the whole of the EU

4. The new regime will also prohibit the holding of naked sovereign credit default swaps — meaning that

any person entering into an EU sovereign debt CDS must, at the time of entering into the agreement, have either secured the sovereign debt or have entered into an agreement to do so

B. Short-selling bans in France, Belgium, Italy and Spain

1. Bans imposed by the regulators in each country on Aug. 11 2011 and extended to date

2. Bans relate to banks listed on the exchanges in those countries

(a) The use of derivatives to create a net short position, a synthetic short, is prohibited and derivatives may only be used to hedge, create or extend a net long position

(b) Existing net short positions (as of Aug. 11, 2011) were not affected; however, if a net short position increases as a result of the variation in volatility, action must be taken before the end of day to reduce any such exposure

(c) Investors exposed to the equity market are permitted to hedge their general market risk by trading in index derivatives. However, trading in index derivatives (or shorting an index containing bank stocks (such as Euro Stoxx 50)) for any purpose other than hedging general market risk is not allowed unless the resulting short positions in the securities concerned are offset by long positions (i.e., there would not be a new net short position)

C. Disclosure regimes

1. Germany, France, Italy and Spain require the holder of a net short position exceeding 0.2% of the French, Italian, Spanish listed company's capital to report that position to the regulator with additional disclosures at 0.3% and 0.4%. Further disclosures are required at every 0.1% threshold thereafter, but any disclosures at 0.5% or greater will be made public on the regulator's website. Downward disclosures are also required when a net short position is decreasing

2. Belgium has the same disclosure requirements as France, Italy and Spain, but the initial disclosure threshold is at 0.25%

3. Greece prohibits the short-selling of all securities listed on the Athens exchange, however, obtaining or increasing short exposure to Greek listed institutions through listed or OTC derivatives is expressly not prohibited

4. The U.K. has no prohibition on short-selling in place. However, the FSA already has a disclosure regime for net short positions of 0.25% or greater in U.K. financial sector companies (and U.K. companies undertaking rights issues). Further disclosures are required at every 0.1% thereafter, with downward disclosures also required when a net short position is decreasing. All U.K. disclosures are currently public

V. ERISA

A. Counting plan assets

1. Counting is still very important, particularly if the manager wants its fund to remain a non-plan asset fund

2. Counting is a manager responsibility — outsourcing does not provide any protection to the manager

3. If counting is outsourced and mistakes are made (which happens regularly) and the fund breaches the 25% limitation, the manager is now running a plan asset fund and assumes all the responsibilities and liabilities that go along with this new state of facts

4. Counting fund-of-funds — proportionate vs. all or nothing. The failure to count by proportions often result in overcounting plan assets and the rejection of subscriptions that could be taken without any problem

5. The rules require excluding manager and manager affiliate money — but it is not just the GP and employee money that is excluded

6. Manager X manages hedge fund A and invests a portion of its assets in hedge fund B, which is also managed by manager X. When hedge fund B does its own 25% count, it has to exclude the investment from hedge fund A, unless hedge fund A is a plan asset fund. If hedge fund A is a plan asset fund, that proportion that is plan assets counts as "bad" money, and the rest is excluded

7. The exception to excluding GP money — employee and partner individual retirement account money is always counted and it is "bad" money

8. Still no definition of class — at SRZ we tend to look to local law to determine what is a class

B. Hard wiring feeder funds into master funds

1. The most common method in attempting to capture more plan assets while avoiding running a plan asset fund

2. While we have no confirmation from the DOL that this methodology works, it's accepted in the industry, and is generally accepted by pension plans and fund-of-fund managers that manage plan asset fund-of-funds

3. It's not correct to say that an over 25% feeder fund is not a plan asset fund. Rather, the analysis is that the "manager" of the feeder fund is not acting in a fiduciary capacity in moving the feeder fund's assets to the master fund

4. All of the "manager's" functions at the feeder fund are basically non-discretionary or ministerial in nature

C. Increasing ERISA capacity while trying to avoid plan asset look-through status — "the hard wired feeder concept"

1. 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 2008 and the 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% 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

2. 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

3. 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% 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% 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 fund 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% 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

4. 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 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

5. 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)

6. 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

7. 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% limit as long as the master fund is kept under 25% 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-fund's 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% 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% 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

D. New DOL Rules

1. New ERISA Section 408(b)(2) regulations may become effective this year that govern the receipt of compensation
2. The DOL issued "interim" final regulations implementing the statutory prohibited transaction exemption that allows pension plan investment managers to be paid
3. The interim final regulation has no impact on non-plan asset funds, but will impact plan asset funds
4. The "final" final regulation was supposed to have been issued "any day now"
5. The "final" final regulation appear to been held up at the White House — it is not clear why
6. The proposed effective date for the "final" final regulation is April 1, 2012, if they ever see the light of day
7. The regulations provide new disclosure rules regarding manager compensation, conflicts and soft dollars
8. The typical offering memorandum for a plan asset fund as currently drafted most likely complies with the disclosure rules in the interim final regulation
9. Soft dollar disclosure is one of the open issues that hopefully will be clarified when the "final" final regulation is issued

E. DOL Regulation defining "who is a fiduciary"

1. The DOL proposed a new regulation under Section 3(21) of ERISA defining who is a fiduciary
2. The proposed regulation was withdrawn after a massive lobbying effort and a stream of bi-partisan criticism from Congress
3. The focus of the most intense criticism was on the impact the proposed regulation would have on the IRA market, and that appears to be what sunk the proposal
4. The DOL claims that they are going to re-propose the regulation "soon"
5. The proposed regulation would have had minimal impact on plan asset funds because the manager of a plan asset fund is a fiduciary under existing regulations
6. The proposal could potentially have raised issues regarding valuation of hard to value securities and dealings with counterparties
7. The proposal should have had no impact on non-plan asset funds, but extreme readings of the proposal left open questions with respect to the marketing of investment funds and the valuation of hard to value securities

F. Form 5500

1. Not many plans make Form 5500 requests, it's mainly just the larger plans
2. Often the request is made as part of a side letter
3. Managers should expect more requests as time passes
4. It appears that many plans are viewing the offering memorandum and the annual financial statements as containing all the information they need
5. The format of requests from plans varies widely

6. Managers typically made up their own response form which answers all the questions and leaves the manager in charge of how it responds

7. The hardest question to answer involves soft dollars

8. The DOL divides soft dollars into two categories: proprietary soft dollars versus soft dollar bank accounts, and requires different reporting for each category

VI. Form ADV Part 1A — key changes impacting private fund managers

A. Deadlines

1. Feb. 14, 2012 — new registering advisers need to file both the new Form ADV Part 1A and Part 2A client brochure

2. March 30, 2012

(a) Existing registered advisers need to file new Form ADV Part 1A as part of annual update

All RIAs this year must file new Part 1A by March 30 regardless of fiscal year

(b) Existing registered advisers with Dec. 31 fiscal year must also file annual update to Part 2A client brochure

(c) Exempt reporting advisers need to complete and file applicable sections of Part 1A

B. CCO contact information requested upfront (Items 1J and 1K)

1. Additional regulatory contact person — if an additional person is authorized to receive information *and* respond to questions, may provide an additional contact

2. Exempt reporting advisers not required to have CCO, but if not must include a regulatory contact person in 1K

Important consideration for firms who do not have a dedicated CCO

C. Investment advisers with $1 billion or more of assets on last day of most recent fiscal year (Item 1O)

1. Dodd-Frank requires additional oversight of certain incentive compensation arrangements

2. Based on most recent balance sheet of the adviser

Consolidation of fund assets for accounting purposes may present an issue

D. Legal entity identifier (Item 1P)

Legal entity identifier standard is still in development

E. SEC registration categories (Item 2A)

1. Large advisory firms — generally regulatory AUM of $100 million or more

2. Mid-sized advisory firms — regulatory AUM of $25 million or more but less than $100 million and either: (1) not required to register with state securities authority; or (2) not subject to examination by state (e.g., New York)

F. Exempt reporting advisers (Item 2B)

1. Exemptions

(a) Venture capital adviser exemption

(b) Private fund adviser exemption — advisers solely to private funds managing less than $150 million from an office in the U.S

(i) Non-U.S. advisers

(1) Only AUM with respect to which the adviser provides continuous and regular supervisory or management services *from a place of business in the United States* are counted toward the $150 million

(2) Non-U.S. adviser could manage more than $150 million of U.S. fund assets from outside the United States and still qualify

(3) Cannot have U.S. clients or investors other than in private funds

2. Complete only the following items on Part 1A:

(a) Item 1 (identifying information)

(b) Item 2.B (SEC reporting by exempt reporting advisers)

(c) Item 3 (form of organization)

(d) Item 6 (other business activities)

(e) Item 7 (financial industry affiliations and private fund reporting)

(f) Item 10 (control persons)

(g) Item 11 (disciplinary disclosure)

(h) Corresponding sections of Schedules A, B, C and D

3. Not subject to “regular” SEC examinations — but subject to SEC “cause” examinations

4. Continue to be subject to the Adviser’s Act’s antifraud provisions under Section 206

5. The SEC has the authority to require ERAs to maintain records and provide reports

   Recordkeeping requirements for ERAs will be addressed by the SEC in a future release

6. The SEC has not sought to apply to ERAs most of the prophylactic rules adopted for registered advisers

G. Foreign private adviser exemption — exempt from any SEC registration or ADV filing requirement

1. No place of business in the United States

2. Fewer than 15 clients and investors in the United States in total

3. Less than $25 million regulatory AUM from U.S. clients and investors in total

4. Does not hold itself out to public in the United States as an investment adviser

5. Does not act as adviser to registered investment company or business development company

H. Information about your advisory business (Item 5)

1. Must now report actual numbers of employees — not just ranges

2. Break the number down by those that perform investment advisory functions

3. From a practical perspective, turnover from year to year will be more transparent

4. Also more detailed breakdown of types of clients required

I. Regulatory assets under management (Item 5F)

1. Calculated by determining the market value of the securities portfolios to which the adviser provides continuous and regular supervisory or management services, or the fair value of such assets where market value is unavailable

2. Gross not net — advisers cannot deduct outstanding indebtedness or other accrued but unpaid liabilities, including accrued fees, expenses or the amount of any borrowing

3. Cannot exclude family or proprietary accounts or no-fee assets

4. Timing of calculation — on an annual basis. Changes between annual updating amendments will not affect the availability of the exemption

5. For private equity funds, generally includes uncalled capital commitments

   Where the commitment period has ended, look to the contract, and if those amounts can still be called for any reason, include amounts

6. Part 2A client brochure — Item 4 requires disclosure of assets under management, but allows RIA to use its own methodology and not rely on "regulatory AUM"

J. Financial industry affiliations (Item 7A and Section 7.A. of Schedule D)

1. Requires information about the registrant and related persons, *including foreign affiliates*

   Related persons = advisory affiliates + any person that is under common control with you

2. Foreign regulated entities would be disclosed in 7A of Schedule D

   Cooperation agreements/joint inspections — U.S. SEC, U.K. FSA, HK SFC, Japan FSA, etc.

K. Private funds (Item 7B and Section 7.B.(1) of Schedule D)

1. Each private fund requires a separate Section 7.B.(1) of Schedule D

   Unless another adviser reports this fund in Section 7.B.(1) (you are the subadviser) — then you just complete Section 7.B.(2)

2. Can preserve anonymity of private funds — using numerical or alphabetical code

   Some single investor funds with the investor name in the fund may want this option

3. For non-U.S. advisers can disregard any private fund that is not a U.S. person, not offered in the United States and not beneficially owned by any U.S. person — standalone offshore funds

4. Must acquire a private fund identification number via IARD website — identification numbers are required for each feeder

5. Different series with different securities portfolios generally regarded as different funds and require separate reporting (not side pockets)

6. Can complete one Section 7.B.(1) for each master/feeder structure

   Provided that answers to questions 8, 10, 21 and 23-28 are the same for all feeders

7. Fund-of-funds — includes a fund that invests 10% or more of its assets in other pooled investment vehicles

8. Regulatory AUM of private fund

9. Approximate number of fund's beneficial owners

   Count in same manner as you would count for 3c1 or 3c7 purposes

10. Percent of private fund beneficially owned by you and related persons

11. Subadviser to private fund (17(a) and (b))

12. Other investment advisers to private fund (18(a) and (b))

13. Service providers — now have to disclose auditors, PBs, custodians, administrators *and marketers*

14. Valuation — during your last fiscal year, what percentage of the fund's assets was valued by a person/administrator that is not a related person

    Include only those assets where the valuation was *determined* by that person

L. Disclosure information (Item 11)

1. Added new question — do any of the events below involve you or any of your supervised persons?

2. Potential variances between Part 1A and Part 2A brochure (Item 9) — rebuttable presumption of materiality in brochure

Tax Update 2012: FATCA and Other Issues

Speakers

Philippe Benedict

Nick Fagge

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Philippe Benedict

Philippe Benedict, a partner at Schulte Roth & Zabel, focuses his practice on the tax aspects of investment funds, mergers and acquisitions, international transactions, real estate transactions and financial instruments.

Philippe has been involved in many major transactions involving sales or spinoffs of investment fund managers. He recently advised Gresham Investment Management LLC in its sale of a 60 percent stake to Nuveen Investments and represented ABS Investment Management LLC in Evercore Partners Inc.'s $45 million purchase of a non-controlling stake in ABS. He also advised Secor Asset Management LP in regard to an investment by Babson Capital Management.

A frequent speaker at prominent industry events, Philippe was invited to present on "Structuring the Transaction: Tax, Accounting and Operational Issues" at the Managed Funds Association Hedge Fund Manager M&A Seminar and spoke on "Managing Intellectual Capital: Talent Retention and Compensation in Challenging Business Environments" at Morgan Stanley's 16th Annual Chief Operating & Chief Financial Officer Forum. He also co-authored "New Paradigm in Asset Manager M&A: Financial Institution Alliances with Hedge Fund Managers," which appeared in *The Hedge Fund Journal*.

Philippe attended New York University School of Law, where he was awarded an LL.M. in taxation and a J.D. While attending NYU for 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.

Schulte Roth & Zabel

Private Investment Funds Seminar

Nick Fagge

Nick Fagge, a special counsel at Schulte Roth & Zabel, principally advises investment management clients on the structuring of U.K. management companies, covering all relevant partnership and tax issues. Nick 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. He has written and spoken about U.K., EU and international tax issues for various publications and engagements, particularly in regard to how changes in tax codes and regulations affect hedge funds and their U.K. managers.

Nick is a Chartered Tax Adviser and associate of the Chartered Institute of Taxation, the leading body in the U.K. for taxation professionals dealing with all aspects of taxation. He is also a member of the Tax Committee of the Alternative Investment Management Association.

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

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Dominique Padilla Gallego, a partner at Schulte Roth & Zabel, focuses her practice on U.S. federal income tax matters relating to investment funds, financial products and structured finance transactions.

Dominique speaks at industry conferences and events, most recently discussing "Withholding on U.S. Equity Swaps Under the HIRE Act" at an American Bar Association's Section of Taxation Mid-Year Meeting. She is also a co-author of "On the CLO Horizon — Regulations Expected to Impact CLOs," a chapter in *The International Comparative Legal Guide to: Securitisation 2011*. In 2000, she received the prestigious AT&T Asia Pacific Leadership Award. She is a member of the New York State Bar Association, the American Bar Association and the Integrated Bar of the Philippines.

After obtaining her undergraduate degree in Economics, *summa cum laude*, from De La Salle University in Manila, Philippines, Dominique earned a J.D., *cum laude* and valedictorian, from Ateneo de Manila University in Manila, Philippines and an LL.M. in International Taxation from New York University School of Law.

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Shlomo C. Twerski, a partner at Schulte Roth & Zabel, 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. Shlomo provides ongoing tax advisory services to a number of hedge fund managers regarding fund structuring and formation, distressed debt investments and other complex transactions.

Shlomo regularly speaks at industry conferences and events, and has recently addressed such topics as "The Return of CLOs: Changes That Matter to Managers and Investors" and "Running a Multi-Jurisdictional Adviser" for various SRZ seminars. He is a member of the Tax Section of the New York State Bar Association.

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

Tax Update 2012: FATCA and Other Issues

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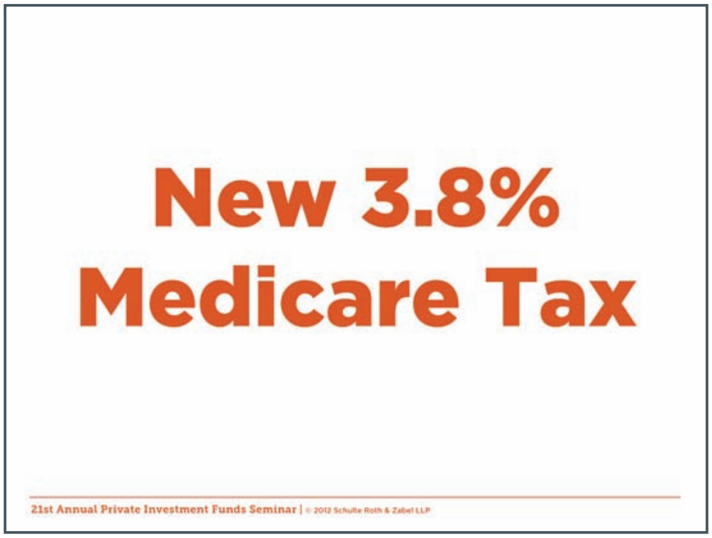

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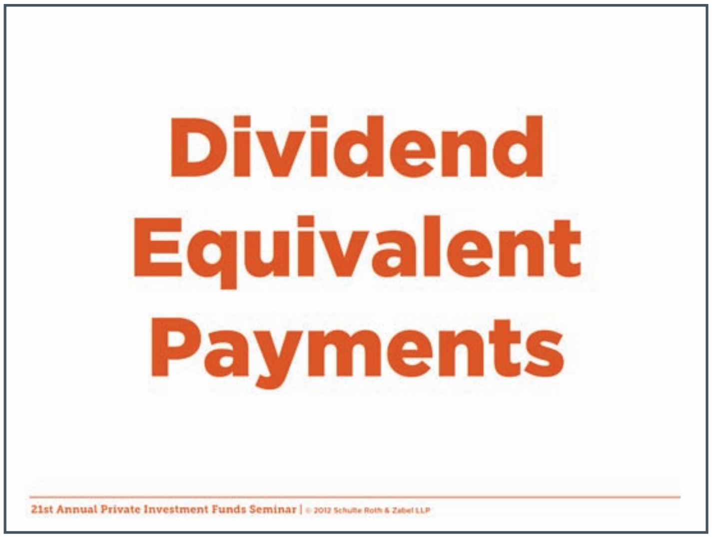
Dividend Equivalent Payments
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Off-Shore Asset Reporting

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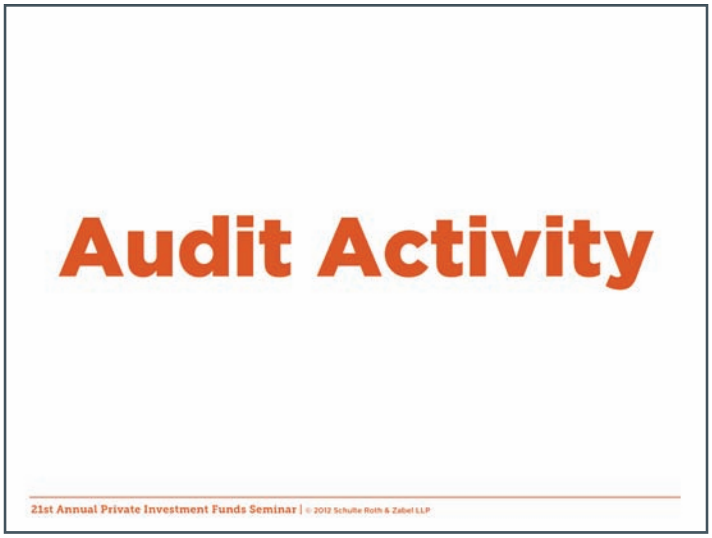

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Tax Update 2012: FATCA and Other Issues

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Tax Update 2012: FATCA and Other Issues

I. Foreign Account Tax Compliance Act ("FATCA")[1]

A. Taxes to enforce reporting on U.S. persons investing through non-U.S. investment vehicles

1. Under the HIRE Act, any "withholdable payment" made to a non-U.S. investment fund is generally subject to 30% U.S. withholding tax, unless the fund enters into an information-sharing agreement with the Treasury and complies with U.S. reporting requirements. The withholding tax is nonrefundable and noncreditable if the fund is considered a corporation for U.S. tax purposes and is not resident in a treaty jurisdiction (as is usually the case)

   (a) Withholdable payments are gross proceeds from the disposition of property that can produce U.S.-source interest or dividends, and payments of U.S.-source interest, dividends, rents, salaries, wages, premiums, annuities, compensation, remunerations, emoluments and other fixed or determinable annual or periodical gains, profits and income

   (b) The information-sharing agreement with the Treasury requires the non-U.S. fund to, among other requirements: (1) obtain, by required procedures, information on U.S. persons' direct or indirect ownership interest in the fund; (2) annually provide such information to the Treasury; (3) withhold 30% of any withholdable payment to an investor who fails to provide the necessary information; and (4) obtain waivers of foreign law confidentiality protection from such investors

2. A U.S. investment fund will be a withholding agent with respect to withholdable payments to non-U.S investors. The U.S. fund is generally required to withhold 30% of the withholdable payments to any non-U.S. investor that is an offshore investment fund that has not entered into an information-sharing agreement with the Treasury. If the non-U.S. investor is not an offshore investment fund, withholding is avoided only if the investor provides the U.S. fund with either: (1) a certification that it is not treated as having any U.S. ownership; or (2) information identifying its U.S. owners. The U.S. fund must report such information to the Treasury

3. FATCA withholding on U.S. source FDAP income begins Jan. 1, 2014 and on gross proceeds and pass through payments on Jan. 1, 2015. Obligations outstanding as of March 18, 2012 are grandfathered

B. What to do now in respect of the FATCA?

1. One approach is to avoid investing in U.S. assets altogether. FATCA is not implicated for any offshore fund whose investment program comprises exclusively of non-U.S. investments. In making this determination, a fund needs to take into account both: (1) direct and indirect investments (e.g., through investment vehicles that are treated as pass-through entities for U.S. tax purposes); and (2) synthetic investments (e.g., investments in derivative instruments). Additional look-through rules could apply

2. Any manager (based in the United States or not) of an offshore fund whose investment program includes or may include U.S. investments (directly or indirectly, and physically or synthetically) needs to

   (a) Identify how it maintains investor information; and ascertain whether the data is kept in paper form versus electronic format. It should also inventory which investors have provided any U.S. tax forms to date (e.g., W-9, W-8s)

   (b) Review internal procedures for identifying existing direct investors in order to group them into: (1) individual versus entity investors; and (2) U.S. versus non-U.S. investors and be able to classify investors in accordance with the following

      (i) Documented U.S. and non-U.S. accounts (and form of identification submitted) versus undocumented accounts

[1] This outline is based on existing guidance as of Jan. 7, 2012. Proposed regulations for FATCA are expected to come out in early 2012, and are expected to be finalized by the summer of 2012. Regulations in respect of dividend equivalents are also expected to come out early this year. Regulations in respect of PFIC reporting are also generally expected to come out

(ii) Accounts that cannot be fully identified but with hallmarks of a possible U.S. connection

(iii) Pass-through entities and any information that indicates any U.S. connections in respect of indirect investors

(c) Identity the personnel/team (e.g., CFO, tax director and staff) who will be in charge of and who will perform the various due diligence, review and record keeping of all investor accounts for FATCA compliance

(d) Establish supplementary procedures to collect identifying information from new investors and additional information from existing investors who cannot be properly identified

(e) For new or updated offering documents and fund constituent and subscription documents, include appropriate risk disclosure and requirement for investors to abide by FATCA requirements and ensure that fund has ability to properly charge FATCA tax to the appropriate investors and the power to expel such investors if required. Careful consideration must be made in respect of confidentiality laws of the fund's jurisdiction of organization to determine what type of investor covenants will be needed

(f) Review fund portfolio composition to determine direct investments in U.S. assets and identify, to extent practicable, any indirect U.S. assets through pass-through entities and derivatives. Establish mechanism to enable fund to track portfolio composition in this manner

(g) Be prepared to execute a timely information sharing agreement with the U.S. Treasury by June 30, 2013. Be prepared to remove investors who persist in refusing to provide sufficient identifying information and/or refuse to waive confidentiality of information to avoid nullification of such information sharing agreement

(h) Be prepared to report on a yearly basis all distributions, redemption payments or any other payment made during a year to each investor. Include a mechanism that splits out U.S. investors in respect of this information if not yet being done

(i) Be prepared to certify that between May 9, 2011 and the effective date of the information-sharing agreement it enters into with the Treasury, the fund's management personnel did not engage in any activity, or have any formal or informal policies and procedures in place, directing, encouraging or assisting account holders with respect to strategies to avoid identification of their accounts as U.S. accounts

II. Selected U.K. tax issues — how to make an offshore fund attractive to U.K. resident investors

A. The U.K. offshore funds tax regime

1. U.K. investors will invest into an offshore fund that is a tax-opaque limited company for U.K. tax purposes. This acts as a "blocker" enabling U.K. investors to defer their recognition of income and gains until they redeem their interest in the offshore fund

2. Without specific anti-avoidance tax provisions, investing in offshore funds in this way might also enable U.K. investors to "convert" the underlying income of the offshore fund (e.g., from dividends or interest) into capital gains realized by U.K. investors on the redemption of their interests. This is attractive because U.K. tax rates on capital gains are substantially lower than U.K. income tax rates

3. The U.K.'s offshore funds tax regime aims to prevent U.K. investors from deriving these advantages by taxing the gains realized by U.K. investors on the redemption of interests in offshore funds at ordinary income tax rates (currently 50% for an upper rate taxpayer) and not at capital gains tax rates (currently 28%)

4. This approach might, however, be perceived to penalize U.K. investors unfairly, since underlying capital gains of the offshore fund become subject to U.K. tax at ordinary income tax rates for U.K. investors when they redeem their interests in the offshore fund. If U.K. investors had realized these underlying capital gains directly (and not through an offshore fund) they would have been subject to tax at capital gains tax rates

B. The reporting fund regime

1. Under the Offshore Funds (Tax) Regulations 2009 (as amended), an investment manager can apply for an offshore fund — or a particular share class or class of interests in an offshore fund — to have “reporting fund” status. Electing for “reporting fund” status is a one-time process, requiring the filing of a simple application form with HMRC. The investment manager is required to give certain undertakings in relation to compliance with the “reporting fund” regime (e.g., that the fund will prepare accounts on the basis of generally accepted accounting principles and will file the necessary reports with HMRC each year)

2. Where a U.K. investor holds shares or interests that have had “reporting fund” status at all times that they have been held by the U.K. investor, any gain realized by the U.K. investor is taxed as capital gain, and not recharacterized as income

3. However, where an offshore fund has “reporting fund” status, the investment manager is annually required to provide investors in the “reporting fund” with a report of the net income per share (or unit of interest) attributable to their investment. U.K. investors are required to treat such reported income as taxable income and include it on their personal tax returns. Reported income must be recognized by a U.K. investor irrespective of whether the offshore fund has made an actual distribution of such income to its investors. Where a U.K. investor recognizes and is taxed upon reported income, the U.K. investor may also include that amount as part of the capital gains “base cost” that reduces any chargeable gain realized upon ultimate redemption of the investment

4. It is only the offshore fund’s net income (and not underlying capital gains of the offshore fund) that must be included in the calculation of the offshore fund’s reportable income. All expenses of the offshore fund (including management fees and incentive fees) are also permitted to be deducted in calculating the offshore fund’s net reportable income. Generally it is only an offshore fund’s passive dividend and interest income that comprises its reportable income, and the effect of deducting expenses against these passive income items is that an offshore fund may have negligible or nil reportable income. In exceptional cases, the nature of an offshore fund’s investment strategy may require the offshore fund’s gains from the realization of its positions to be treated as “trading income” and so included in reportable income, but generally it is possible for such gains to be excluded from reportable income on the basis that they are capital gains and not income items

5. The investment manager is also required to provide the offshore fund’s audited financial statements and certain other information (including the reportable income per share or unit of interest) to HMRC on an annual basis

C. The previous distributing fund regime

1. The “reporting fund” regime replaces a previous regime (called the “distributing fund” regime) that allowed U.K. investors to obtain capital gains treatment on the redemption of their shares or interests in offshore funds if certain conditions were met

2. However, the “distributing fund” regime imposed significantly greater compliance obligations on offshore funds and investment managers and was not frequently used by investment managers of alternative investment funds. In particular, the “distributing fund” regime required an actual, physical distribution to investors of their share of the net distributable income of the offshore fund within six months of the end of each accounting period, and the investment manager was required to apply to HMRC within the same timescale for certification that the offshore fund had met the “distributing fund” conditions for the relevant accounting period

3. The replacement of the "distributing fund" regime with the "reporting fund" regime was intended to provide a more straightforward and streamlined administrative procedure for investment managers by replacing the need for annual certification with a once-for-all approval process and removing the requirement for an actual, physical distribution of net income each year. The early indications are that the introduction of the new regime has been successful in enabling offshore funds and their investment managers to provide a more attractive investment opportunity to U.K. tax-paying investors

III. New medicare tax — effects of the new medicare tax on net earnings and investment income

A. Under current law, self-employment income and an employee's wages and bonuses are subject to Medicare tax at a rate of 2.9%. Half of the tax is borne by the employer and half by the employee, while a partner or self-employed individual bears the full amount of the Medicare tax (50% of which is deductible against adjusted gross income). Currently, the limited partners of an investment manager can benefit from an exemption from this tax under Section 1402(a)(13) of the Code with respect to their profits interests (but not their guaranteed payments)

B. As of Jan. 1, 2013, the "employer" piece will increase to 2.35% for earned income over a specified amount,[2] for a total tax of 3.8%. Employer and partner (self-employed individuals) deductions will remain available only for the first 1.45%

1. The IRS has not provided clear guidance on who is considered a limited partner under Section 1402(a)(13). Case law has generally looked to state law definitions to determine who is considered a limited partner for this purpose (*see*, however, the recent *Renkemeyer* case)

2. Proposed Regulations Section1.1402(a)-2(h), issued in 1997, attempted to define "limited partner" by excluding anyone who by virtue of being a partner has personal liability for the claims and debts of the partnership, has authority to contract for the partnership or participates in the partnership's trade or business in excess of 500 hours during the partnership's taxable year. Congress promptly issued a temporary moratorium on finalizing these Proposed Regulations, and no subsequent action has been taken to issue temporary or final regulations. As such, the Proposed Regulations are currently inapplicable

3. There exists some negative authority that alters the definition of a limited partner. In *Renkemeyer, Campbell & Weaver, LLP*, 136 TC 137 (2011), the Tax Court determined that the partners of a limited liability partnership law firm organized in Kansas should not be treated as limited partners within the meaning of Section 1402(a)(13) with respect to their "investing partner interests" in the entity (they also held "general managing partner interests"). The Tax Court asserted that Section 1402(a)(13) limited partners are partners whose partnership earnings are of an investment nature and are not attributable to the services they rendered to the partnership

4. The ABA recommended in December 2011 amending Section 1402(a)(13) to focus on whether a partner's income is attributable to services provided or capital contributed rather than to state law terms. Under the ABA's proposal, limited partners who are active service providers to the investment manager would be subject to the Medicare tax. Likewise, the NYSBA proposed in November 2011 to exclude active, "material participants" in the partnership's activities from the Section 1402(a)(13) definition of limited partner

C. As of Jan. 1, 2013, a new 3.8% Medicare tax on investment income will apply. Section 1411 of the Code imposes this tax on "net investment income" (or undistributed "net investment income," in the case of estates and trusts) of taxpayers whose adjusted gross income (with certain modifications) exceeds a specified amount[3]

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[2] The amount is $250,000 for married couples filing jointly, $125,000 for married individuals filing separately and $200,000 for others

[3] The amount is $250,000 for married individuals filing jointly, $125,000 for married individuals filing separately, $200,000 for other individuals and the dollar amount at which the highest income tax bracket for estates and trusts begins

Net investment income generally includes net income from interest, dividends, annuities, royalties and rents and net gain attributable to the disposition of investment property, as well as trade or business income which is income from a "passive activity" (within the meaning of the passive activity rules of Section 469 of the Code)

D. This Medicare investment tax would apply to incentive allocations or other "carried interest" allocated to investment management firms and investment returns for investors in the funds

E. In contrast, fee income allocated to the limited partners who work for the investment manager could be exempt from the Medicare investment tax under Section 1411 if the limited partners are active service providers (i.e., the investment in the firm is not a "passive activity" of such partner under Section 469). Accordingly, the non-passive limited partners may qualify for the Section 1402(a)(13) exception to the traditional Medicare tax in the absence of other legislation, as well as an exemption from the new Medicare tax on investment income

F. The Economic Growth and Jobs Protection Act of 2011 (S. 1738), which would repeal the Medicare investment tax, has been introduced in Congress and is currently referred to the Senate Committee on Finance. Additionally, the Supreme Court of the United States granted certiorari to rule on the constitutionality of the healthcare reform law, which includes the 3.8% Medicare tax, in the cases *National Federation of Independent Business v. Sebelius*, No. 11-393, and *U.S. Department of Health and Human Services v. Florida*, No. 11-398

IV. Dividend equivalent withholding — Section 871(m) sourcing dividend equivalent payments

Dividend equivalent — a dividend equivalent is treated as a dividend from sources within the United States. "Dividend equivalent" means: (1) any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction that, directly or indirectly, is contingent upon or determined by reference to the payment of a dividend from sources within the United States; (2) any payment made pursuant to a specified notional principal contract that, directly or indirectly, is contingent upon or determined by reference to the payment of a dividend from sources within the United States; and (3) any other substantially similar payments as determined by the Secretary of the Treasury

A. Specified notional principal contract means, currently, any notional principal contract where any of the following exists: (1) when entering into such contract, any long party to the contract transfers the underlying security to any short party to the contract ("crossing-in"); (2) when terminating such contract, any short party to the contract transfers the underlying security to any long party to the contract ("crossing-out"); (3) when the underlying security is not readily tradable on an established securities market; or, (4) when entering into such contract, the underlying security is posted as collateral by any short party to the contract with any long party to the contract

B. Unless the Treasury promulgates new regulations, in the case of payments made after March 18, 2012, any notional principal contract will be considered a specified notional principal contract and subject to 30% gross income withholding if payments made pursuant to such contract are directly or indirectly, contingent upon or determined by reference to the payment of a dividend from sources within the United States

V. Other tax matters

A. New Form 8938 and Reporting Certain Foreign Financial Assets (Section 6038D) — individuals holding an interest in specified foreign financial assets ("SFFAs") valued over the applicable threshold must file Form 8938 annually. Form 8938 requires disclosure of information regarding the SFFAs, the foreign institutions maintaining the SFFAs for the taxpayer, and, if applicable, the foreign issuers of SFFAs

1. SFFA means any financial account maintained by a foreign financial institution, or any security, financial product, including swaps, options and derivatives contracts, or interest in a foreign entity held for investment and not held in an account maintained by a foreign financial institution

2. SFFA does not include accounts maintained by U.S. payors (1.6049-5(c)(5)(i)), accounts to which Section 475 mark-to-market rules apply, and assets used or held for use in the conduct of a trade or business (trade-or-business test 1.6038D-3T(b)(4))

3. Taxpayers do not need to report any information on Form 8938 that is reported on Form 3520, "Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts"; Form 3520-A, "Annual Information Return of Foreign Trust With a U.S. Owner"; Form 5471, "Information Return of U.S. Persons With Respect To Certain Foreign Corporations"; Form 8621, "Return by a Shareholder of a Passive Foreign Investment Company or a Qualified Electing Fund"; Form 8865, "Return of U.S. Persons With Respect To Certain Foreign Partnerships"; Form 8891, "U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans." But amounts reported on these other forms are taken into account when determining whether the taxpayer has exceeded the applicable threshold for the tax year. Based on the current form, a taxpayer who records all of his SFFAs on these other forms would still have to file Form 8938 but without filling in any substantive information on the SFFAs

4. Thresholds — single taxpayers living in the United States with $50,000 in SFFAs on the last day of the tax year or $75,000 in SFFAs at any point during the year; joint filers living in the United States with $100,000 in SFFAs on the last day of the tax year or $150,000 in SFFAs at any point during the year; single taxpayers living outside the United States with $200,000 in SFFAs on the last day of the tax year or $300,000 in SFFAs at any point during the year; joint filers living outside the United States with $400,000 in SFFAs on the last day of the tax year or $600,000 in SFFAs at any point during the year

5. A domestic entity holding SFFAs must file Form 8938 just like an individual. A person is not treated as having an interest in any SFFA held by a corporation, partnership, trust, or estate solely by being a shareholder, partner, or beneficiary of such entity (1.6038D-2T(b)(3))

6. There is a $10,000 penalty for an initial failure to disclose SFFAs. If the IRS sends a notice of failure to file Form 8938 and, after 90 days of the IRS mailing such notice, the taxpayer still has not filed Form 8938, the taxpayer is penalized an additional $10,000 per each subsequent 30-day period (up to $50,000) during which the failure to file Form 8938 continues

B. PFIC Reporting and New Section 1298(f) — the HIRE Act added Section 1298(f), which requires information reporting by PFIC shareholders. The Treasury has yet to promulgate regulations on what reporting will be required

1. 1298(f) — "Except as otherwise provided by the Secretary, each United States person who is a shareholder of, or who directly or indirectly forms, transfers assets to, is a beneficiary of, has a beneficial interest in, or receives money or property or the use thereof from a passive foreign investment company shall file an annual report containing such information as the Secretary may require"

2. Notice 2011-55 exempts PFIC shareholders from reporting requirements under Section 1298(f) if such shareholders are already exempt from filing Form 8621. PFIC shareholders are exempt from filing Form 8621 if they: (1) hold their interest in a PFIC through an S corporation, partnership, trust or estate; (2) such entity files Form 8621; and (3) such shareholders do not have 1291 or 1293 income, do not have to report a non-recognition transfer or a 1294 election. Future Section 1298(f) regulations might affect exempt PFIC shareholders' reporting requirements

3. Taxpayers required to report under Section 1298(f) might also be required to report the same information on Form 8938 pursuant to Section 6038D. Forthcoming Treasury regulations are expected to avoid duplicative reporting caused by this overlap

C. Section 892 — foreign government income and new proposed regulations

1. Generally, a foreign government is exempt from U.S. tax on income derived from investments in U.S. stocks, bonds and other securities, income from financial instruments held as part of its financial/monetary policy, and interest income on deposits in U.S. banks. This exemption does not apply when the income is derived from commercial activity (within or without the United States), received by or from a controlled commercial entity, or derived from the disposition of any interest in a "controlled commercial entity"

   A "controlled commercial entity" is an entity engaged in commercial activity (within or without the United States) in which the government holds either at least a 50% interest (value or voting), or an interest giving the government effective control over the entity

2. Proposed regulations

   (a) Generally, an investment in a financial instrument does not constitute a commercial activity regardless of whether such instrument is held as part of the foreign government's financial or monetary policy. An investment in the context of a banking, financing or similar business, however, is a commercial activity

   (b) The disposition of a "United States real property interest" does not *per se* constitute commercial activity, *but* the gain is *not exempt* under Section 892

   (c) Inadvertent commercial activity — a controlled entity that conducts only inadvertent commercial activity is not a controlled commercial entity. An activity is inadvertent only if: (1) failure to avoid such commercial activity is reasonable; (2) commercial activity is promptly cured; and (3) record maintenance requirements prescribed under the regulations are met

   (d) Failure to avoid commercial activity is reasonable only if "facts and circumstances" indicate reasonableness. Under a safe harbor, reasonableness is met if the value of all assets used in commercial activities does not exceed 5% of entity's total asset value for the taxable year *and* income earned from commercial activities does not exceed 5% of entity's gross income for the taxable year

Leverage for Investment Funds

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Investment Management

Private Equity

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Omoz Osayimwese is a partner at Schulte Roth & Zabel, where he focuses his practice on the representation of sponsors and investors in the formation and structuring of private equity funds, hedge funds and hybrid funds. Omoz has extensive experience representing sponsors and investors on funds employing real estate, buyout, credit, distressed investment, activist, multi-strategy and long-short equity strategies. He also represents hedge fund managers and investors in the negotiation of seed capital transactions, and advises sponsors of private equity firms in the structuring of complex carry-sharing arrangements among principals and employees.

Omoz's recent representations 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's speaking engagements have included "Private Equity Funds: New Investor Demands" at SRZ's Investment Management Hot Topics seminar, a roundtable discussion at the AIFEA meeting regarding investment advisor registration for private equity firms and the Hedgeworld Webinar "Emerging Managers: Raising a Hedge Fund in a Bear Market."

Omoz received his B.A., with highest honors, from Michigan State University and his J.D. from University of Michigan Law School.

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- Private Equity
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Daniel V. Oshinsky

Daniel V. Oshinsky, a partner at Schulte Roth & Zabel, represents hedge funds, private equity funds, asset managers, specialty finance companies and investment banks in a wide range of financing transactions. Dan has particular expertise in liquidity facilities, such as CLOs, warehouse lines, leverage finance vehicles, capital call facilities and fund-of-fund loans. Dan's practice also encompasses a variety of other secured and unsecured finance transactions, both on the borrower and lender side, including cash-flow and asset-based loans, acquisition financing, Term B loans, unitranche loans, mezzanine and subordinate loans, distressed debt investments, workout and restructuring transactions, debtor-in-possession and exit financings, cross-border transactions and other complex credit arrangements.

Dan's most recent transactions include representing a finance company in the negotiation and closing of a warehouse credit facility to finance the origination and purchase of middle market and broadly syndicated commercial loans; representing a finance company in the negotiation and closing of a capital-call facility to be utilized to support the issuance of stand-by letters of credit; representing a hedge fund in its acquisition of a portfolio of distressed assets; representing an asset manager in its acquisition of multiple collateral management contracts for CLOs and related equity investments; representing a private equity fund and its portfolio company in connection with the refinancing of an asset based credit facility; and representing a lender in connection with a delayed draw term loan to a security company.

Dan recently served as moderator of the "Buy Side Panel" at Yeshiva University's Wall Street Connections Series: Industry Forum.

Dan received his B.A., *magna cum laude*, from Yeshiva University and his J.D. from New York University School of Law.

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Structured Products & Derivatives

Trading Agreements

Craig Stein

Craig Stein, a partner at Schulte Roth & Zabel and co-head of the Structured Products & Derivatives Group, focuses his practice on swaps and other derivative products, prime brokerage and customer trading agreements, and structured finance and asset-backed transactions. He also represents issuers, underwriters and portfolio purchasers and sellers in public and private structured financings, including collateralized loan obligations (CLOs).

A sought-after speaker for hedge fund industry conferences, Craig is also the author of articles on advanced financial products for such publications as *Credit* magazine, *Loan Market Week*, *Pratt's Journal of Bankruptcy Law* and the *Journal of Derivatives*. He co-authored "Dodd Frank — One Year On" for the *International Financial Law Review* and "On the CLO Horizon — Regulations Expected to Impact CLOs," which appeared in *The International Comparative Legal Guide to: Securitisation 2011*.

Craig is a member of the American Bar Association, the New York State Bar Association and the ISDA Credit Derivatives Market Practice Committee. He has been recognized by the prestigious legal directory *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.' "

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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Investment Management

Securities & Capital Markets

Structured Products & Derivatives

Paul N. Watterson, Jr.

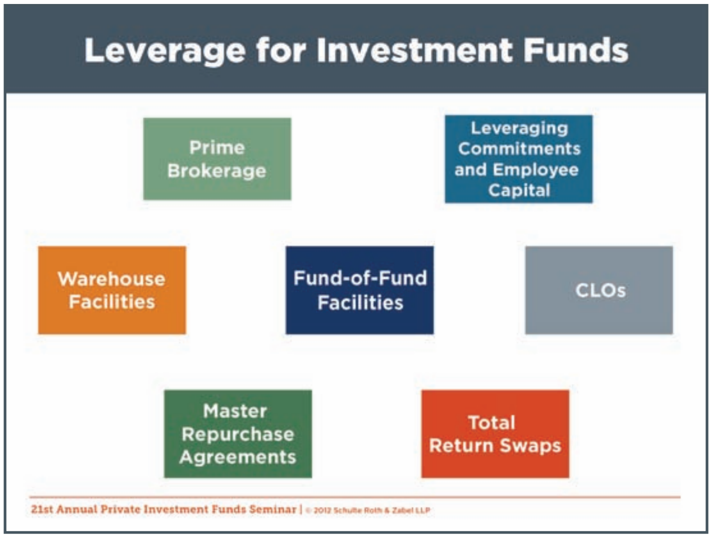
Paul N. Watterson, Jr. is a partner at Schulte Roth & Zabel and co-head of the Structured Products & Derivatives Group. He concentrates on structured product and derivative transactions, the formation and representation of credit funds, and capital markets regulation. Paul is counsel to many participants in the securitization, credit and derivatives markets. He represents underwriters, issuers and managers in structured financings, including collateralized loan obligations (CLOs). He is involved in many structured finance transactions that use credit derivatives, including regulatory capital transactions and repackagings. Schulte Roth & Zabel is widely acknowledged as having the nation's premiere investment management practice, and Paul advises many private investment funds and other alternative investment vehicles on their transactions in derivatives, portfolios of loans, asset-backed securities and CDOs. He has also been active in the creation of derivative products that reference hedge funds.

A frequent speaker on securitization, derivatives and regulatory issues, Paul is a regular presenter at Structured Credit Investor, American Securitization Forum and other major industry events. He is also widely published, most recently co-authoring "Dodd Frank — One Year On" for the *International Financial Law Review* and "On the CLO Horizon — Regulations Expected to Impact CLOs" for *The International Comparative Legal Guide to: Securitisation 2011*.

Paul is listed in *Chambers USA*, *The Legal 500 United States*, *The Best Lawyers in America*, *New York Super Lawyers*, *IFLR Guide to the World's Leading Structured Finance and Securitisation Lawyers*, *IFLR Guide to the World's Leading Capital Markets Lawyers*, *IFLR Best of the Best USA and New York Super Lawyers*.

Paul earned his A.B., *cum laude*, from Princeton University, and received his J.D., *magna cum laude*, from *Harvard Law School*, where he was an editor of the *Harvard Law Review*. Paul served as a law clerk to the Honorable Leonard I. Garth, U.S. Court of Appeals for the Third Circuit, then as Assistant to the Mayor of the City of New York.

Leverage for Investment Funds



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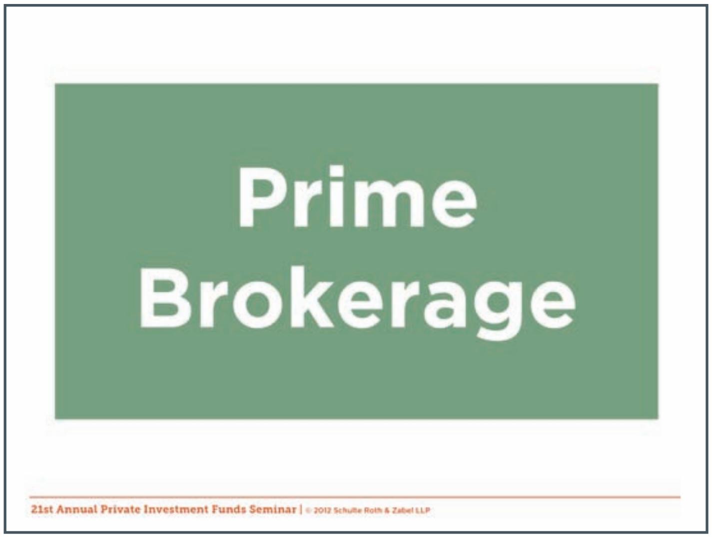

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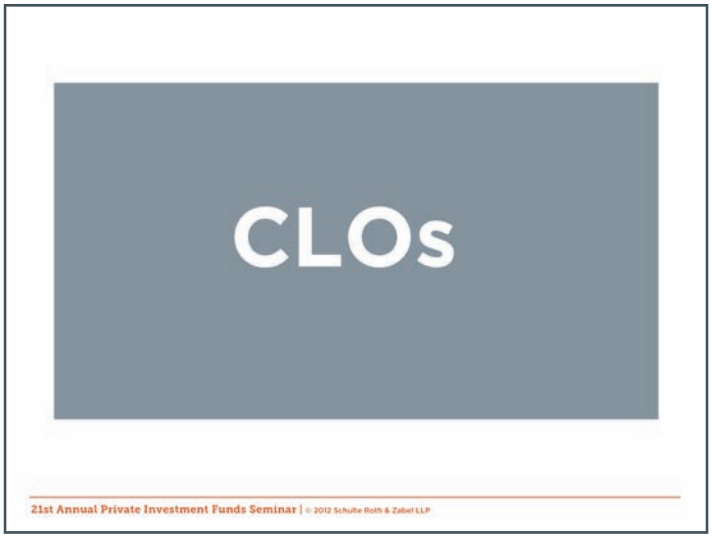

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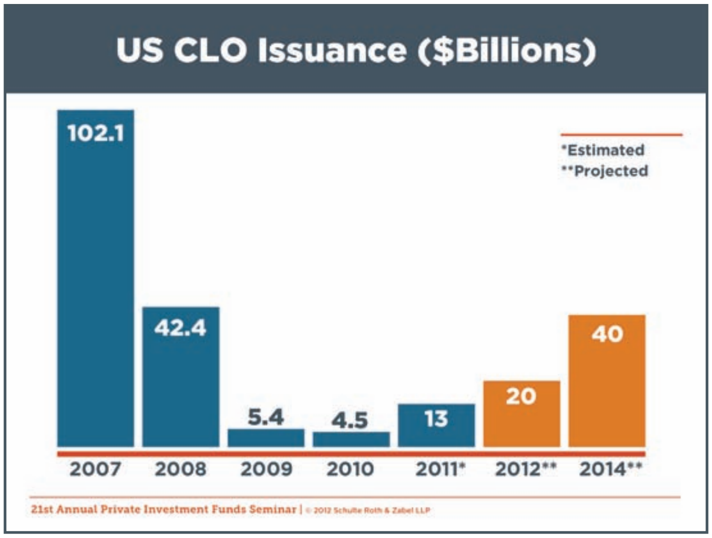

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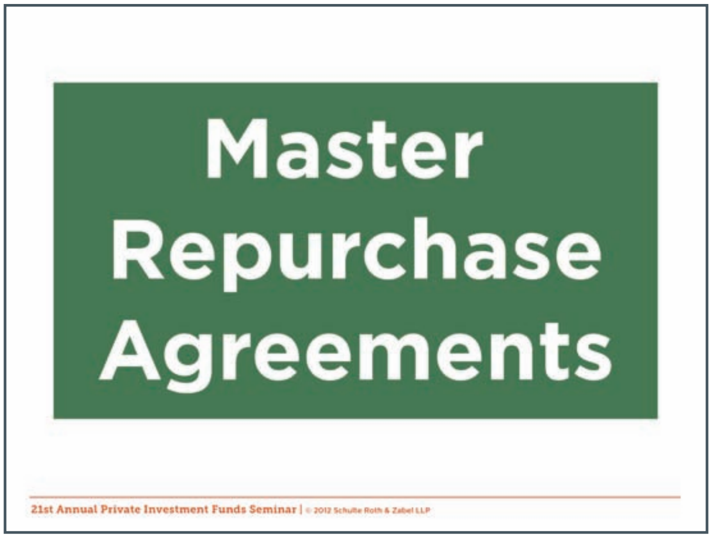

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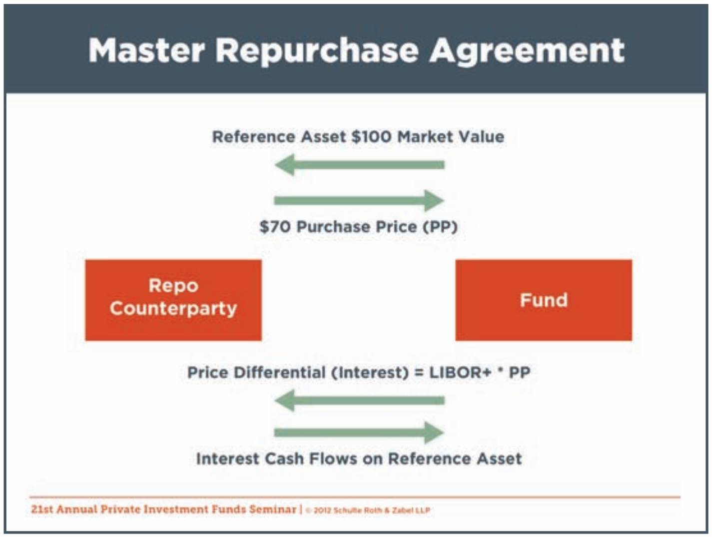

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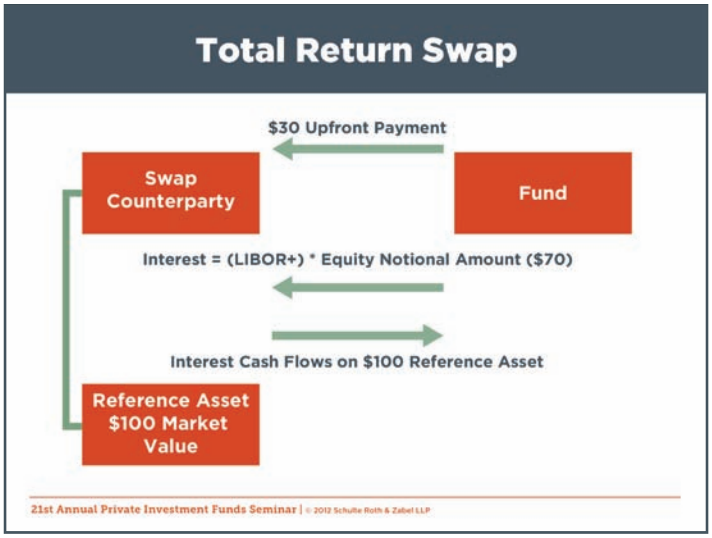

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Leverage for Investment Funds

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Schulte Roth & Zabel

Leverage for Investment Funds

I. Prime brokerage services

A. General

One of the main functions of prime brokers is to provide financing to investment funds, so they can obtain the leverage needed to implement their trading strategies. The method by which a prime broker extends leverage to an investment fund is through margin financing. When purchasing a security, the investment fund borrows some portion of the purchase price of the security from the prime broker

B. Regulation T, portfolio margining and enhanced prime brokerage

1. Margin requirements generally for new securities — Regulation T

The Federal Reserve System's Regulation T governs the amount of margin that must be obtained when a customer buys or sells a security, sells a security short or removes funds or securities from a margin account. Generally, Reg T prohibits a broker-dealer from initially lending its customers more than 50% of the value of securities or from extending credit based on more than 50% of the value of securities collateral. While Reg T imposes margin requirements for new securities transactions and for withdrawals of cash or other collateral, Reg T does not otherwise establish any requirements relating to the amount of margin that must be maintained in a customer's account after it has bought (or sold short) one or more securities

2. Portfolio margining

(a) Regulation T permit broker-dealers to use exchange-approved "portfolio margining" programs to compute their customers' initial and continuing margin requirements provided that the relevant exchange's portfolio margining rules have been approved by the SEC

(b) NYSE Rule 431 permits NYSE member firms to apply a risk-based margin requirement to eligible products — including equity (single stock) options and single stock futures, listed broad-based securities index options, index futures and futures options, and related exchange-traded funds — as an alternative to strategy-based margin requirements

3. Enhanced prime brokerage

"Enhanced prime brokerage" arrangements are similar to traditional prime brokerage arrangements except that they are with a non-U.S. financial institution and they have an enhanced ability to lend to hedge funds. But in exchange for the increased leverage, investment funds take on additional legal risk. Generally, there are fewer protections for customers of prime brokers in jurisdictions outside the United States. One major concern for investment funds that use enhanced prime brokerage arrangements is the rehypothecation of assets. The United States has customer protection rules that protect the customer whereas in other jurisdictions it may be unclear who has title to the rehypothecated assets

C. Lock-up agreements

A margin lock-up or term commitment is a facility provide by a prime broker to an investment fund. This arrangement prevents the prime broker from changing collateral requirements and margin rates. Lock-up terms typically range from 30 to 90 days. Without a lock-up, the prime broker can change the margin rates. If a prime broker wants to make a change covered by the margin lock-up, they are required to provide the manager with the requisite notice before doing so. A lock-up agreement is negotiated separately from a prime brokerage agreement and may be negotiated at the same time the prime brokerage agreement is negotiated or after the prime brokerage relationship has been established. The main points that get negotiated in a lock-up are the scope of the commitment and the termination events

D. Customer protections

1. Rehypothecation of assets and Rule 15c3-3

(a) All prime brokerage agreements permit the prime broker to rehypothecate the investment fund assets held in a client's margin account. Rehypothecation is commonly defined as the right to sell, lend, use or vote a security. All prime brokers that are U.S. SEC registered broker-dealers are limited in the amount and type of assets they can rehypothecate at a given time. This limitation is set forth in Rule 15c3-3 of the Securities Exchange Act of 1934, as amended. When negotiating a prime brokerage agreement with a prime broker that is not a U.S. SEC registered broker-dealer, investment funds may request a contractual rehypothecation limit similar to that imposed under the Act. Prime brokers that are not U.S. SEC registered broker-dealers are not subject to these limitations

(b) Rule 15c3-3 under the Securities and Exchange Act of 1934 ("Rule 15c3-3") sets forth requirements for the possession and control of customer assets held by a broker-dealer which is registered with the Securities and Exchange Commission ("SEC"). Rule 15c3-3 addresses two main areas of client asset protection: (1) the required lock-up of customer cash balances in a special reserve bank account; and (2) possession and control of securities by the broker-dealer (under which re-hypothecation of customer assets by a broker-dealer is addressed). In sum, Rule 15c3-3 is intended to prevent a broker-dealer from financing its proprietary business through the use of its customers' assets, thus ensuring the full return of all customers' assets in the event of a broker-dealer's insolvency

2. Insolvency of U.S. broker-dealers — SIPA proceedings

The U.S. Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa *et seq.* ("SIPA") seeks to protect "customer property" in the event of the failure, insolvency, or liquidation of a broker-dealer. SIPA does not afford the certainty of a 100% recovery, however. Brokerage customers will thus face certain risks if their broker-dealer becomes the subject of a case under SIPA. For example, if the liquidating broker improperly hypothecated customer securities prior to commencement of its SIPA insolvency proceeding, there may not be sufficient assets in the broker's estate to satisfy all of its customers' claims in full. Additionally, because the length of a SIPA case is uncertain, customers may be deprived of the use of their property for an extended time pending asset distributions from the estate

E. Prime brokerage agreements

1. There is no industry standard agreement governing prime brokerage. Each prime broker has its own version. One of the main goals of the prime brokerage agreement is to protect the prime broker from the investment fund's insolvency, rather than protecting the investment fund from the prime broker's insolvency. This could lead investment funds exposed to the insolvency of their prime broker

2. Selected issues for investment funds

(a) Parties acting as prime broker

(b) Sub-custodians and agents

(c) Timing of payments

(d) Events of default

(e) Customer's movement of assets

II. Warehouse facilities

A. Creation and purpose of warehouse facilities

1. A warehouse facility can be used to finance commercial loans and many other asset classes

2. Before the credit crisis, warehouse facilities were often short-term financings, used to "ramp-up" to a CLO. Today, a warehouse facility may be a permanent facility for the fund, although an exit to a CLO is still feasible, and is often contemplated in an exception to a facility's sale restrictions

3. To create a warehouse facility, a fund forms a special purpose vehicle (SPV), contributes an initial pool of assets to the subsidiary, and then uses its equity and third party financing to expand the pool

B. Current trends affecting warehouse facilities

1. The borrower/SPV is designed to be bankruptcy remote. Several features which are building into the organizational documents of the borrower that support the bankruptcy remoteness of the subsidiary include

   (a) An independent director or manager whose consent is needed for a bankruptcy filing or other material action

   (b) "Separateness provisions" that require the borrower to maintain separate books and records and a separate identity from affiliates

   (c) Limited purpose provisions to limit the scope of creditors

   As a result of the General Growth Property case (equity sponsor replaced the independent directors on its leveraged SPVs which then filed for bankruptcy with parent; upheld by the court), lenders will now require that organizational documents of the SPV limit independent directors to employees of recognized securitization service providers and only allow replacement of an independent director "for cause"

2. In keeping with the trend of funds seeking longer term warehouse facilities that will not necessarily lead to a capital markets take-out, warehouses now may be highly structured facilities, with many of the trappings of a CLO, such as

   (a) Special purpose vehicle (SPV) borrower

   (b) Collateral quality and coverage tests

   (c) Priority of payment waterfalls

   (d) Debt under the warehouse facility may be rated, and the lender may require the underlying loans to be shadow rated, as in a CLO. However, it's rare to have multiple tranches of debt, and typically the lender group is small. Many warehouse facilities in fact do not have rated debt

3. Warehouse facilities now incorporate a pre-determined list of eligibility criteria and concentration limits for the SPV's assets, which are generally formulated based on a target asset pool and the lender's credit parameters. Some lenders insist on retaining an approval right for each asset added to the warehouse

4. Other ways warehouses remain distinct from capital markets deals include

   (a) Documentation under a credit agreement or using a total return swap (TRS) instead of a bond indenture

   (b) "Club deals" with limited number of finance providers

(c) More likely to be a U.S.-based issuer instead of Cayman-based

(d) Administrative agent plays activist role in approving portfolio and actions by the collateral manager

5. Current warehouses also differ from the warehouses that were used solely to jump-start a CLO

(a) Currently, assets are much more likely to be held in an SPV owned by the fund. Previously, assets were often held or "warehoused" on the books of an investment bank

(b) New arrangements may have revolving periods as long as three years followed by an amortization period, whereas prior to the credit crisis, reinvestment period rarely extended beyond a year and were timed to the launch of a CLO

(c) Currently, recourse is more likely to be limited to the asset pool. Previously, hedge fund sponsors were more willing to guaranty repayment of the warehouse debt if a planned CLO failed to launch

III. Post-crisis use of CLOs for leverage

A. A CLO is a private investment fund that issues multiple classes of secured notes as well as subordinated notes or equity and invests in a portfolio of noninvestment grade loans and other noninvestment grade assets. Usually the secured notes bear LIBOR-based interest and are rated by a rating agency, with ratings ranging from AAA to BB

B. What assets can a CLO finance in 2012?

Before 2009, CLOs were used to finance senior secured loans, second-lien loans, LCDS mezz, high-yield bonds, CLO notes, asset backed securities, warrants, equity kickers, distressed loans and other assets. The market now requires that a high percentage (90-95%) of assets financed by the CLO be first-lien senior-secured loans with only limited capacity to invest in high-yield bonds and second-lien loans. Loans financed through a CLO may be either syndicated leveraged loans or loans to "middle market" borrowers. CLOs may be able to invest in mezz and equity securities by financing exercise of warrants and equity kickers and through distressed exchanges

On the other hand, CLOs have not been issuing "revolving" classes of senior notes, and as a result CLOs have reduced capacity to finance investments in revolving credits. CLOs of distressed loans and CLO squareds have not reemerged post-crisis, although CLOs have capacity to invest in DIP loans. Investments by new CLOs in loans to non-U.S. borrowers have been very limited. CLOs investing primarily in loans to European borrowers have not reemerged. New CLOs either cannot invest in synthetic assets (such as LCDS) or have very limited capacity for such investments

C. What assets will a CLO be able to finance in 2012?

Recent CLOs have expanded slightly their ability to invest in assets that are not first-lien senior-secured loans, and the types of assets which may be financed. However, regulatory changes are coming that may limit the assets financed by CLOs to senior secured loans that meet high quality standards

For example, the SEC's proposed risk retention regulations exempt managers of CLOs which only finance loans which meet very strict qualitative standards. The proposed regulations implementing the Volcker Rule-exempt CLOs but only if a CLO limits its portfolio investments to loans (and interest rate and FX swaps related to those loans)

D. CLO terms are likely to continue to improve in 2012. An increased volume of CLO debt is expected to be issued in 2012. Trends include

1. Longer reinvestment periods, with more ability for the manager to reinvest after the reinvestment period ends

2. More AAA and AA investors and even some equity investors entering or reentering the market. With the return of investors, CLO offerings have been more broadly distributed than in 2010

3. Issuances of fixed rate notes, principal protected notes and "combo" notes

4. More tranching of liabilities (BB through AAA), instead of simple two-class CLO structures

5. Changes in the capital stack have resulted in an increasing leverage, as measured by the ratio of a CLO's rated note issuance to its unrated note (or "equity") issuance

6. The practical requirement in 2010 that manager affiliates take down all of the equity in the CLO was diluted in 2011 (but manager affiliates still need to take down significant equity)

E. How can managers position themselves to access the leverage available in the CLO market?

1. Only a limited set of managers were able to access the CLO market for leverage in 2011. Typically, these managers either had a large footprint in the high-yield space, or they managed registered business development companies with middle-market mandates

2. In the current environment, it is difficult for a manager to access the CLO market if it does not take down a portion of the equity in the CLO. Rules went into effect last year in the European Community that prevent European credit institutions from investing in a CLO where the manager (or a qualifying active deal participant) does not make and maintain a minimum investment in the transaction. U.S. regulators also have proposed risk retention rules, which are expected to go into effect for CLOs as soon as 2014

IV. Leveraging commitments and employee capital

A. Capital call lines and subscription facilities

1. General

These facilities are typically used to bridge an investment to be made by a private equity fund prior to receipt of proceeds of capital calls and also occasionally to fund working capital needs of a private equity fund (e.g., to pay fund expenses, including management fees). A subscription facility may also be used to provide standby letters of credit. For tax purposes, drawdowns are usually repaid within 180 days

Typically, a security interest on portfolio assets is not taken but instead the fund's GP pledges its right to call capital out of unfunded capital commitments to the lender and limited partners agree (usually pursuant to the partnership agreement of the fund) that their unfunded capital commitments can be called directly by a lender to repay amounts drawn under the facility

2. Obligations of limited partners

Limited partners are usually required under the fund's partnership agreement to provide financial information about themselves so that the lender can assess individual limited partners' credit. Some limited partners (e.g., certain pension funds or foundations) enter into side letters with a fund pursuant to which they agree only to provide publicly available financial information about themselves. In addition, certain tax-exempt limited partners who want minimal UBTI risk will enter into side letters with the fund that provide that they will be given the chance to pre-fund (usually on notice shorter than the notice required for capital calls) their share of any drawdown from a subscription facility and such limited partners usually also request that no portion of the interest expense charged on the fund's drawdown from the subscription facility will be allocable to a limited partnerthat has pre-funded its share of such drawdown from the subscription facility. Private equity funds also frequently agree with limited partners to side letter provisions that limit the subscription facility documentation required by a lender to be executed by such limited partners to "customary" documentation and/or documentation "reasonably satisfactory" to such limited partners

3. Terms of borrowing

The borrowing base (i.e., the amount of funds that can be drawn down under a subscription facility) created is equal to the percentage of unfunded capital commitments of eligible limited partners. Limited partners that do not provide sufficient financial information about themselves, or whose credit the lender deems insufficient, are typically excluded from the borrowing base. The default or bankruptcy of a single eligible limited partner should not result in default if outstanding loans are less than the amount of borrowing base

The advance rate on drawdowns may be a blended rate that takes into account different advance rates for different limited partners in the borrowing base (e.g., limited partners with higher rating effectively get to borrow a higher percentage of their collateral). In addition to interest on amounts drawn down from the subscription facility, lenders may also charge a facility fee payable at closing as well as an unused commitment fee

B. Leveraged co-investment arrangements

1. General

Investors in private equity funds usually want the fund's investment team to have "skin in the game" and make capital commitments to the private equity fund that such investment team is managing. A manager may also want the investment team for a particular fund to participate in the fund's P&L through an actual investment (i.e., capital commitment) in the fund

Leveraged co-investment arrangements provide a means for a manager to facilitate loans from a lender to the employees and principals of a private equity fund manager to fund capital commitments to be made by such employees and principals to a private equity fund. Managers with sufficient internal capital may also loan money to employees to fund employees' capital commitments under a similar arrangement. More typically, a manager will arrange for a lender to provide loans to employees to make capital commitments. Private banks and the private banking units of larger banks are typically the types of lenders who offer leveraged co-investment arrangements

2. Terms of borrowing

Loan advances are typically made each time the private equity fund makes a capital call and an employee's partnership interest in the private equity fund is usually pledged as collateral to the manager, who then guarantees repayment of the loan to the lender. The manager in turn pledges to the lender its right to receive management fees. A more manager-friendly option is for the employees to pledge their interest in the private equity fund directly to the lender. Proceeds from any distribution (other than distributions subject to reinvestment) are usually paid directly to the lender to repay principal on the loan and the lender often requires employees participating in the leveraged co-investment to maintain bank accounts with the lender

3. Structure

Instead of having employees invest directly in the fund, sometimes the manager will establish solely for employees

(a) A parallel fund in which the loan advances will be invested

(b) A feeder fund in which loan advances will be invested and which will in turn invest substantially all of its capital into the main private equity fund

The parallel fund option may not necessarily be economically efficient since it would necessitate allocating investments across funds, which entails additional operational costs that are not incurred with a feeder fund structure

4. Regulatory requirements

For securities law purposes employees will need to be accredited investors under Regulation D, and since most private equity funds rely on the Section 3(c)(7) exemption to the Investment Company Act, employees also typically need to be "qualified purchasers" or "knowledgeable employees"

V. Master repurchase agreements

A. Basic terms of repo

1. Under a repo, the fund will sell the asset to the repo counterparty for cash with an agreement by the fund to repurchase the asset at the end of the term. During the term of the trade, the fund will pay a financing fee to the counterparty, known as the price differential in repo parlance. Cash flows on the asset get paid by the counterparty to the fund (net of the price differential) during the term of the trade

2. Market value financing — repos are typically market value financing arrangements whereby the fund will be required to deliver margin or collateral if the market value of the asset declines. But depending on asset and business deal, they don't have to be

3. Complex repos are documented under non-standard negotiated agreements similar to traditional asset-based credit agreement financings (as opposed to industry standard MRA and GMRA for treasuries)

4. Custodial arrangements — many repos have assets deposited with custodian thereby protecting fund against dealer credit risk. If there is no custodian, the dealer has the right to use and abuse the asset or collateral; but are still required to sell back the asset at termination

B. Legal considerations

1. Safe harbor bankruptcy for repurchase agreements and securities contracts

(a) Section 555 of the Bankruptcy Code — contractual right to liquidate, terminate or accelerate a securities contract

(b) Section 559 of the Bankruptcy Code — contractual right to liquidate, terminate or accelerate a repurchase agreement

(c) Section 651 of the Bankruptcy Code — contractual right to terminate, liquidate, accelerate or offset under a master netting agreement and across contracts; proceedings under Chapter 15

(d) Section 362(b)(6) of the Bankruptcy Code — contractual rights, including right to offset or net out any termination value, payment amount, or other transfer obligation, under any security agreement or arrangement or other credit enhancement forming a part of or related to any commodity contract, forward contract or securities contract

2. Section 101(47) of the Bankruptcy Code — definition of "repurchase agreement"

(a) The term "repurchase agreement" (which definition also applies to a reverse repurchase agreement)

(i) Means:

(1) An agreement, including related terms, which provides for the transfer of one or

more certificates of deposit, mortgage related securities (as defined in Section 3 of the Securities Exchange Act of 1934), mortgage loans, interests in mortgage related securities or mortgage loans, eligible bankers' acceptances, qualified foreign government securities (defined as a security that is a direct obligation of, or that is fully guaranteed by, the central government of a member of the Organization for Economic Cooperation and Development), or securities that are direct obligations of, or that are fully guaranteed by, the United States or any agency of the United States against the transfer of funds by the transferee of such certificates of deposit, eligible bankers' acceptances, securities, mortgage loans, or interests, with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, eligible bankers' acceptance, securities, mortgage loans, or interests of the kind described in this clause, at a date certain not later than one year after such transfer or on demand, against the transfer of funds;

(2) Any combination of agreements or transactions referred to in clauses (1) and (3);

(3) An option to enter into an agreement or transaction referred to in clause (1) or (2);

(4) A master agreement that provides for an agreement or transaction referred to in clause (1), (2) or (3), together with all supplements to any such master agreement, without regard to whether such master agreement provides for an agreement or transaction that is not a repurchase agreement under this paragraph, except that such master agreement shall be considered to be a repurchase agreement under this paragraph only with respect to each agreement or transaction under the master agreement that is referred to in clause (1), (2) or (3); or

(5) Any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in clause (1), (2), (3) or (4), including any guarantee or reimbursement obligation by or to a repo participant or financial participant in connection with any agreement or transaction referred to in any such clause, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with Section 562 of this title

(ii) Does not include a repurchase obligation under a participation in a commercial mortgage loan

3. Section 741 of the Bankruptcy Code — definition of "securities contract"

(a) "Securities contract"

(i) Means:

(1) A contract for the purchase, sale, or loan of a security, a certificate of deposit, a mortgage loan, any interest in a mortgage loan, a group or index of securities, certificates of deposit, or mortgage loans or interests therein (including an interest therein or based on the value thereof), or option on any of the foregoing, including an option to purchase or sell any such security, certificate of deposit, mortgage loan, interest, group or index, or option, and including any repurchase or reverse repurchase transaction on any such security, certificate of deposit, mortgage loan, interest, group or index, or option (whether or not such repurchase or reverse repurchase transaction is a "repurchase agreement," as defined in Section 101);

(2) Any option entered into on a national securities exchange relating to foreign currencies;

(3) The guarantee (including by novation) by or to any securities clearing agency of a settlement of cash, securities, certificates of deposit, mortgage loans or interests therein, group or index of securities, or mortgage loans or interests therein (including any interest therein or based on the value thereof), or option on any of the foregoing, including an option to purchase or sell any such security, certificate of deposit, mortgage loan, interest, group or index, or option (whether or not such settlement is in connection with any agreement or transaction referred to in clauses (1) through (11));

(4) Any margin loan;

(5) Any extension of credit for the clearance or settlement of securities transactions;

(6) Any loan transaction coupled with a securities collar transaction, any prepaid forward securities transaction, or any total return swap transaction coupled with a securities sale transaction;

(7) Any other agreement or transaction that is similar to an agreement or transaction referred to in this subparagraph;

(8) Any combination of the agreements or transactions referred to in this subparagraph;

(9) Any option to enter into any agreement or transaction referred to in this subparagraph;

(10) A master agreement that provides for an agreement or transaction referred to in clause (1), (2), (3), (4), (5), (6), (7), (8) or (9), together with all supplements to any such master agreement, without regard to whether the master agreement provides for an agreement or transaction that is not a securities contract under this subparagraph, except that such master agreement shall be considered to be a securities contract under this subparagraph only with respect to each agreement or transaction under such master agreement that is referred to in clause (1), (2), (3), (4), (5), (6), (7), (8) or (9); or

(11) Any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in this subparagraph, including any guarantee or reimbursement obligation by or to a stockbroker, securities clearing agency, financial institution, or financial participant in connection with any agreement or transaction referred to in this subparagraph, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with Section 562

(ii) Securities contract does not include any purchase, sale, or repurchase obligation under a participation in a commercial mortgage loan

VI. Total return swaps

A. General

Total return swaps are an effective financial tool for private investment funds that want to obtain leverage on their investments in a variety of asset classes, including corporate loans, bonds or even other hedge funds ("reference assets"). Total return swaps enable investment funds to obtain the economic exposure to a reference asset or a portfolio of reference assets on a leveraged basis without taking ownership of the reference assets. The investment fund will receive all of the cash flow benefits of the reference assets without actually owning them. At the end of the transaction, or at pre-determined time periods, the investment fund will make a payment to the swap dealer in an amount equal to the decline of the reference assets or the swap dealer will make a payment to the investment fund in an amount equal to the increase in value of the reference assets. During the life of the transaction, the investment fund will receive from the swap dealer all cash flows received on the reference assets and in exchange, the investment fund will make periodic payments to the swap dealer equal to the financing cost of an investment in the reference assets

B. Ancillary benefits to total return swaps

There are other reasons for investment funds to utilize total returns swaps, although they are typically ancillary to the main reason, leverage. Other reasons include the ability to outsource the administration and operation of trading and maintaining the reference assets, and the ability to gain exposure to reference assets that an investment fund might not otherwise be able to own due to, for example, eligibility restrictions on ownership and issuer consent rights to any transfer. If the total return swap is characterized as a derivatives contract instead of as a secured financing, there are additional benefits. Typically the swap dealer will not incur a substantial regulatory charge if derivative accounting treatment is achieved. In addition, in the case of a bankruptcy of the investment fund, certain swap agreements are exempt from the automatic stay imposed by the Bankruptcy Code, and the swap dealer may be permitted to terminate and liquidate the transaction outside of the bankruptcy proceeding. These features will enable the swap dealer to provide the investment fund better financing terms

C. Downside of total return swaps — voting rights

Although the investment fund does not have legal ownership of the reference assets, the swap dealer may, for purposes of its hedge, acquire the reference assets. Accordingly, one issue typically negotiated is if and to what extent an investment fund will have the right to direct the swap dealer on how to vote on any issues that arise with respect to the reference assets (e.g., votes on amendments to financial covenants, changes to economic terms, etc.). Voting rights are especially important when dealing with reference assets that become defaulted obligations because of a payment default or bankruptcy of the issuers if the investment fund manager wants to control or have some input in dealing with the defaulting obligors. Note that typically the swap dealer has a strong desire to achieve derivative accounting treatment. While there is no bright line rule to ensure derivative treatment, providing the investment fund the sole unfettered right and discretion to direct the swap dealer on voting issues with respect to the reference assets is not a good fact in achieving the desired derivative treatment. Therefore, any voting rights that are passed along to investment funds typically take the form of consultative rights if the investment fund is granted any rights at all

D. Types of TRS facilities

1. Committed versus non-committed facilities

2. Recourse versus limited recourse facilities

3. Market value triggers

4. Certain tax considerations — the tax considerations related to a private investment fund's investment in total return swaps are influenced by, among other factors, the fund's jurisdiction, level of trading activities and/or investor base

E. Dodd-Frank Act

Under the Dodd-Frank Act, a total return swap on a single loan or security is a "security based swap" and a "security" and is now subject to the jurisdiction of the SEC and the anti-fraud and anti-manipulation provisions of the Securities Act and the Exchange Act. In addition, total return swaps on a single loan or security must be traded with a counterparty that is an "eligible contract participant" unless there is an effective registration statement for the swap. A total return swap on a portfolio of loans or securities is probably not a "security based swap," but is a "swap" under the Dodd-Frank Act and therefore subject to the jurisdiction of the CFTC and the anti-manipulation provisions of the CEA

VII. Fund-of-funds facilities

A. Nature of collateral

Fund-of-funds financings are a unique, specialized lending area due to the nature of the collateral. A fund-of-funds is a fund that invests in other hedge funds. The sole collateral under a fund-of-funds facility will be

1. The fund-of-funds' interests in the underlying hedge funds

2. The accounts into which redemption proceeds and distributions are paid to the fund-of-funds

A lender has to assess not just whether the underlying funds are good investments, but also difficulty of realizing upon the collateral. Realizing on the collateral may be difficult without cooperation of the fund-of-funds borrower

Withdrawal/redemption restrictions have to be assessed, as well as transfer restrictions. The lender will look at "gates," suspensions and lock-ups as well as provisions that permit in-kind distributions

B. Role of underlying hedge funds

1. In the past, lenders required upfront consent from the underlying hedge funds. The consent authorized the pledge, provided for admission of the lender and provided for redemption or withdrawals by the lender. The primary problem with this approach was a lack uniformity among consent forms

2. Currently, a fund-of-funds generally holds its fund interests through a nominee. The nominee's interest is held through a securities account and the securities account is subject to a control agreement, which perfects the lenders security interest. It is noteworthy that lenders retain tight control on withdrawals. This can hinder a fund-of-funds' ability to access its cash

C. Structure of fund-of-funds facilities

1. Fund-of-funds facilities are typically structured as revolving credit facilities secured by the underlying portfolio of fund interests. Custodial control arrangement is entered into through the creation of a perfected security interest in a securities account to which the underlying fund interests are credited. In addition, the lender obtains a perfected security interest in the deposit accounts into which redemption proceeds are placed

2. Account control agreements are entered into with the borrower and the custodian bank that holds the accounts

3. The fund interests are held in the name of the lender or custodian to facilitate redemptions without borrower consent. This structure can create problems for borrowers due to constraints on transferring interests and accessing proceeds of distributions and redemptions

4. Lending formulas are generally tied to values of the underlying investments and function as a variant of a typical borrowing base. The lending formula caps the lenders exposure to a percentage of the actual collateral values. The formula might be determined by taking the aggregate collateral value and multiplying by a maximum risk ratio. The risk ratio will incorporate a haircut formula that can be lengthy and will be customized to the funds' strategy

5. Maturities vary from one year to longer; some lenders wish to review the facility annually before deciding whether to renew

D. Use of loan proceeds

Loan proceeds are used for a variety of purposes

1. Finance further investments in pledged funds or new funds

2. Finance redemptions, especially larger than anticipated redemptions

3. General liquidity (which may be left untapped)

E. Specialized provisions

Fund-of-funds facilities have tests that allow the lender to react quickly to problems with the portfolio. Some examples include

1. Volatility tests (look at variations in standard deviations of NAVs)

2. NAV and net equity tests (look at the high point during a specified period and then require a certain percentage of high point to be met)

3. Diversification tests (minimum number of funds and maximum allocation per investment fund or manager; possibly also by type of strategy)

4. Material adverse effect tests (will test for adverse changes affecting the fund, the general partner, investment manager and the portfolio)

Real Estate Funds: Terms and Trends

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Stephanie R. Breslow is a partner at Schulte Roth & Zabel, where she is also co-head of the Investment Management Group and a member of the Executive Committee. Her practice includes investment management, partnerships and securities, with a focus on the formation of liquid-securities funds (hedge funds, hybrid funds) and private equity funds (LBO, mezzanine, distressed, real estate, venture), 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 represents funds of funds and other institutional investors in connection with their investment activities.

Stephanie is a sought-after speaker on fund formation and operation and compliance issues, and also regularly publishes books and articles on the latest trends in these areas. She co-authored *Private Equity Funds: Formation and Operation* published by Practising Law Institute, contributed a chapter on "Hedge Funds in Private Equity" for inclusion in *Private Equity 2005-2006* (PLC Cross-border Handbooks) and co-wrote *New York and Delaware Business Entities: Choice, Formation, Operation, Financing and Acquisitions* and *New York Limited Liability Companies: A Guide to Law and Practice*, both published by West Publishing Co.

Currently the secretary of the Investment Funds Committee of the International Bar Association, Stephanie is also a founding member and former chair of the Private Investment Fund Forum, a former member of the Steering Committee of the Wall Street Fund Forum and a member of the Board of Directors of 100 Women in Hedge Funds.

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Dan A. Kusnetz is a partner at Schulte Roth & Zabel, where his practice concentrates on tax planning for complex transactions, including mergers and acquisitions, private equity, real estate, finance, bankruptcy, workouts, corporate restructuring and distressed asset investing.

Some of Dan's more significant engagements and transactions, throughout a professional career spanning more than 25 years, include his recent representations of: Cerberus Capital Management LP in the acquisition of a controlling interest in Chrysler LLC (and, later, in the sale of Chrysler and its debtor subsidiaries' assets in their Chapter 11 reorganization and the sale of the Chrysler Financial business to TD Bank); Blackstone's real estate funds in their acquisitions of distressed mortgage loan portfolios; a foreign life insurance company in its debt and equity restructuring of over $1 billion of commercial real estate assets; groups of private institutional investment funds in their recent acquisitions and recapitalizations of Chapter 11 debtors GSI, Orleans Homebuilders, Hines Nurseries, and Lenox Inc.; an institutional real estate investor in a $3 billion leveraged recapitalization of a real estate joint venture; and a major investment bank in connection with the formation of Argentine and Brazilian real estate private equity funds. In addition, Dan served as tax counsel to Lionel LLC in its successful Chapter 11 reorganization and to a major European bank in its acquisitions of controlling interests in fund of funds managers with over $4 billion in assets under management. Over the years, he has served as tax counsel to debtors' and creditors' committees in numerous Chapter 11 cases, including TWA, Drexel Burnham Lambert, Phar-Mor Drugstores, Resorts International, Bibb Companies, the New York Daily News, Seaman's/Levitz Furniture, Ranger Industries and Mayflower Group.

Dan is a frequent speaker at Tax Executives Institute (TEI) programs and other tax seminars throughout the country and has been recognized for numerous years by *The Best Lawyers in America* as a leading tax attorney.

Dan received his B.A., *cum laude*, from Tulane University; his J.D., *magna cum laude*, from Tulane University Law School, where he was Order of the Coif and managing editor of the *Tulane Law Review*; and his LL.M. in taxation from New York University School of Law.

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Jeff frequently speaks and writes on real estate topics. He is a member of the editorial board and a regular columnist for the Distressed Assets Investor; his column has recently discussed "Private Equity's New Role in Real Estate." Jeff has spoken at dozens of conferences and seminars over the past year, most recently at the IMN's Real Estate Subordinated Debt Origination & Investment Forum, where he discussed "The View From 30,000 Feet: A Macroeconomic & Real Estate Debt Market Overview & Update" and "CMBS in a Different World: What to Expect in 2012 & the Impact on the Debt Market," and at IMN's Real Estate General Counsel's Forum, where he discussed "Deal Structuring, Loan Origination & Financing Regulatory & Business Developments."

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Real Estate Equity Investments & Joint Ventures

Regulatory & Compliance

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A member of New York's Private Investment Fund Forum, Phyllis frequently shares her insights on effective fund formation strategies at industry conferences and seminars. She recently presented on the "State of the Industry" at FRA's Private Equity C-Level Summit and discussed "Fund Formation: Considerations for Effective Tax and Operational Standards" at FRA's 2nd Annual Private Investment Funds Tax Master Class. She is co-author of *Private Equity Funds: Formation and Operation* published by Practising Law Institute in 2009, which is considered the leading treatise on the subject.

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Real Estate Funds: Terms and Trends

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Taking Advantage of Investment Opportunities

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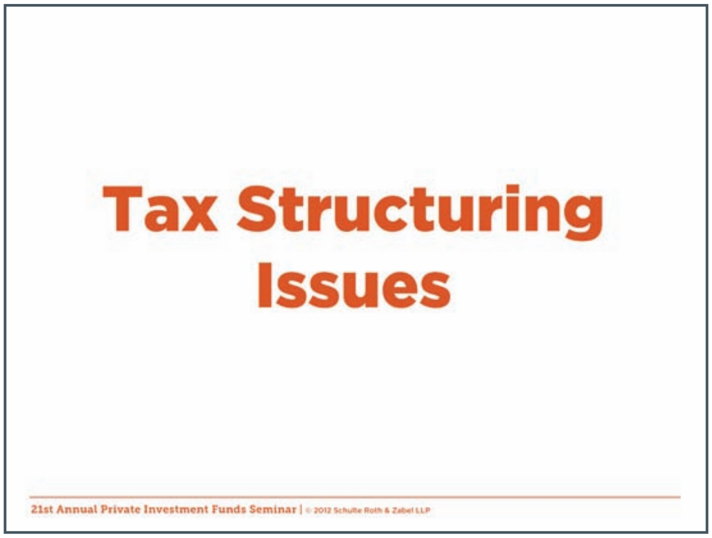
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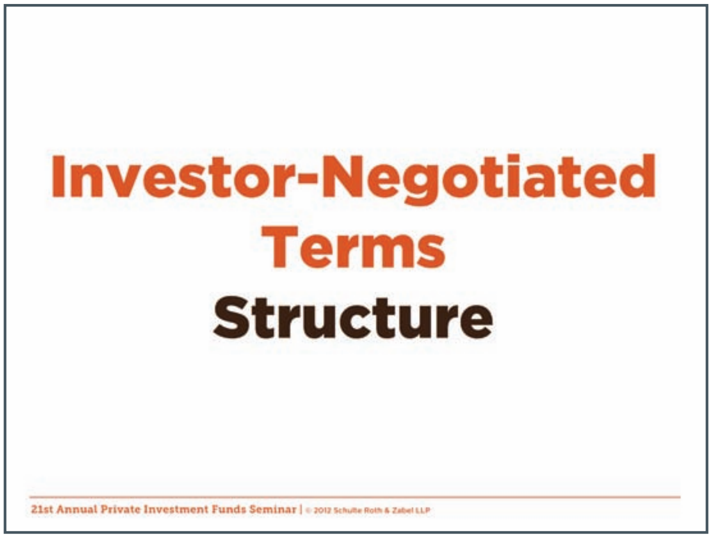
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Real Estate Funds: Terms and Trends

I. Introduction

A. The real estate investment environment is a key driver of the terms and structure of real estate private equity funds

B. The general economic condition has constrained real estate investment activity

C. Private equity funds have been challenged by prominent scandals and poor performance

1. Investors are more aware of the importance of strong operational controls, good sponsorship and compliance with regulations

2. Investors are scrutinizing managers more thoroughly

D. On the brighter side, the current economic uncertainty has caused many investors to rely more heavily on alternative investments, including real estate

II. Real estate market conditions

A. General consensus

1. The general consensus is that there is no consensus

2. Our clients are anxious and the real estate markets are volatile

3. Real estate investors are looking to do deals, make loans, start projects, buy distressed assets; but there is reluctance to pull the trigger — the price is too high, the cap rate is too low, the vacancy rate is too high, the leasing is too soft, the market fundamentals are too weak and the distressed assets are not distressed enough to earn the hoped-for returns

B. Positive indicators

1. We are experiencing the lowest interest rates we have ever experienced

2. For the right borrowing structure, debt financing is plentiful (particularly from banks and life companies)

3. There is lots of capital looking to make equity investments

4. It is not a bad time to be selling fully leased trophy office buildings

C. Negative indicators

1. There is angst and concern in the market — not just with the domestic economy but with the broader world situation

2. Unemployment remains high — the best minds in the country search for a way to generate jobs

3. The economy is weak and the fear is that it will remain so for an indeterminate time

4. There is uncertainty about future federal tax policies as concerns real estate, particularly the imposition of the so called “carried interest” tax

D. Observations

1. There is an abundance of equity and debt financing available if you are the right owner, with the right property type, that is properly structured and in a desirable market

2. Underwriting structures have become more stringent

3. Location is of prime importance
4. Core properties are attractive
5. Character and reputation are equally important
6. Don’t incur too much leverage
7. New development is difficult to justify in most markets, but there are exceptions
8. Everyone loves multi-family rental housing, but how long can good times continue?
9. Affordable and mixed-use housing continues to be developed with the use of many federal and state assisted programs

III. Private equity’s new role in real estate

A. Restraint on growth in real estate markets

1. With the consolidation and disappearance of many investment banks, the elimination of many of the commercial and savings banks, the difficulties encountered by owners and developers and the issues facing many other real estate players, what will it take to create the next new influx of capital?
2. Many players in the secondary markets — banks, CMBS lenders and REITs — continue to be burdened by distressed or defaulted loans
3. The players in the equity markets continue to be plagued by their legacy assets
4. Private equity has begun to provide the liquidity required to drive up property prices and resolve bad loans, replacing the capital markets

B. Private equity is poised to take a leading role in real estate markets

1. Few commercial banks are currently looking for new business since many of them are burdened by non-performing loans
2. CMBS lenders have experienced drastic declines in volume and pricing
3. REIT prices continue to be extremely volatile and more REITS are expected to make strategic defaults to renegotiate, refinance or hand over keys to their owned real estate
4. In the absence of the predicted deluge of foreclosures, various sources estimate that real estate private equity funds are sitting on more than $100 billion of capital

C. Private equity generally reaches out to the real estate market following one of three strategies

1. Core assets — core strategies focus on building a long term, low to moderate risk portfolio of expensive, durable assets, usually comprised of Class A properties
2. Moderate risk — in the moderate risk, value-added strategy, trophy assets comprised the portfolio foundation, while riskier assets target higher returns, for example, properties that require redevelopment or other improvements
3. Opportunistic — an opportunistic strategy focuses on the highest available returns, including assets with broken capital structures, but features high risk and little diversification

D. Current state of real estate private equity investments in real estate

1. For years, real estate private equity firms have been lavished with huge sums of money by investors

looking to own real estate; but in the past year, there have been fewer deals that those firms are finding attractive — ones that offer quick and bountiful yields

2. Many so-called distressed opportunities that were supposed to materialize over the past year or two have not, as banks have worked out new loan terms with their struggling borrowers (“extend and pretend”)

3. As a result, many real estate private equity firms’ buckets of cash have been sitting unspent and, under typical investment rules, funds that are not deployed during a specified period of time must be returned to investors

4. Because private equity firms often seek greater returns than other types of investors, such as pension funds and institutional players, their portion of the commercial real estate investing pie has shrunk in 2010 and 2011

5. It is said that from 2009 to 2010 real estate private equity raised $63 billion (according to data from the London-based financing research firm Prequin). That equaled almost all of what was raised during the entire pre-boom period from 1990 to 2004

6. In 2011, the Prequin data shows that $160 billion was raised. This pot of cash will inevitably compete with capital from earlier fundraising rounds, and thus probably struggle to find worthy investments in 2012. However, there are many private equity firms that are showing themselves to be up to the challenge with some large, notable and profitable transactions

7. The competition for core properties in primary locations continues to exist and is great

8. As real estate private equity realizes that it needs to put more of its capital to work, it will look to Class B and C properties and properties in secondary locations for opportunities before other lenders and equity players, injecting liquidity throughout all classes of real estate. Private equity has the potential to flush the markets with liquidity and to an extent has already begun to do so

IV. Investor-negotiated terms: economics

A. Payments of the carried interest are being made later

1. More real estate funds are using the “European” or “back-ended” distribution waterfalls to ensure that investors receive a return of their capital before the carry is paid to the general partner

2. Total return waterfalls have been required of some managers even if they are forming successor funds to prior funds that had deal-by-deal carry

3. Hybrid waterfalls are alternatives to back-ended waterfalls

   This commonly results in the cost of deals sold plus all fund expenses, including management fees, to be returned to investors before the carried interest is paid

4. Interim clawbacks are now sometimes required well before the fund approaches its winding-up period

5. Escrows are not gone either but, in that case, it may be better to use a back-ended waterfall than to have cash sitting in accounts earning little returns

6. Some investors are requesting joint and several liability personal guarantees of clawbacks

B. Management fees

1. Investors continue to seek lower management fees to avoid management fees servicing as a profit center

2. Smaller funds have less certainty in their ability to raise a successor fund plus have increased compliance costs, which all raise the level of management fees needed to run the business

3. Management fee offsets for transaction and monitoring fees are seen as the largest non-alignment issue

    (a) Many investors are now demanding 100% offsets for transaction fees

    (b) Property servicing fees still generally fall outside offset requirements because they are earned for a business purpose unrelated to management of a fund

4. Step-downs of management fees are now often triggered upon the earlier of the end of the investment period and the formation of successor funds

C. General fund expenses are scrutinized more carefully by investors

1. Travel expenses should be covered by the fund for investments and divestments; however, monitoring costs are generally covered by the management company

2. Internal costs (e.g., accounting services) are unlikely to be borne by the fund

D. Larger investors are requiring preferential treatment

1. These arrangements may be established in separate vehicles, but will generally be disclosed or at least referenced in offering materials and under "most favored nation" side letters

2. Side letters

    (a) Side letters may provide for special economic rights, but these rights should be expressly disclosed, such as special management fees and carried interest arrangements

    (b) Side letters need to be evaluated in light of a manager's fiduciary duty to investors and are considered a potential means of treating investors unevenly and a potential source of unfairness among investors

V. Tax structuring for real estate private equity funds

A. Real estate funds attract a broad array of investors that are much more likely to require special structuring under applicable tax laws

1. Examples of investors requiring special structuring include: (1) non-U.S. investors; (2) sovereign wealth funds; and (3) tax-exempt U.S. investors

2. As a result of these investors' differing tax needs, a single private equity real estate fund often consists of multiple parallel investment vehicles. To the maximum extent possible, parallel funds have the same economic terms and conditions, other than those required to adequately address tax structuring concerns. However, these tax concerns may limit the amount a parallel fund invests in a specific transaction, and therefore could result in its investors recognizing differing returns on their investments. In addition, it is common to permit investors in private equity funds to "opt-out" of certain investments if the tax profile of the investment meets certain criteria

B. Tax considerations for non-U.S. investors — there are four main categories of tax that may be imposed on non-U.S. investors in a real estate private equity fund: (1) taxes imposed on certain dispositions of U.S. real property under the Foreign Investment in Real Property Tax Act ("FIRPTA"); (2) withholding taxes imposed under FIRPTA; (3) taxes on a non-U.S. investor's "effectively connected income" ("ECI"); and (4) withholding taxes imposed under the Foreign Account Tax Compliance Act ("FATCA")

1. Effectively connected income

    (a) There are three general categories of income that a non-U.S. investor in a real estate private equity fund may receive from the fund's investments in U.S. real property: (1) interest income from any amounts invested as debt; (2) dividend income from distributions made by a corporation holding such U.S. real property; and (3) rental income from such real property

        With certain exceptions, these three categories of income will be considered "FDAP" income and subject to a gross 30% tax rate if they are received from a source within the United States

    (b) However, if any of the income described above is effectively connected with the conduct of a trade or business in the United States, non-U.S. investors will be subject to net income tax at the rates applicable to U.S. persons

    (c) Income will be considered to be effectively connected with the conduct of a U.S. trade or business if a party (or an agent on its behalf) is engaged in profit-seeking activities in the United States with some regularity and continuity. However, merely managing or preserving investment assets is not considered trade or business activity, even if it is engaged in for profit on a full-time basis

    (d) Thus, ECI includes each of the following

        (i) All U.S.-source income derived from a U.S. trade or business

        (ii) U.S.-source capital gains and FDAP income if

            (1) The gain or income is derived form assets used or held for use in the conduct of the trade or business, or

            (2) The activities of the trade or business are a material factor in the realization of such income

        (iii) All other U.S.-source income (except for capital gains and FDAP income not described above)

    (e) Foreign corporations that are engaged in a trade or business in the U.S. are also subject to a branch profits tax equal to 30% of its "dividend equivalent amount." Generally, this is defined to include any earnings and profits of the corporation that are effectively connected with its conduct of a trade or business in the United States, with certain adjustments. While the branch profits tax may be avoided through the use of a domestic holding company, this structure will subject any income received from the U.S. real property that is part of the U.S. trade or business to corporate-level tax and then to a second level of tax when the after-tax earnings and profits of the domestic corporation are distributed to shareholders (other than in liquidation)

    (f) While ECI may lead to the imposition of a branch profits tax on foreign corporations, and U.S. taxation at rates applicable to U.S. persons for all foreign persons, taxpayers realizing ECI are able to take deductions applicable to the property giving rise to the ECI, but only to the extent that the deductions relate to ECI and then only to the extent that they are effectively connected with such income. The 30% tax imposed on non-ECI income for foreign persons is imposed on gross income (i.e., deductions are not taken into account)

    (g) Under Section 1446 of the Code, foreign partners of a domestic partnership having ECI are subject to a withholding tax on their distributive shares of the partnership's income and at the highest rate generally applicable to a U.S. individual (in the case of foreign individuals) or a U.S. corporation (in the case of foreign corporations)

2. FIRPTA

    (a) In 1980, Congress enacted FIRPTA to help eliminate a perceived tax advantage for non-U.S. persons on their investment in U.S. real property

(b) Applicable terminology

(i) "United States real property interest" ("USRPI") is defined as either: (1) an interest in real property in the U.S. or the Virgin Islands; or (2) an interest (other than solely as a creditor) in a U.S. real property holding corporation at any point during the shorter of the period after June 18, 1980, during which the taxpayer held the interest, or the five-year period ending on the date of the disposition of the interest. For this purpose, the taxpayer bears the burden of demonstrating that its interest in a corporation was not an interest in a U.S. real property holding corporation

(1) There is a carve-out from this definition for classes of stock in a corporation that are regularly traded on an established securities market. Such interests are not considered USRPIs unless the investor held at least 5% of such class for the time period described above

(2) For this purpose, "real property" includes: (1) land and unsevered natural products of the land; (2) improvements on the land; and (3) personal property associated with the use of real property

(ii) "United States real property holding corporation" ("USRPHC") is defined as any corporation if the fair market value of its USRPIs equals or exceeds 50% of the aggregate of: (1) its USRPIs; (2) its interests in real property located outside the United States; and (3) any other of its assets used or held for use in a U.S. trade or business. While this definition applies only to corporations, Section 897(g) of the Code provides that, under Treasury Regulations, the sale of an interest in a partnership, trust or estate may be treated as a USRPI to the extent any gain on the sale or disposition is attributable to USRPIs

Currently, the Treasury Regulations apply only to partnerships, trusts or estates in which at least 50% of the gross assets are, directly or indirectly, USRPIs and in which at least 90% of the gross assets are USRPIs plus cash equivalents. However, the IRS has taken the position that regulations are not required to be issued under Section 897(g) for that section to be effective

(c) Imposition of tax under FIRPTA

(i) Section 897 of the Code provides that a non-U.S. person's gain or loss on its disposition of a USRPI is considered to be effectively connected with the conduct of a U.S. trade or business. For this purpose, a "disposition" is any transfer that would constitute a disposition by the transferor for any purpose under the Code or Treasury Regulations

(ii) A disposition of an interest in a partnership is taxable to the extent of the gain attributable to the USRPIs held by the partnership

(iii) Certain dispositions that would otherwise qualify for nonrecognition treatment under other provisions of the Code and Treasury Regulations will not be treated as nonrecognition transactions under FIRPTA. Such treatment only applies (and therefore, the taxpayer only avoids a taxable event) if the following three conditions are satisfied: (1) the foreign transferor receives a USRPI in exchange for the transferred USRPI; (2) the USRPI received would be subject to income tax in the United States upon its disposition; and (3) the transferor satisfies certain filing requirements provided in Treasury Regulation 1.897-5T(d)(1)(iii)

3. FIRPTA withholding taxes — Section 1445

(a) Under the general rule, Section 1445(a) imposes a 10% withholding tax on the disposition of a USRPI by a foreign person, subject to certain exemptions. These exemptions include instances where the transferor provides an affidavit stating that it is not a foreign person and instances where the disposition is of stock of a class that is regularly traded on an established securities market

(b) In general, if a domestic partnership, trust or estate sells or otherwise disposes of a USRPI, a 35% tax is imposed on the portion of the gain from the disposition attributable to a foreign person that is a partner or beneficiary or that is allocable to the portion of a trust treated as owned by a foreign person. If, rather than selling or disposing of the USRPI, the domestic partnership, trust or estate distributes the USRPI to its foreign investors in kind, a 10% tax is imposed on the fair market value of the USRPI distributed

(c) Foreign corporations making distributions under which gain is recognized pursuant to Sections 897(d) or (e) of the Code must withhold tax in an amount equal to 35% of the gain recognized on such distribution. Section 897(d) imposes a tax on the gain recognized on the distribution of a USRPI, subject to certain exceptions, while Section 897(e) imposes a tax on nonrecognition transactions where a USRPI is not exchanged for another USRPI

(d) Amounts realized on a disposition of an interest in a partnership in which at least 50% of its gross assets are USRPIs and at least 90% of its gross assets are USRPIs or cash equivalents is subject to a 10% withholding tax

4. FATCA

(a) FATCA imposes a 30% withholding tax on certain “withholdable payments” made to foreign entities. The term “withholdable payment” for this purpose includes, among other things, “any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends from sources within the United States.” Thus, the 30% withholding tax may apply to dividends received by foreign persons from a USRPHC or from interest received by a foreign person making an investment in debt relating to U.S. real property

(b) However, FATCA withholding does not apply to ECI. Thus, gains recognized on the disposition of a USRPI are subject to withholding tax under the FIRPTA withholding rules described in more detail above

C. Tax considerations for sovereign wealth funds

1. Generally, under Section 892 of the Code, income received by a foreign government from its investments in U.S. securities or bonds, financial instruments held as part of its financial or monetary policy and interest on deposits in a U.S. bank is exempt from U.S. taxation

2. However, a foreign government is subject to tax on income: (1) derived from its conduct of a commercial activity; (2) received by or from a “controlled commercial entity”; or (3) derived from its disposition in a “controlled commercial entity.” For this purpose, a “controlled commercial entity” is any entity (domestic or foreign) in which the foreign government holds at least 50% of the vote or value, or in which the foreign government holds an interest allowing it effective control over the entity

Note: A foreign central bank or foreign pension plan is a “controlled commercial entity” only if and to the extent it is engaged in commercial activities within the United States

3. While not a *per se* commercial activity, under Temporary Treasury Regulations, income received from a USRPI and gain recognized upon the disposition of a USRPI is taxable under Section 892

D. Tax considerations for tax-exempt U.S. investors

1. Although generally exempt from federal income tax, a tax-exempt U.S. investor is subject to tax on its “unrelated business taxable income” (“UBTI”). UBTI is defined to include both gross income derived

from a trade or business not substantially related to the tax-exempt entity's exempt function and certain "debt-financed income"

Specifically excluded from the category of income derived from a business not substantially related to the entity's exempt function is rental income received from real property. However, this exclusion does not extend to rents that are contingent on the productivity of the property such as in the case of retail commercial space leases, which provide for "participating rent" where a portion of the rent is determined by the gross revenues of the retail tenant

2. "Debt-financed income" is generally defined to include income from property that is subject to indebtedness incurred to facilitate its acquisition or improvement (including property acquired subject to a mortgage). Indebtedness incurred by certain "qualified organizations" is not considered for this purpose

3. However, the exception generally does not apply if the "qualified organization" owns an interest in an entity treated as a partnership for federal tax purposes (e.g., a domestic fund) that holds such real property. In that case, the partnership must also comply with several additional requirements, including whether: (1) all of the partnership's partners are "qualified organizations"; (2) each allocation to a partner which is a "qualified organization" is a "qualified allocation"; or (3) all of the partnership's allocations have substantial economic effect and each allocation to a partner that is a "qualified organization" complies with the "Fractions Rule"

   Under the "Fractions Rule," no qualified organization's distributive share of partnership income may exceed its percentage share of partnership loss for the taxable year in which its share of partnership losses will be the smallest. Tax planning from the commencement of the partnership is crucial, as a partnership generally will not satisfy the Fractions Rule unless it satisfies the rule for every year in which it would apply

E. Taxable mortgage pools

1. An entity or certain portions of an entity that is considered a "taxable mortgage pool" ("TMP") is considered to be a taxable corporation for federal tax purposes. As a corporation, a TMP is subject to two levels of taxation: the first at the corporate level and the second upon distributions from the TMP to its equity holders

2. A TMP is defined as any entity or portion of an entity (other than a Real Estate Mortgage Investment Conduit) where, on specified "testing dates": (1) substantially all of the entity's assets consist of debt obligations (or interests in debt obligations) and at least 50% of those obligations are real estate mortgages (or interests in real estate mortgages); (2) the entity is the obligor under debt obligations with at least two maturities; and (3) the payments on debt obligations in which the entity is the obligor bear a relationship to the payments on the debt obligations held by the entity. Generally, whether "substantially all" of the entity's assets consist of debt obligations is determined based on all the facts and circumstances. However, under a safe harbor, less than substantially all of the entity's assets will consist of debt obligations if less than 80% of the entity's assets are debt obligations

VI. Investor-negotiated terms: structure

A. Before committing to a fund, investors are performing extensive due diligence on managers, which can take many months to complete

B. Marketing periods are longer

1. The contractual marketing period between the actual first closing and final closing under a fund's limited partnership agreement may now allow for closings 18 months after the first closing, even though, historically, it has been routine to amend partnership agreements for closings after the twelfth month

2. Longer marketing periods may result in more valuation issues and the price at which investors buy into a real estate fund, similar to NAV issuances by hedge funds

3. Managers may need to warehouse deals

4. Investors may request that investors admitted at later closings be excluded from investments completed

C. Investment and harvest periods for real estate funds are also longer

1. Real estate deals are taking longer to locate, negotiate, finance and exit, which in turn has resulted in longer investment and harvest periods in private equity funds

2. Managers seeking investor approval to extend the investment period of the older funds may find that those amendments require 100% approval

3. Investors have placed greater limits on the ability to make capital calls after the investment period

4. Follow-on investments in existing projects are often limited as to timing and scope after the investment period ends, which can present an issue if assets are held longer than anticipated due to poor market conditions

   For example, a fund may not be allowed to invest more than 30% of capital commitments for follow-on investments after the investment period and may not be permitted to make capital calls for such purpose after the third anniversary of the investment period

D. Liquidation of the portfolio has become challenging

1. Once the fund reaches its date of dissolution (whether at the end of the term or earlier based on an investor vote to dissolve a fund for "cause" or under a "no-fault divorce"), the fund must engage in orderly liquidation or "winding-up" of its assets

2. The time period for winding-up is generally left to the reasonable discretion of the general partner, but older funds may have deadlines for completing the liquidation, and may not provide for continued fees after the deadline has passed

3. While the interests of investors and managers are aligned in benefiting from distributions, neither group wants a "fire sale" of assets; therefore, the date of dissolution of a fund has become less relevant, as there is no certainty as to when assets can be sold at their perceived best value

4. Management fees should also continue to be paid through the winding-up of the fund; drafting is very important here

5. Funds must also reserve for ongoing operating costs of funds through winding-up, such as audit fees and tax reports

E. No-fault termination rights are creating uncertainty in managing funds

1. Investors are negotiating for the right to terminate the investment period and to dissolve the fund (meaning a trigger of the wind-down period) without cause may also have no-fault general partner removal

2. Their right generally requires a super-majority vote, which is generally a 70% or 75% vote

3. The general partner's continuing right to receive carry following removal is an issue

   (a) Will the general partner take a haircut on its future compensation?

   (b) At what value will the general partner receive its carry?

VII. Investor-negotiated terms: alignment of interest

A. Investors are increasingly seeking to broaden the general partner's standard of liability to protect their interests

1. Traditionally, a general partner would be liable for its gross negligence, willful misconduct, fraud and bad faith

2. Delaware law allows fiduciary duties to be modified or replaced pursuant to the fund's limited partnership agreement, but does not allow bad faith to be waived

3. Certain institutional investors are now requiring the general partner to acknowledge that it owes a fiduciary duty to investors. This could result in the general partner having liability at a level closer to simple negligence. The general partner should be protected from claims for breach of fiduciary duties if it obtains limited partner committee approval for a transaction

4. It is standard for a material breach of the fund's partnership agreement to give rise to a claim by investors. The issue is whether such a breach must be willful

5. A material breach of laws is now standard as a measure of the general partner's liability. Again, the issue is whether such breach must be willful. Also, a breach of law should be the conviction of a felony or other laws related to securities businesses

6. Cure rights are common

   (a) The removal of the employee engaged in misconduct is often deemed a cure

   (b) Some institutional investors will only respect removal of the employee if the economic loss suffered by the fund is also restored

7. Investors are unlikely to wait for appeals to be exhausted. If a lower court determines that disabling conduct has occurred, it is common for investors to be able to terminate the fund for cause

8. Indemnification obligations are being curtailed by investors

   (a) When a significant amount of investors (typically 40–50% in interest of the limited partners) bring a claim against the general partner or its related parties, the fund will not be permitted to advance the costs of defense

   (b) The fund will not be permitted to indemnify one general-partner-indemnified party with respect to a dispute with another general-partner-indemnified party

   (c) Clawbacks of distributions made to investors are being restricted

   For example, investors may limit the amount subject to return to the lesser of 30% of their capital commitments and 30% of aggregate distributions made to them

B. Advisory committee members and limited partners are focused on limiting their liability

1. Advisory committee members often seek a simple good faith liability standard, although frequently, a fund agreement will also include fraud as a standard

2. Advisory committee members often ask that the limited partnership agreement provide that advisory committee members do not owe any duties (including fiduciary duties) to other partners, as there is not clear legal guidance on this standard

3. Consistent with not owing duties to other partners, an advisory committee member may be allowed to take into consideration the individual interest of the limited partner such member represents

4. Investors have requested that the fund cover legal costs of the advisory committee in connection with fund disputes, although it is fairly unusual for this cost to be borne by the fund

5. The advisory committee is helpful for both the general partner, to protect against possible claims for self-dealing, and for investors, to protect against unauthorized interested party transactions

C. Conflicts of interest

1. The general partner will generally be required to bring conflict-of-interest transactions to the attention of the advisory committee for approval

(a) Certain transactions may be carved out from such obligation, such as authority for the fund to retain an affiliate to provide management or property services for the fund's properties

(b) Investors are now requesting copies of materials sent to the advisory committee and notice of actions taken by the advisory committee

2. The advisory committee members may not be willing to act if the transaction is of sufficient controversy or if they have their own conflict

When a successor fund wishes to invest in the property owned by a prior fund, valuations are of significant importance

3. Funds are subject to more disclosure than ever to allow investors to identify conflict transactions and to determine whether the general partner is in compliance with partnership documents

(a) Regular reports include summaries of material events, payments of management fee payments (including offsets for transaction fees), calculation of carried interest distributions and certification of compliance with the partnership agreement

(b) Special reports including notice of general partner defaults, claims for indemnification and other litigation

VIII. SEC registration

A. Many real estate fund managers will become registered with the SEC

B. Registration could alleviate some aspects of investor concerns, but the formation of private equity funds involves extensive investor negotiations, and it is unlikely that investors will defer their attention to the SEC's oversight

C. Marketing

1. The SEC is expected to review marketing materials for purposes of evaluating whether investors have been misled. Therefore, registered advisers must focus on compliance with applicable SEC guidelines

2. Flip books, DDQs and customized investor presentations will be reviewed as well as PPMs and should all be prepared in a consistent manner

3. Performance results are anticipated to be a significant focus of SEC review of marketing materials

4. Target returns should only be included if the manager has a reasonable basis for including them; projections can be viewed as inherently unreliable

5. Net returns should be presented whenever available

D. Side letters

1. Subject to SEC review

2. Under anti-fraud rules, the general partner should disclose the existence of side letters

E. Allocation of investment opportunities

1. The general partner should not give away investment opportunities without predetermined allocation arrangements or a determination that the fund has received an adequate allocation of the opportunity

2. The general partner should not be allowed to cherry-pick co-investments on a personal basis

Current Trends in M&A, PIPEs and Co-Investment Transactions

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Practices

Distressed Investing
Mergers & Acquisitions
PIPEs
Private Equity

Robert Goldstein

Robert Goldstein is a partner at Schulte Roth & Zabel, where his practice focuses on private equity and leveraged buyout transactions, non-control investments, mergers and acquisitions, restructuring transactions, PIPEs transactions, and capital markets and general corporate representations.

Some of Rob's recent M&A representations include Morton's Restaurant Group in its pending sale to an affiliate of Landry's Inc., private equity fund Castle Harlan Partners V LP in its acquisition of Pretium Packaging Corporation and Pretium's contemporaneous acquisition of Novapak Corporation; 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 writes and speaks on topics of interest to the private equity industry. He authored "Distressed M&A: Lots of Distress and Not Much M&A — But Some Interesting Opportunities for Creative Private Equity Dealmakers" for *Private Equity Developments*, and presented on "M&A in Bankruptcy" at an SRZ Distressed Investing seminar.

Rob received his undergraduate degree from Columbia University and 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.

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- Distressed Investing
- Mergers & Acquisitions
- PIPEs
- Private Equity
- Regulatory & Compliance
- Securities & Capital Markets

Eleazer Klein

Eleazer Klein, a partner at Schulte Roth & Zabel, practices in the areas of securities law, mergers and acquisitions, and regulatory compliance. Ele is best known for his expertise, since the early 1990s, in the development and implementation of alternative investment structures for private equity investments and, specifically, the structuring and negotiating of private investments in public equity, or PIPEs, and related products including Registered Direct offerings, Convertible 144A offerings, Reverse Mergers, Equity Lines and SPACs.

Ele currently works on approximately 200 PIPE or PIPE market-related transactions every year for some of the largest private investment groups and investment banks in the United States and abroad. In addition, Ele advises clients on restructurings, reorganizations, initial public offerings and secondary offerings, venture capital financing, indenture defaults and interpretation, and activist investing, as well as counseling clients in the regulatory areas of short-selling, Regulation SHO, Sections 13 and 16, Rule 144, insider trading and Regulation M/Rule 105.

Because of his extensive PIPEs experience, Ele is a contributing author to *PIPEs: A Guide to Private Investments in Public Equity*, published by Bloomberg Press, which is a leading treatise in the PIPEs arena. Ele is also a co-author of the "Private Investments in Public Equity Securities ('PIPES')" chapter in the *Insider Trading Law and Compliance Answer Book*, published by Practising Law Institute, and author of "Transaction Reporting," in *Investment Management Law and Practice*, published by Oxford University Press. In addition, he has become a leading source for business journalists and business news organizations, and a much sought-after speaker by sponsors of PIPEs, SPACs and regulatory conferences. Recently, Ele chaired a discussion of "Registered Directs, CMPOs, Follow-ons and Other Small Cap Capital Formation Tools" at DealFlow Media's PIPEs Conference and discussed PIPEs at FRA's 11th Annual Valuation of Hard-to-Value Securities and Portfolios Conference. Ele is listed in *New York Super Lawyers*.

Ele received his J.D. from Yale Law School, where he was senior editor of *The Yale Law Journal*, and his B.S., *summa cum laude*, from Brooklyn College.

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John M. Pollack

John M. Pollack, a partner at Schulte Roth & Zabel, practices in the areas of public and private mergers, acquisitions, divestitures, restructurings, recapitalizations and tender/exchange offers. His clients include private investment funds as well as U.S. and foreign publicly traded companies.

John recently co-authored the *2011 Schulte Roth & Zabel Private Equity Buyer/Public Target Deal Study*, a report detailing the notable trends and themes in recent mergers and acquisitions involving private equity buyers and public company targets. He worked on the merger of DynCorp International Inc. with an affiliate of Cerberus Capital Management LP, a transaction that was selected by *The Deal* as one of 2010's "Private Equity Deals of the Year." He also recently spoke on "Deal Protections: Latest Trends and Best Practices" at the CLE International 5th Annual Private Equity Conference and participated in "Private Equity Deal Review: Analyzing the Trends and Navigating the Future," a webinar presented by *The Deal*. John is also part of The George Washington University Law School's board of advisers as well as an advisory board member of its Center for Law, Economics & Finance.

John received his B.A. from The George Washington University, and his J.D., *magna cum laude*, from The George Washington University Law School, where he was Order of the Coif and recognized for having the highest overall proficiency in securities law.

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Richard A. Presutti

Richard A. Presutti, a partner at Schulte Roth & Zabel, practices primarily in the areas of private equity, mergers and acquisitions, leveraged buyouts and alternative asset management transactional matters. Rick received the M&A Atlas Deal of the Year award for his representation of Chrysler in its sale to the Fiat-led group.

Rick regularly advises parties involved in private equity M&A transactions, recently representing Cerberus Capital Management in its sale of Chrysler Financial to TD Bank Group, Levine Leichtman Capital Partners in its acquisition of Revenew International, and Red Pine Advisors in its sale to Houlihan, Lokey, Howard & Zukin. He also counsels clients involved in investment adviser M&A deals, including representing FrontPoint Partners in its spin-off from Morgan Stanley, representing Montrica in its sale to TPG-Axon, and representing Level Global Investors in the sale of a minority interest to Goldman Sachs' Petershill Fund.

Rick writes and speaks on business transactions topics, co-authoring "Taking Stakes in Hedge Funds" for *The Daily Deal*, and presenting "Negotiating the Agreement: Pricing, Governance, Marketing and Investor Consent" at the Managed Funds Association Hedge Fund Manager M&A Seminar.

Rick received his B.A. from Bentley College and his J.D., *cum laude*, from Tulane University Law School.

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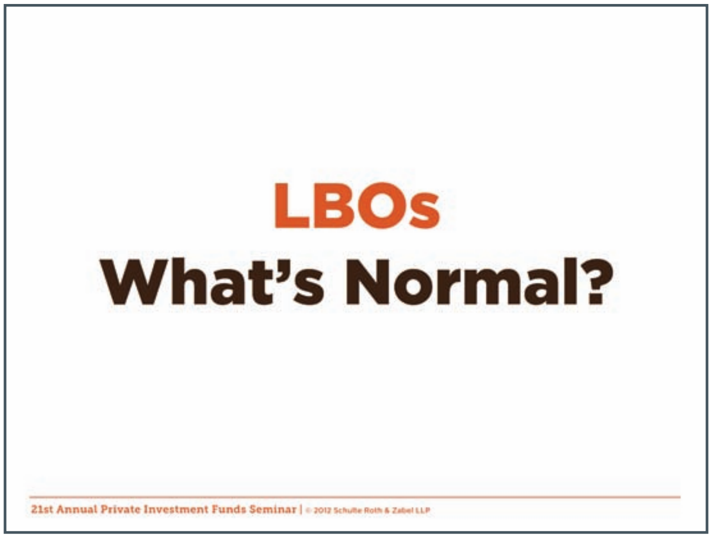
David E. Rosewater

David E. Rosewater is a partner at Schulte Roth & Zabel, where his practice focuses on mergers and acquisitions, private equity/leveraged buyouts, distressed investments and acquisitions, and shareholder activism. David has represented numerous corporate and private equity buyers and sellers, including in connection with the acquisitions of Caritas Christi Health Care System, which was named the "North America Private Equity Deal of the Year" by Global M&A Network as well as the 2010 "Deal of the Year" in the health care category by *Investment Dealers' Digest* magazine, Austrian bank BAWAG, integrated logistics systems services provider Syncreon, tabletop icon Lenox Group, GMAC, certain Newell Rubbermaid divisions and the factoring businesses of GE Capital and HSBC Business Credit. He has represented companies and shareholders in connection with a number of major campaigns, including those involving The New York Times Co., CNET Networks, CSX Corp., Red Robin Gourmet Burgers Inc. and Mentor Graphics Inc.

David regularly speaks and writes on business transactions topics, recently co-authoring the *Schulte Roth & Zabel Private Equity Buyer/Public Target Deal Study, Summer 2011 & 3Q 2011 Update* and "Corporate Governance Guide 2011 — USA" for *The International Comparative Legal Guide to: Corporate Governance 2011*. In addition, he discussed "Restructurings, Turnarounds, and Operational Improvements" at Thomson Reuters' Buyouts Texas and participated in "Q&A: The 2012 Annual Meeting Season — Lessons Learned From 2011 and What to Expect Next Year" at *IR Magazine*'s East Coast Think Tank.

David received his B.A., with distinction and high honors, from the University of Michigan and his J.D., *cum laude*, from New York University School of Law.


LBOs
What's Normal?
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Notes:


Private Non-Control
Investments
What to Expect
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Current Trends in M&A, PIPEs and Co-Investment Transactions

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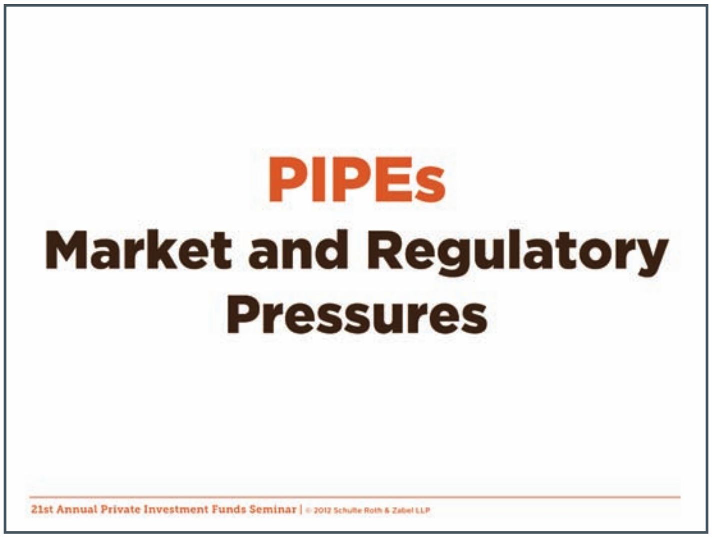

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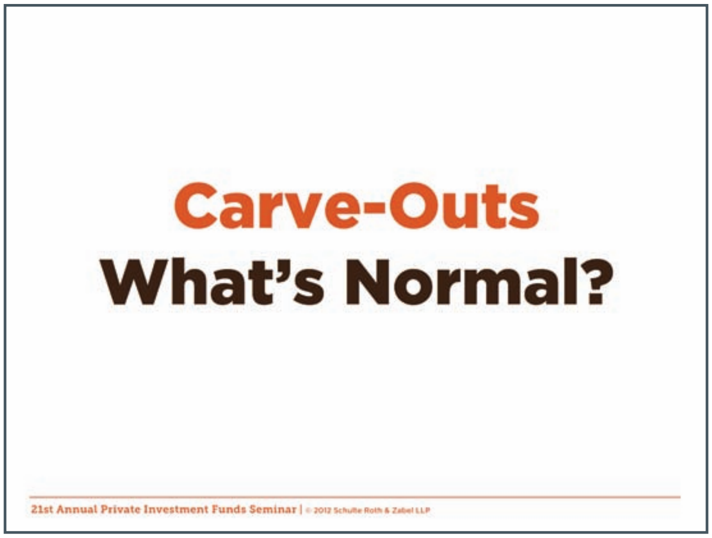
Current Trends in M&A, PIPEs and Co-Investment Transactions



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Current Trends in M&A, PIPEs and Co-Investment Transactions

I. What is "normal"? — LBO transactions

A. We analyzed the key deal terms from all private equity buyer/public company target all-cash merger transactions involving consideration of at least $500 million in enterprise value entered into during the period from Jan. 1, 2010 to Sept. 30, 2011 (totaling 31 transactions)

B. Observations on "market practice"

1. None of the deals included a traditional "force the vote" provision

2. None of the deals included a closing condition regarding appraisal rights

3. None of the single-step merger transactions included a financing closing condition

4. Approximately 90% of the transactions

   (a) Provided the buyer with matching rights and "last look" matching rights

   (b) Included a "tail provision" that required the target to pay the buyer in the event the target enters into or consummates an alternative transaction after the merger agreement is terminated under certain circumstances

   (c) Had a "marketing period" provision providing the buyer with time prior to closing to market its debt financing

5. Approximately 80% of the transactions

   (a) Gave the target company a limited specific performance right that was only available if: (1) the buyer's closing conditions to the merger agreement were satisfied; and (2) the buyer's debt financing was available

   (b) Were structured as one-step mergers (rather than as tender offers)

   (c) Permitted the target board to make a change in recommendation other than specifically in connection with a superior proposal (e.g., because "gold is discovered under the target's headquarters" after signing)

C. Observations on target break-up fees

1. Delaware courts have not provided any bright-line rules regarding when a break-up fee will be deemed unreasonable in amount

2. Nevertheless, practitioners usually take comfort that fees in the range of 2.0% to 4.0% of equity value are generally permissible

3. The range of break-up fees (as a percentage of equity value) was 0.72% to 4.99% (mean: 3.09%; median: 3.02%)

4. We observed that the average size of the break-up fee as a percentage of equity value did not decrease appreciably as the deal size increased

5. We also compared the size of break-up fees in transactions with pre-signing market checks with those that did not have pre-signing market checks[1]

[1] We characterized a deal as involving a "pre-signing market check" if, as per the "background of the merger" discussion in the applicable proxy statement or Schedule 14D-9: (1) the target solicited interest from at least 25 possible bidders pursuant to an active process prior to execution of the applicable merger agreement; (2) the target was in discussion with five or more possible bidders without engaging in a broader solicitation of interest; or (3) the target issued a public announcement to the effect that it was exploring "strategic alternatives"

We expected to observe that breakup fees are generally higher in transactions involving pre-signing market checks than those that do not involve such market checks. We generally observed this relationship; however, in transactions with a deal value below $1 billion, we observed that such fees were actually lower in transactions involving pre-signing market checks

D. Observations on reverse termination fees

1. The range of the reverse termination fee ("RTF") payable by a buyer (as a percentage of target's equity value) varied dramatically — from 4.69% to 38% (the latter payable in the event of a willful breach by the buyer)

(a) The range of RTF payable in the event of a willful breach was 5.51% to 37.89% (mean: 17.83%; median 8.30%)

(b) The range of RTF payable in the event of financing failure was 4.46% to 7.27% (mean: 5.44%; median 5.77%)

E. Observations on "go shop" provisions

1. Negotiations concerning "go shop" provisions can be highly contentious (which is to be expected because this provision empowers a target company to find an alternative suitor to top the target's agreed-upon deal with the buyer)

2. While "go-shop" provisions are not standard, they continue to be widely used — over 50% of the deals included a "go-shop" provision

3. As expected, "go shop" provisions were more prevalent in those transactions where the target did not conduct a pre-signing market check prior to signing the merger agreement

4. Transactions involving "go shop" provisions had significantly higher deal premia based on the target's stock price 30 days prior to announcement, but if calculated based on the target's stock price one day or 60 days prior to announcement, the difference is negligible

II. Non-control investments — what to expect

A. With a slow-down in M&A activity and sluggishness in the traditional financing markets, investors of all kinds are looking for alternative investment strategies. As a consequence, non-control and other minority investments have become commonplace, serving the interests of investors looking to deploy capital and companies looking for much-needed capital for liquidity and growth

B. Types of non-control investments (there are numerous types of non-control investments but we will focus on two principal areas):

1. Non-control investments in mature private companies such as:

(a) Direct minority investment in private companies by a single investor or small group of investors

(b) Minority participant in lead sponsor's LBO transaction

(c) Minority participant in distressed acquisition or reorganization

2. Equity "kickers" as part of debt financing transaction

C. Economic considerations — what to expect

1. Minority deals are, for the most part, sui generis — there is no blueprint for what the economics or other deal terms will look like. Every target company and deal is different

2. In traditional private investments, typical economics involve some sort of preferred equity or mezzanine debt with a guaranteed return, as well as common equity upside. Typically no current payment of interest or dividends is contemplated

3. Equity kicker deals usually involve warrants for anywhere from de minimis to substantial percentages of the company's capital with a nominal exercise price

4. Return will depend on risk profile of target company, amount of leverage, cash flow needs to service debt and other capital requirements and other credit characteristics

D. Deal protections — "must haves"

1. Often, but not always, minority investors, whether as part of a consortium, a minority participant in a financial sponsor's LBO or a reorganization led by one or two significant lead parties, want to know what protections "must I have" to participate as a minority investor:

2. So-called "anti-screw provisions"

(a) Anti-dilution protection or preemptive rights — prevents the company and/or majority shareholders from unfairly diluting an investor's stake in the company

(b) Covenants against "self-dealing" by the majority shareholder

(c) No amendments to deal documents that fundamentally alter rights or obligations or treat an investor disproportionately and adversely

(d) "MFN" protection so no other minority investor gets better rights

(e) "Tag-along" rights on change of control transactions so an investor can't be left behind

(f) Information rights — monthly, quarterly and annual financial information

(g) No change to corporate structure to adversely affect investor's tax position, which could have severe consequence for fund investors with limits on the types of entities in which they can invest

(h) Depending on the size of the investment, board representation or observation rights

E. Deal protections — "nice to haves"

1. Input, if not veto, on timing and terms of exit transaction

2. Consent rights on various operational and financial matters

(a) Incurrence of significant debt

(b) Material acquisitions or capital investments

(c) Approval and amendment of annual budgets and deviations therefrom

(d) Key management hire and fire determinations

(e) Issuance of new senior or *pari passu* equity

3. Tag-along rights on non-change of control transactions

4. Participation in ROFR rights with respect to other shareholder transfers

5. Board of director representation rights (or board observation rights)

F. Liquidity rights

1. Liquidity rights for minority investors are, again, sui generis

2. Minority investors should expect to be subject to a "drag-along" obligation in a sale of the company — meaning a majority shareholder or group of shareholders comprising a majority of the shares can force the investor to sell in a change of control transaction at the time and at the price determined by the majority

3. Oftentimes, target company and majority shareholder will severely restrict transfers or subject them to ROFR and/or tag-along rights of other shareholders making liquidity very difficult

4. In reorganization deals where disparate ownership, sometimes restrictions are limited and minority holders have relative free rein to transfer equity

5. In equity kickers, often investors require limited restrictions on transfer, particularly if transfer is made "stapled" to related debt

6. Always should achieve guaranteed exit on change of control transaction through tag-along rights

7. In some minority deals, particularly equity kickers, minority investor requires "put" right at designated time (five to seven years) and for set price

III. Investment management M&A: transactions with an inherently personal business

A. Who is doing these deals and why?

1. Buyers who are

   (a) Financial institutions that are not bank holding companies and that are seeking to expand their platform and provide a further diversified offering of products

   (b) Cash-rich sovereign wealth funds and pension funds in search of a relatively hassle-free way to enjoy revenues from the hedge fund fee model

   (c) Serial acquirers such as private equity-type funds established for the purposes of acquiring minority investments in hedge funds

2. Hedge fund managers who are selling because they

   (a) Are concerned about future tax regime and, therefore, wish to take some money off the table now

   (b) Are seeking to institutionalize their platform

   (c) Are attracted to the strategic benefits of an acquirer/buyer, such as enhanced distribution, marketing, infrastructure (e.g., back-office, regulatory, accounting, payroll, information technology, etc.)

   (d) Require working capital

   (e) Desire to fund an employee incentive pool

   (f) Wish to establish a mark on the valuation of their firm

3. Banks and other financial institutions who are selling (e.g., spinning off) an investment in a hedge fund manager because

   (a) The employment contracts and non-compete agreement with the hedge fund's management team is set to expire

(b) Put, call or other disposition rights have been exercised

(c) There has been a change in the institutions business objectives

(d) The Volcker Rule will generally restrict the ability of U.S. banks (and foreign banks with banking operations in the United States) and their affiliates from owning or sponsoring private investment funds

(e) The relationship between the institution and the hedge fund manager has not been working out

B. The general economics involves an investment in the hedge fund manager's

1. Net profits

2. Pure gross revenues

3. Gross revenues with some cap on shared expenses (i.e., modified gross revenues)

C. Pricing tends to be across the board, but may involve

1. A multiple of run-rate EBITDA, percentage of AUM or, in the case of some gross revenue deals, a multiple of revenue

2. Earn-outs which, if a component of purchase price, vary from deal to deal

(a) Often based on AUM or EBITDA

(b) Calculation variables

(iii) The percentage of total purchase price

(iv) The allocation between management compensation and performance compensation

(v) The length of the term: typically test periods from two to five years post closing

(c) A hedge fund manager's success in realizing the earn-out may be tied to the manager's ability to retain some degree of managerial autonomy; therefore, the buyer's control rights may be limited during the earn-out period

3. A purchase price adjustment to account for the actual economics at closing

D. Control and governance

1. The manager's retention of managerial control and independence is typically limited by the buyer's consent rights

2. The general economics tend to influence the extent of the buyer's control rights

(a) In a "net" deal, expense sharing drives discussion on rights and, therefore, the buyer, unless limited by other factors (such as regulatory issues), is likely to have relatively more vetoes over expenditures and operational business decisions than in a 'pure gross' deal

(b) In a "pure gross" deal, the buyer is mainly focused on having control over extraordinary transactions because it is not affected by expenses

(c) In a "modified gross" deal, the buyer is focused on having control over both extraordinary transactions and other areas where the expense cap may not on its own protect the buyer's investment

E. Employment, non-compete and non-solicit agreements

1. Buyers typically require some combination of these types of agreements

2. The length of the terms of these agreements may be influenced by the length of any earnout. However, the parties need to consider any tax implications that would result from tying an earnout to employment

3. The parties need to consider the proper effect of a principal's breach of these agreement and the buyer's remedies in the event of such a breach

4. Carve-outs and other limitations are highly negotiated

F. Transfer issues

1. The negotiation of the buyer's ability to transfer is based on the buyer's potential need for liquidity balanced against the manager's desire to have control over who the manager's partner is

2. The buyer's desire for the manager to keep some level of "skin in the game" could result in restrictions on the manager's ability to transfer its interest in the firm

G. Confidentiality and limitations on information rights can be extensively negotiated because managers are concerned

1. That information could end up in the hands of a competitor (e.g., if the buyer has relationships with the manager's competitors)

2. About misuse of information in the other roles in which the buyer may serve the manager (such as prime brokerage)

3. That the buyer, as a current or prospective public company or as a result of other compliance obligations applicable to the buyer, may be required to disclose information about the manager

IV. PIPE and registered direct market trends and regulatory issues

A. Two main market trends

1. Market volatility, which explains why investors are reluctant to part with capital and why more registered direct deals/CMPOs are completed, as opposed to PIPE deals

2. Contraction of the pool of investors

B. As a result, the following investments have become more prevalent

1. Self-amortizing investments

2. Variable-rate conversion price investments ("toxic converts") — historically seen as financings of last resort

C. Distressed issuers continue to try and work out existing deals

D. Common disagreement among investors

1. Ability to amend securities (e.g. notes and warrants) by holders of a majority (or supermajority) of the securities or whether each holder should be able to amend its own securities independently

2. Those supporting the approach allowing securities to be amendable by each holder want to be able to cut side deals with issuers without having to offer the same deal to all investors, since issuer may not be able to offer the same deal on a larger scale. On the other hand, investors who support the other approach fear that they could be cut out of such side deals

E. More investments in smaller issuers trigger certain legal issues

1. So-called "baby-shelf" rules, among other things, provide that if the issuer's non-affiliate public float is less than $75 million, the aggregate market value of the securities that may be sold by such an issuer during the period of 12 calendar months immediately prior to, and including, the sale is no more than one-third of the aggregate market value of the voting and non-voting common equity held by non-affiliates of the issuer

2. Extension of black box line of no-action letters with respect to simultaneous public and private deals are especially helpful in these scenarios. It is not uncommon in these situations for the issuer to privately place warrants to keep more flexibility under the "baby shelf" rules for the issuance of other securities

F. Fall out of Chinese market is also worth noting

G. Certain regulatory issues

1. Difficulty in determining beneficial ownership when holding a security with a variable-rate conversion price that fluctuates with the market price

2. In order to structure deals around Section 16, investors have been using penny warrants or stripped down preferred stock, where such instruments include a blocker which would prevent them from exercising or converting their security to the extent such exercise or conversion would cause the investor (together with its affiliates) to exceed 9.99% beneficial ownership and become subject to Section 16. Blockers need to be carefully structured to be effective. The efficacy of any given blocker will be tested if and when challenged

3. NASDAQ has recently indicated that they will generally prohibit NASDAQ listed companies from issuing penny warrants as these raise "public interests" concerns. NASDAQ has accepted penny warrants when the investor pays "real value" for the warrants. In certain cases, NASDAQ allowed these warrants as contractual resets of the purchase price, such that the issuer may be required, based on a market price determined at a later date, to issue more shares, subject to a floor, and even be required to pay cash to the extent such market price falls below the floor

4. In order not to be subject to stockholder approval requirements imposed by stock exchanges, such as NASDAQ, registered directs are being structured as true "public offerings" (i.e., Confidentially Marketed Public Offerings ("CMPOs") or Underwritten Registered Directs). In CMPOs, issuers will approach a small group of investors to determine indications of interest. These "over-the-wall investors" will be asked to sign a confidentiality agreement. The issuer will negotiate the transaction documents with these investors and then price the deal and do a broad overnight marketing effort to retail investors. The issuer will finalize allocations among all investors the next day and typically close the deal within T+3. Since this truly is a public offering, none of the private placements restrictions of the stock exchanges apply

V. What is "normal"? — carve-out transactions

A. We analyzed certain key deal terms from the largest carve-out transactions of U.S. public companies involving financial sponsor buyers since 2010

B. Observations on "market practice"

1. In terms of transaction structure, there was no "market practice" observed — 40% of the deals were structured as asset sales, 30% as stock sales and the remaining 30% as asset and stock sales

2. 80% of the deals had the buyer paying solely cash at closing

   The remainder involved cash plus the assumption of debt, issuance of notes or issuance of equity by the business being acquired

3. 80% of the deals had a post-closing purchase price adjustment based on working capital

   All of the deals had a post-closing purchase price adjustment calculated based on adjusted GAAP (whether it was GAAP in accordance with the seller's historical practice or as set forth on a schedule or exhibit)

4. In terms of the seller's specific performance right to force the buyer to close if the buyer's closing conditions are satisfied

   (a) 60% of the deals provided the seller with such a right (which we refer to as a "full" specific performance remedy)

   (b) 40% provided the seller with only a "limited" specific performance remedy against the buyer, such that in the event of a financing failure, the buyer was not required to close the transaction but only had to pay a reverse termination fee (which we refer to as a "RTF")

   The size of RTFs ranged from 6.1% to 12.9%, with a median of 7.1%

5. Almost all of the deals included indemnification from the seller to the buyer in the event of a breach of the seller's representations and warranties. In terms of limitations on the buyer's indemnification rights

   (a) The standard survival period for breach of representations was six to 18 months, with a median of 15 months

   (b) Deductibles were much more common than "tipping baskets" — however, both fell within the same general range of 0.6% to 2% of deal value, with a median of 1%

   (c) Mini-baskets (or de minimis thresholds) were standard and generally ranged between $25K to $175K and did not increase as a function of deal size

   (d) 80% of the transactions read out materiality with respect to determining whether a representation was breached

   (e) An overall limitation (a "cap") on the buyer's right to recover for breach of representations was standard — ranging from 3.4% to 24.3%, with a median of 10%

   (f) It is common to exclude from such limitations the "fundamental" seller representations (e.g., due authorization and enforceability)

6. Stand-alone indemnities used to address risk-allocation on certain specific issues were standard (100%) for pre-closing taxes and common (30%) for individual litigation matters

Insider Trading: Latest Insights

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Harry S. Davis is a partner at Schulte Roth & Zabel, where his practice focuses on regulatory investigations, enforcement actions and complex commercial litigation for financial services industry clients, including hedge funds, funds of funds, private equity funds, prime and clearing brokers, auditors and administrators. Harry has substantial experience in both securities regulatory matters and private litigation, including investigations by the SEC, U.S. attorneys' offices, the Department of Justice, the CFTC, the FTC, state attorneys general, state securities regulators and self-regulatory organizations.

Harry has litigated numerous cases in federal and state courts throughout the U.S., including the successful representation of a prime broker in a hotly contested and high-profile fraudulent transfer trial brought by the bankruptcy trustee of a failed hedge fund. Over the course of his career, Harry has represented clients in investigations and litigations involving allegations of insider trading, market manipulation, market timing and late trading, alleged securities law violations concerning PIPEs, short-swing profits, securities and common law fraud, advertising, breach of fiduciary duty and breach of contract, among other claims. To prevent minor issues from growing into bigger problems, he provides litigation and compliance counseling to many of the firm's clients, and conducts internal investigations.

A prolific author and highly sought speaker, Harry recently served as the editor of the *Insider Trading Law and Compliance Answer Book*, published by Practising Law Institute, and authored two chapters: "Introduction to the Law of Insider Trading" and "Materiality." He also recently spoke on "Current Issues in Trading Fixed Income Securities" at SRZ's Investment Management Hot Topics and participated in the "Regulatory Panel: Hot Button Regulatory Enforcement and Compliance Issues for the Hedge Fund Industry" at IIR's GAIM Ops Cayman Conference.

Harry graduated with a J.D., *magna cum laude*, from Cornell Law School, where he was associate editor of the *Cornell Law Review*, a member of the Moot Court Board and Order of the Coif. Following law school, Harry clerked for Hon. Joseph L. Tauro (U.S.D.C. D. Mass.). Harry was awarded his B.A., with departmental honors, from Johns Hopkins University.

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Securities Enforcement & White Collar Defense

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Howard Schiffman is a partner at Schulte Roth & Zabel and is co-chair of the Litigation Group. Nationally known in the area of securities litigation and regulatory developments, Howard's 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. He has also served as special internal investigative counsel to public companies.

A corporate problem solver, Howard is adept at dispute containment and resolution as well as 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. Still, 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 obtained victories in three tried matters, including prevailing in a price adjustment case involving the dispute of several hundred million dollars for a portfolio of real estate mortgages. He represented the former CEO of the largest Nasdaq market-making firm, Knight Securities, in a federal court action brought by the SEC. After a 14-day bench trial, all parties were completely cleared of wrongdoing.

Howard began his career as a trial attorney with the SEC Division of Enforcement and has long been at the forefront of securities litigation and regulatory developments, including his representation of hedge funds in connection with SEC investigations into market manipulation and trading on rumors.

Howard is a member of American Bar Association sections on litigation, corporation, finance and securities law, and is a director (and former president) of the Association of Securities and Exchange Commission Alumni Inc. Howard is listed as a "Local Litigation Star" for the Washington, D.C. metro area in *Benchmark Litigation: The Definitive Guide to America's Leading Litigation Firms and Attorneys*, was included in *Washingtonian* magazine's "800 Top Lawyers" listing (a ranking of "Washington's best — the top one percent") and has been recognized by *Chambers USA*, *The Best Lawyers in America* and *Lawdragon* as a leader in securities law.

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.

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Complex Commercial Litigation

Internal Investigations

Investment Funds Litigation

Litigation — General

Regulatory & Compliance

Securities & Shareholder Litigation

Securities Enforcement & White Collar Defense

Gary Stein

Gary Stein is a partner at Schulte Roth & Zabel, where he 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 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 represented the government on appeal in 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 businesses. He has handled more than 150 appeals in federal and state courts involving issues of both criminal law and procedure and complex commercial law and has successfully argued 15 appeals in the U.S. Court of Appeals for the Second Circuit.

An accomplished public speaker and writer, Gary has presented on risk management and crisis management issues at global conferences and seminars. He recently co-authored the "Scienter/Trading 'on the Basis of'" chapter in the *Insider Trading Law and Compliance Answer Book*, which was published by Practising Law Institute. In 2008, he won 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*.

Gary obtained his J.D. from New York University School of Law, where he was senior articles editor of the *New York University Law Review*, and his B.A. from New York University.

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Sung-Hee Suh

Sung-Hee Suh, a partner at Schulte Roth & Zabel, practices in the areas of white-collar criminal defense, securities regulatory enforcement, internal investigations, anti-money laundering ("AML") compliance and complex commercial litigation. Her recent white-collar criminal and regulatory matters include representing the subject of an SEC investigation into alleged insider trading in the stock of a pharmaceutical company; conducting an internal review of a global financial institution's AML program in the aftermath of a Ponzi scheme involving numerous bank and brokerage accounts; representing a fund manager in pension fund-related "pay-to-play" investigations by the New York Attorney General's Office and the SEC; conducting an internal investigation for a global telecommunications company into possible Foreign Corrupt Practices Act ("FCPA") violations; representing an interdealer brokerage firm in a FINRA investigation into certain brokerage practices; and defending a former in-house attorney at Hollinger International Inc. against federal criminal fraud charges based on an "honest services" theory that was ultimately rejected by the U.S. Supreme Court.

A frequent speaker and writer, Sung-Hee recently authored the chapter on the "Use of Paid Consultants" in the *Insider Trading Law and Compliance Answer Book* published by Practising Law Institute and co-authored "Government Launches FCPA Inquiry into Investments by Sovereign Wealth Funds in U.S. Banks and Private Equity Firms," which appeared in the *Financial Fraud Law Report*. She also spoke on "Methods for Streamlining Complex Litigation" at Practising Law Institute's "Bet the Company" Litigation: Best Practices for Complex Cases Conference.

Prior to joining SRZ, Sung-Hee served as an assistant U.S. attorney in the Eastern District of New York, including as Deputy Chief of the Organized Crime and Racketeering Section. She currently serves on the Federal Bar Council's Program Committee and on the New York City Bar Association's Judiciary Committee and is also a member of the New York Council of Defense Lawyers. In 2011, the New York chapter of the National Organization for Women honored Sung-Hee with its annual Women of Power & Influence Award.

Sung-Hee received her A.B., *cum laude*, from Harvard/Radcliffe College and her A.M. from Harvard Graduate School of Arts and Sciences. She received her J.D., *cum laude*, from Harvard Law School, after which she was a law clerk to the Honorable Robert L. Carter, U.S. District Judge of the Southern District of New York.

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Private Investment Funds Seminar

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Peter H. White

Peter H. White, a partner at Schulte Roth & Zabel, concentrates his practice on representing corporations and executives in criminal and related civil and administrative matters, including grand jury investigations, internal investigations, SEC enforcement proceedings, False Claims Act and qui tam lawsuits, and shareholder class actions. Pete has litigated disputes involving accounting and securities fraud, Foreign Corrupt Practices Act violations, government program fraud, false claims and statements, antitrust violations, public corruption, tax evasion, insider trading, environmental violations, and other claims. A former assistant U.S. attorney for the Eastern District of Virginia and the District of Columbia, Pete has served as lead counsel in over 80 federal and local jury trials and many more bench trials.

A recipient of the Department of Justice Director's Award for Superior Performance as an Assistant U.S. Attorney, Pete has performed with comparable skill as a private practitioner. Among the many publications that have recognized him as a leading litigator are: *The Best Lawyers in America* (white collar criminal defense; corporate governance & compliance law), *Ethisphere: Attorneys Who Matter*, *Washington, D.C. Super Lawyers*, *Washingtonian Magazine* (white collar defense) and *The Washington Post* ("Their Own Defense," June 18, 2007).

Pete regularly speaks and writes on regulatory compliance topics, recently authoring the chapter on "Civil and Criminal Enforcement" in the *Insider Trading Law and Compliance Answer Book*, which was published by Practising Law Institute, and co-authoring "Government Launches FCPA Inquiry into Investments by Sovereign Wealth Funds in U.S. Banks and Private Equity Firms" for the *Financial Fraud Law Report*. He also spoke on "Best Practices to Prevent Insider Trading" at the Managed Fund Association's Regulatory Compliance conference and participated in an SRZ webinar titled "Update on UK and US Insider Trading."

Pete obtained his B.A., with high honors, from the University of Notre Dame and his J.D. from The University of Virginia School of Law, where he was Order of the Coif and on the Management Board of the *Virginia Law Review*. Upon graduation, he had the distinction of serving as a law clerk to The Honorable Richard L. Williams of the Eastern District of Virginia.

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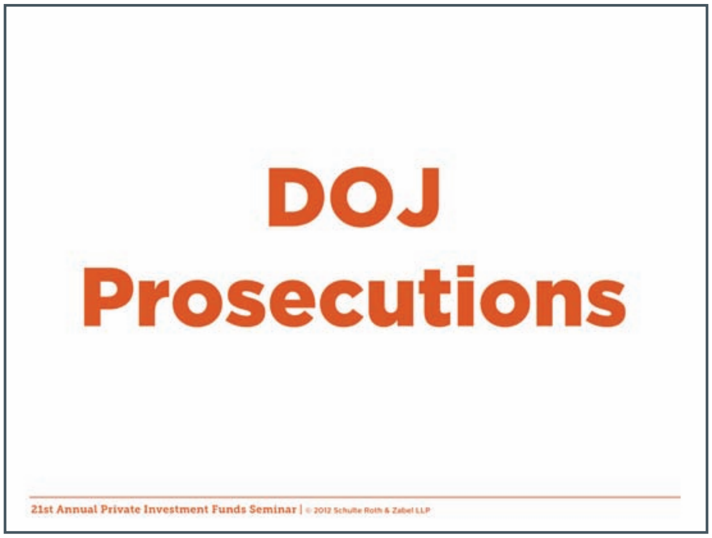
Insider Trading: Latest Insights



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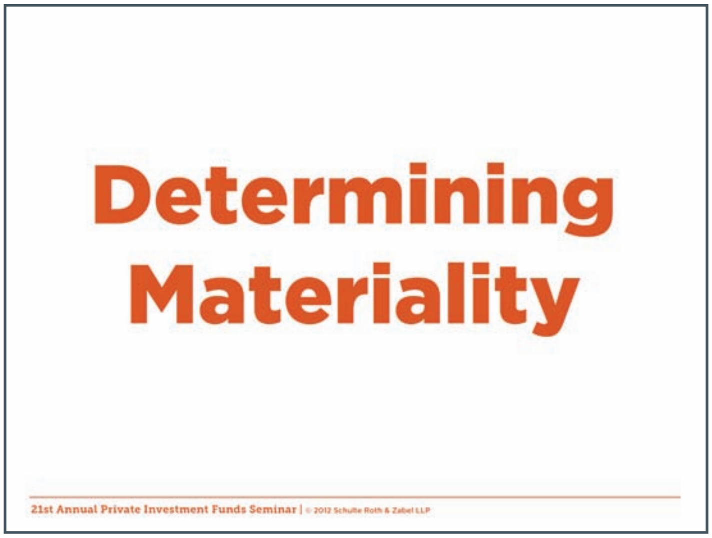
Insider Trading: Latest Insights



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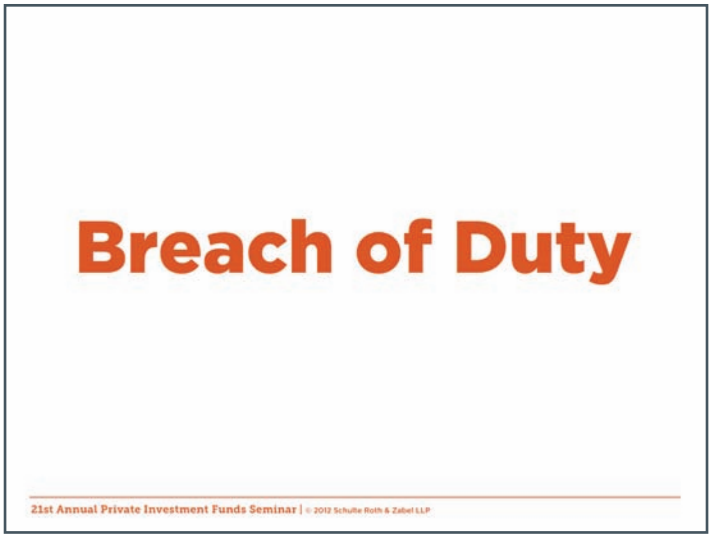

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Insider Trading: Latest Insights

I. Materiality

A. What is material information?

1. Information is material if a reasonable investor would consider the information important in making a decision to buy or sell a company's securities

2. Materiality is a difficult concept

   (a) It is highly dependent on the facts and circumstances of each individual case

   (b) Must predict or determine whether a reasonable investor would place significance on the single piece of information being evaluated in the context of all publicly available information about the company in question, and the broader market in which the company operates

3. How do the courts and the SEC distinguish between material information and non-material information?

   (a) Courts

      (i) Consider the actual impact on the market after the public release of the information

      (ii) Consider the actions of those who had access to the information (whether the insider or tippee actually traded based on the information is evidence of materiality)

      (iii) Evaluate the method by which the issuer handles the information (keeping the information confidential might imply materiality)

   (b) The SEC's expansive approach emphasizes importance of the information to business people, rather than to lawyers

4. What standard is used to predict whether a reasonable investor would consider the information important in making an investment decision?

   Certainty is not required in making a materiality determination. For determining whether speculative or uncertain events are material, the Supreme Court has adopted a "probability magnitude" test

   The test requires balancing the probability of an event's occurrence with the potential magnitude of impact due to the event's occurrence

5. What are some examples of types of nonpublic information the courts and regulators frequently regard as material?

   (a) Imminent tender offers, restatements of financials, earnings information, mergers and acquisitions, impending bankruptcy filings and new product developments

   (b) The SEC released a non-exhaustive list of nonpublic information that "should be reviewed carefully to determine whether they are material." That list includes: (1) earnings information; (2) mergers and acquisitions; (3) new products; (4) customer/supplier developments; (5) changes in control; (6) issues regarding auditors; (7) notable events involving the issuer's securities; and (8) bankruptcy

   (c) The SEC has also identified: calls for redemption, repurchase plans, stock splits or changes in dividends; changes to the rights of security holders; and public or private sales of additional securities

6. What sorts of "facts and circumstances" are important in making a materiality determination?

   The most important considerations in making a materiality determination are: (1) the likelihood that the event will occur; (2) the likely impact on the market if that event were to occur; (3) the actual impact on the market after release of the previously nonpublic information; (4) the existence of other information in the market that may be related to the information being analyzed and how the information being analyzed differs from information that is already in the public domain; (5) the source of information, including the credibility of that source; and (6) whether the information is expected or unexpected. Also considered are the insider or tippee's trading behavior after obtaining the information, and the method by which the issuer handled the information (i.e., did the issuer treat the information as confidential)

7. What is the "mosaic theory" and how does it relate to materiality determinations?

   Under the "mosaic theory," a person can assemble many disparate pieces of information about a company, many of which may be nonpublic, and analyze and use that information to arrive at an investment decision even if that analysis of that information provides superior insight unknown to the market as a whole, as long as the resulting information "mosaic" does not incorporate any material nonpublic information

B. Recent case law: materiality

1. *SEC v. Rorech*, No. 09 Civ. 4329 (JGK), 2010 WL 2595111 (S.D.N.Y. June 24, 2010) (illustrates how materiality determinations are highly dependent on specific facts of case)

   (a) The SEC alleged that a "sell-side" coverage person at an investment bank illegally tipped a "buy-side" trader at a hedge fund about a contemplated restructuring of a bond that could be expected to increase the price of the credit-default swap on that bond

   (b) When the alleged "material" nonpublic information was released, the price of the credit-default swaps increased

   (c) Holding (from bench trial): at the time the alleged material information was conveyed, it was already widely known that the investment bankers were going to be restructuring the bonds due to large investor demand. Further, the alleged inside information conveyed to the hedge fund trader by the sell-side coverage person was not sufficiently different from the information that was already in the public domain to be considered material. Further, the court found that much of the allegedly shared information was inherently speculative because the investment bank would not have the final say on the structure of the bonds at issue

2. *In The Matter Of Mindlin*, Sec. Act Rel. No. 9261 (Sept. 21, 2011) (first insider trading case involving ETFs brought by the SEC)

   (a) The SEC charged a former employee of Goldman Sachs, Spencer Mindlin, and his father, Alfred Mindlin, with insider trading

      (i) The SEC alleged that while working on Goldman's ETF desk, the son obtained material nonpublic information concerning Goldman's plans to purchase and sell large amounts of securities underlying an ETF

      (ii) Prior to Goldman placing large buy orders in securities underlying the ETF, the son and father took long positions in those same securities

   (b) The entire market knew which securities were going to be added to or dropped from the fund because the S&P Index, which the fund mirrors, published that information a few weeks before the fund's quarterly rebalance

(i) While Goldman was the largest institution with an interest in the fund, it was not the only institution, and it is likely that other financial institutions engaged in similar hedging practices to protect their own interests

(ii) The only information that was not publicly known was the size of the hedging trades that Goldman intended to make

(c) Issue: whether the size of the institution's anticipated hedges, without more, was sufficiently important to a reasonable investor to meet the requirement of materiality; all other pertinent information was already known to the marketplace

(d) The SEC could attempt to distinguish *Rorech* by demonstrating that the institution's hedges were so large that information of its size would be material in and of itself

3. *In re Washington Mutual, Inc.*, No. 08-12229 (MFW) (Bankr. D. De. Sept. 13, 2011) (applying a "colorability" standard)[1]

(a) The Bankruptcy Court found that the committee of equity security holders (the "equity committee") stated a colorable claim sufficient to confer standing on the equity committee to pursue equitable disallowance against certain hedge fund creditors' claims based on allegedly improper trading

(b) The court noted that the colorability standard is a low threshold used to determine whether to permit a bankruptcy committee to undertake an inquiry into whether or not to bring a claim. The opinion does not constitute a finding that there actually had been any insider trading

(c) The court concluded that undisclosed negotiations between the debtor and stakeholders in bankruptcy could be material even after those negotiations had broken down and that the debtor's view of what is material nonpublic information is not dispositive

(d) Background

(i) Washington Mutual Inc. ("WMI") is the former parent of Washington Mutual Bank ("WMB"). WMB was seized by the Office of Thrift Supervision on Sept. 25, 2008. The next day, WMI and one of its affiliates filed bankruptcy petitions in Delaware

(ii) The debtors and certain other parties began negotiating a resolution of their disputes in March 2009. The funds participated in discussions with the debtors and other parties about settlement of claims

(iii) As a condition to their participation in the discussions, the funds entered into confidentiality agreements with the debtors. Those agreements required the funds either to restrict trading in the debtors' securities or to establish an ethical wall between those who made trading decisions and those engaged in settlement negotiations

(iv) The confidentiality agreements contained an express termination date and also required that at the end of the confidentiality period, the debtors publicly disclose any material nonpublic information that may have been communicated during the confidentiality periods

(v) There is no dispute that the funds abided by the confidentiality agreements and that the debtors represented at the end of those periods that any material nonpublic information had

[1] SRZ represents one of the four creditors in the case. As such, this discussion will be limited to the facts and arguments contained in the public record. Nothing herein is intended to constitute an endorsement of the court's opinion, or to suggest that the opinion accurately reflects the facts or the correct state of the law in this area. This is also not intended to be a complete description of the judge's opinion and readers are referred to the opinion for a full description of its contents at *In re Washington Mutual, Inc.*, Case No. 08-12229 (MFW) (Bankr. D. Del. Sept. 13, 2011) [Docket No. 8612]. The court's decision has been appealed

been disclosed. After the expiration of the confidentiality periods, the funds traded in the securities of the debtors

(e) Insider trading issues

Among the issues in the proceedings was whether the funds were trading while in possession of material nonpublic information about the status of the settlement discussions

(f) Materiality

(i) The funds argued that the information they had was not material because the discussions to which they were privy were not sufficiently advanced

(ii) The court held that it could not find at this stage that the discussions were not material and that the equity committee presented enough evidence to suggest that settlement negotiations may have shifted to the material end of the spectrum

4. *SEC v. Berlacher*, 2:07-Cv-03800-MSG (E.D. Pa. Sept. 14, 2010) (failure of proof by the SEC to prove materiality)

(a) The SEC alleged that hedge fund manager, Berlacher, his investment advisory entities, and the hedge funds he managed illegally profited by short-selling four companies' shares while in possession of knowledge regarding those companies' planned private investment in public equity ("PIPE") offerings

(b) Holding: the District Court dismissed the insider trading charges because the SEC had not proven the materiality element of insider trading

The SEC failed to show that disclosure of the offerings actually affected stock prices

5. *SEC v. Ni*, CV-11-0708 (N.D. Cal. Feb. 16, 2011)

(a) The SEC alleged that, while visiting the office of his sister, a Bare Escentuals executive, Ni overheard a conversation revealing the unannounced acquisition of the company

(i) This conversation included "key words spoken by his sister such as 'due diligence file,' 'potential buyer' and 'merger structure.' Ni also observed from the state of his sister's office and numerous phone calls that she was very busy at work"

(ii) Ni purchased Bare Escentuals stock and earned profits of $175,066

(iii) The SEC alleged that Ni misappropriated the information from his sister, violating the duties of trust and confidence owed to his sister

(b) Ni consented to a judgment against him

6. *In The Matter Of Merrill Lynch, Pierce, Fenner & Smith Inc.*, SEC Admin. Proc. File No 3-14204 (Jan. 25, 2011) (*available at* http://www.sec.gov/litigation/admin/2011/34-63760.pdf)

(a) Although not cast as an insider trading case, this settlement provides guidance on materiality

(b) According to the SEC's order, during a two-year period, a Merrill Lynch proprietary trading desk was located on the firm's equity trading floor, where traders on the firm's market making desk received and executed orders for institutional customers

(c) The SEC alleged that on four occasions in 2003 and early 2004 the Merrill Lynch proprietary trading desk traded on information about institutional customer orders provided by market makers. Notably, in each instance, the customer order was allegedly executed from 1 to 31 minutes before the proprietary trade

(d) Based on the facts alleged in the order, it appears the SEC lacked a basis for charging Merrill Lynch or its traders with insider trading

The SEC observed that, as a general matter, customer order information can constitute material nonpublic information ("particularly information concerning potentially market moving orders submitted by institutional customers"), but did not allege that any of the information conveyed to the Merrill Lynch proprietary traders in this instance was material

C. CFTC "insider trading" authority

1. The Commodity Futures Trading Commission ("CFTC") will become more involved in insider trading actions. Under the Dodd-Frank Act, a new section, Section 6(1), has been added to the Commodities Exchange Act. Unlike securities markets, futures markets do not have corporate issuers. Section 6(1) prohibits any deceptive device or contrivance in connection with a swap, future, or cash contract in contravention of CFTC rules

Under this new law, the CFTC has promulgated Rule 180.1(1)-(3), which is expressly patterned on SEC Rule 10b-5. Thus, the new rule prohibits trading on the basis of material nonpublic information obtained through deceit or fraud in breach of a pre-existing duty. This rule does not create a new duty to disclose

2. Under Rule 180.1, trading on material nonpublic information is permitted. However, trading on information that was improperly obtained or used in breach of a duty created by the circumstances under which it was obtained, is not

II. The duty requirement in insider trading cases

A. Breach of duty: classical theory

1. The classical theory of insider trading liability focuses on the duty a corporate "insider" owes to the shareholders and the corporation

Insiders are entrusted with confidential information as part of their employment so that they can do their job on behalf of the company. Insiders owe a fiduciary duty to use such information to serve the best interests of the company and not for personal gain

2. Under the classical theory, a corporate insider in possession of material nonpublic information has a duty either to abstain from trading in the shares of the corporation or to disclose the information to the market before trading (the "abstain-or-disclose" rule)

In many instances, of course, the insider's duty of confidentiality prohibits him or her from disclosing the information to the market, which means that the insider must abstain from trading

3. Who are typical insiders?

(a) Corporate officers, directors, employees at all levels and controlling shareholders, all of whom owe fiduciary duties to the corporation and its shareholders under traditional state-law principles

(b) Insider trading law has recognized an additional category of "temporary insiders," such as lawyers, accountants and investment bankers retained by the corporation, who may be entrusted with material nonpublic information and are under a duty not to misuse such information for their personal advantage

B. Breach of duty: misappropriation theory

1. Under the misappropriation theory, a party is liable for insider trading when he violates a fiduciary-like duty of trust or confidence to the source of material nonpublic information by converting that

information for his own personal use by trading on the information or conveying it to a third party who trades on the information

(a) The misappropriation theory thus extends insider trading liability to corporate "outsiders." The defendant does not have to be an employee of the public company in whose securities he or she trades and does not have to owe any duty of confidentiality to that company. Rather, the defendant can be held liable for breaching a duty owed to a third party

(b) The United States Supreme Court recognized the misappropriation theory of insider trading liability in *United States v. O'Hagan*, 521 U.S. 642 (1997)

2. Examples of persons who may be held liable for insider trading under the misappropriation theory

(a) An attorney who learns information about an anticipated corporate control transaction between one of his clients and another corporation owes a fiduciary-like duty to the client to keep that information confidential and not to use it for his or her own personal benefit by trading in the stock of the other corporation

(b) An employee of a financial printer learns details of tender offers from the documents provided by the printer's clients, and then trades on that information

(c) An individual who learns information about an issuer through a close family relationship (where parties have a history of sharing this type of information)

(d) A financial analyst who attends a U.S. Treasury Department press conference and agrees to abide by Treasury regulations imposing an embargo on release of the information disclosed at the press conference

3. SEC Rule 10b5-2 provides a non-exclusive list of circumstances under which a duty of trust or confidence exists sufficient to establish liability under the misappropriation theory

(a) Where the person receiving the information agreed to maintain the information in confidence

(b) Where there is a history, pattern, or practice of sharing confidences between the parties, such that the recipient of the information knows or reasonably should know that the person communicating the information expects that the recipient will maintain its confidentiality

(c) Where a person receives or obtains information from his or her spouse, parent, child or sibling

Unless the person receiving or obtaining the information demonstrates that no duty of trust or confidence existed with respect to the information, by establishing that he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential, because of the parties' history, pattern, or practice of sharing and maintaining confidences, and because there was no agreement or understanding to maintain the confidentiality of the information

4. Rule 10b5-2 is analyzed based on the subjective understanding of the recipient of the information concerning the state of mind of the source of the information

C. Tippee liability: knowledge of the duty

1. A tippee who receives material nonpublic information may be held liable for insider trading, even though the tippee did not himself or herself owe or breach any duty to the source of information

2. Tippee liability can exist whether the duty breached existed by virtue of the classical theory of insider trading or the misappropriation theory of insider trading

3. To establish liability on the part of a tippee under Section 10(b), the government must show that: (1) the tipper possessed material nonpublic information concerning a publicly traded company; (2) the tipper disclosed this information to the tippee; (3) the tippee traded in the company's securities while in possession of the material nonpublic information provided by the tipper; (4) the tippee knew or should have known that the tipper violated a relationship of trust by relaying the information; and (5) the tipper benefited from the disclosure to the tippee

   In many cases the key issue will be whether the tippee "knew or should have known" that the tipper breached a duty in providing the information to the tippee

4. Remote tippees, as well as the immediate tippee, face liability if they knew or should have known that the information came from an impermissible source

5. *Note:* the "knew or should have known" requirement for tipper-tippee liability is distinct from the scienter requirement for liability under Rule 10b-5. The "should have known" test connotes a lower negligence standard

6. Whether something constitutes a "personal benefit" is a question of fact measured by objective criteria. The benefit may be direct or indirect

   A personal benefit includes pecuniary benefits, but may also include non-pecuniary benefits such as enhancement of one's reputation, the strengthening of an existing mutually beneficial relationship, and, in some cases, the good feeling derived from tipping a relative or friend

D. Recent case law — duty

1. *In re Washington Mutual, Inc.*, No. 08-12229 (MFW), ___ B.R. ___, 2011 WL 4090757 (Bankr. D. Del. Sept. 13, 2011) (negotiating creditors in the bankruptcy context) (see facts above at I.B.3.)

   Among the issues in the proceedings was whether hedge fund creditors had a duty to refrain from trading in the securities of the debtors

   (a) The funds argued that, even if the information had been material, they had no duty to refrain from trading after the confidentiality periods because, among other things, they were not insiders. The funds also noted that the debtors were not deceived in any way by the funds' conduct

   (b) The court held that the equity committee stated a colorable claim that the funds became "temporary insiders" of the debtors when the debtors gave them confidential information and allowed them to participate in settlement negotiations

   (c) The court also held that the funds may have been "non-statutory" insiders of the debtors by virtue of holding blocking positions in two classes of the debtors' debt securities

2. *SEC v. Obus*, No. 06 CIV 3150 GBD, 2010 WL 3703846 (S.D.N.Y. Sept. 20, 2010) (No liability under classical or misappropriation theory)

   (a) The SEC alleged that Strickland, an employee of GE Capital Corp., tipped his friend, Black, about an acquisition of SunSource Inc., and that Black then tipped his boss, Obus, who allegedly directed the purchase of SunSource stock

   (b) The alleged tip occurred during a conversation between Strickland and Black, which the defendants argued constituted a due diligence inquiry into SunSource on the part of Strickland, who noticed that Black's employer was invested in SunSource

   (c) Holding: claims dismissed against all defendants. The District Court found that the SEC failed to adduce enough evidence to demonstrate that Strickland breached a duty under either the classical or misappropriation theories of liability

(i) Classical theory: the record lacked any facts to support a finding that Strickland owed a fiduciary duty to the target, SunSource, because Strickland was not an insider of SunSource and could not have become a temporary insider because his employer was not a fiduciary but rather just one of many banks that were considering a loan to SunSource. The court pointed out that financial institutions typically owe no fiduciary duties to borrowers, and that the arms-length negotiations between transacting parties are averse to the concept that either party would owe a fiduciary duty to the other

(ii) Misappropriation theory: the court found that the evidence, viewed in the light most favorable to the SEC, established that, although Strickland owed a fiduciary duty to his employer, he did not breach that duty

(iii) Deceptive conduct: the court also found that the SEC failed to put forth evidence of deceptive conduct. Obus openly spoke with SunSource's CEO both before and after he directed the purchase of SunSource stock, thereby negating any inference of deception by someone secretly in possession of material nonpublic information. The factual record was also insufficient to prove that Obus subjectively believed that the information he allegedly received was obtained in breach of a fiduciary duty

(d) The SEC has appealed the District Court's ruling

3. *SEC v. Cuban*, 620 F.3d 551 (5th Cir. 2010), *rev'd* 634 F. Supp. 2d 713 (N.D. Tex. 2009) (duty of confidentiality on the part of prospective PIPE investor)

(a) The SEC alleged that the CEO of Mamma.com, in which Cuban was a minority shareholder, telephoned Cuban to ask whether he wanted to purchase shares in a planned PIPE. The CEO allegedly prefaced the conversation by saying that the information about the PIPE transaction was confidential and that Cuban agreed. According to the SEC, Cuban became upset when he learned of the PIPE offering and said to the CEO, "Well, now I'm screwed. I can't sell." Cuban later sold his entire position in Mamma.com stock before the public announcement of the PIPE offering

(b) The District Court dismissed the SEC's complaint on the ground that the SEC did not sufficiently allege an agreement not to trade in Mamma.com shares. The court reasoned that where an agreement serves as the basis for misappropriation-theory liability, that agreement must include not only a promise by the defendant to keep the information confidential, but also an agreement not to trade on it. The SEC's complaint was deficient, according to the court, because it failed to plead that Cuban agreed to refrain from trading on the information learned during his conversation with the Mamma.com CEO

(c) The Court of Appeals for the Fifth Circuit reversed, holding that it was plausible to infer from the complaint that Cuban had agreed not to trade and that his understanding with the CEO "was more than a simple confidentiality agreement." While it agreed with the district court that the "I'm screwed" statement in isolation did not constitute an agreement not to trade, it found that there was a reasonable basis to conclude that Cuban's additional efforts to gain confidential information by contacting the sales agent demonstrated that Cuban understood that he could not use the information for his personal benefit. The court declined to decide the broader issue of whether a confidentiality agreement alone can satisfy the duty requirement of insider trading, or whether an express agreement not to trade is also required

4. *SEC v. Kueng*, No. 09-8763 (S.D.N.Y. Dec. 8, 2011) (denying summary judgment motion)

(a) Through a long chain of different actors beginning with an employee of Jamdat Mobile Inc., the defendant learned of the planned acquisition of Jamdat by Electronic Arts, or at least rumors of it, while she was intoxicated at a bar. She passed this information along to her clients and co-workers. Her clients subsequently traded on the information, earning substantial profits, but she did not personally trade on the information. The defendant filed a motion for summary judgment

(b) In denying the motion for summary judgment, the court stated there were two triable issues of fact. First, there was a question whether the Jamdat employee (and soon-to-be employee of Electornic Arts) breached his fiduciary duty to Electronic Arts shareholders. Even though he did not trade on the information himself, the employee apparently had a record of tipping the same person with insider information and both have records of trading on that information. This history created a question of whether the employee breached his duty. Second, there was a question whether the defendant acted with the requisite scienter. The defendant admitted that she was intoxicated when she received and dispersed the alleged rumors, and she charted a mock trade of a purchase of Jamdat, which could be enough to satisfy a trier of fact that she acted recklessly in passing along potentially nonpublic information

5. *United States v. Teo*, Indictment, No. 04-cr-00583 (D. N.J. June 15, 2007)

(a) Musicland had a shareholder rights plan that provided that no shareholder could hold more than 17.5% of outstanding stock or else the remainder would be diluted. Beginning in July 1998, Teo began to buy shares in Musicland Stores Corp. and devised a scheme to buy more than the allowed shares. He used a trust to hide his stake in the corporation, which grew to 36% of its stock

(b) In 2000, Teo signed a confidentiality agreement with Musicland, which also prohibited him from trading its stock for two years. As the largest shareholder, Teo was able to obtain confidential information about the company, such as multi-year revenue projections. In July 2000, Teo learned that Best Buy and Musicland were in discussions for Best Buy to buy Musicland shares. Musicland's CFO told Teo about the sale to Best Buy and cautioned Teo not to tell anyone, referencing the confidentiality agreement. Teo, however, revealed the information to investment bankers and his stockbroker, who organized the buying and selling of his shares in Musicland stock to maximize his benefit from the sale. In January 2001, Best Buy bought his shares and, as Teo failed to disclose that his holding exceeded 17.5%, which should have triggered a dilution of his shares, Teo made a large profit

(c) Criminal and SEC charges were brought against Teo. The SEC complaint alleged that Teo "owed a duty to keep confidential, material, nonpublic information concerning Musicland" because he "was an insider of Musicland." The SEC also alleged that Teo breached his fiduciary duties to Musicland shareholders when he traded in Musicland stock while in possession on nonpublic information that Best Buy was making a tender offer for Musicland shares, and when he shared the information with others

(d) In June 2006, Teo pleaded guilty to the insider trading charges, and in March 2010, Teo agreed to settle the civil case with the SEC for $996,783

6. *SEC v. Rorech*, 720 F. Supp. 2d 367 (S.D.N.Y. 2010) (hedge fund manager's liability as tippee) (see facts above at I.B.2.)

(a) The court found that the SEC failed to demonstrate the elements of liability under the misappropriation theory, where

(i) The SEC did not present evidence that anything "nefarious" was said during the telephone conversations

(ii) The bank had not made its decision to recommend the modification of the bond offering when the defendant called the hedge fund manager

(iii) The bank had a wall in place to control the flow of information between its investment banking and sales businesses

(b) The court also found that there was no breach of duty where the bank had no expectation that the information about restructuring the bond offering would be kept confidential, and the information about customer interest in bonds was not confidential under bank policy

7. *United States v. Gansman*, 657 F.3d 85 (2d Cir. 2011)

   (a) Gansman, a former Ernst & Young lawyer, was accused of passing inside information about potential mergers and acquisitions to a woman with whom he was having an affair, Donna Murdoch. Although Gansman himself did not make any money from her trades, the government alleged that he gave Murdoch — who testified as a cooperating witness for the government at Gansman's trial — the information to prolong the affair

   (b) As part of his defense theory, Gansman argued that he and Murdoch had a history and practice of sharing work and personal confidences, such that he reasonably expected that she would maintain as confidential the information he provided her and not use it to buy or sell securities. The jury rejected this defense and convicted Gansman for tipping Murdoch

   (c) The Court of Appeals affirmed Gansman's conviction, despite his argument that the district court erred in refusing to give his proposed jury instruction reflecting his defense theory, which relied in part on the language of Rule 10b5-2. The Court of Appeals held that the instruction given at trial was substantially similar to the one proposed by Gansman, and pointed out that the government presented ample evidence that Gansman knew or had reason to know that Murdoch was trading on the information he gave her

   (d) However, the court also ruled that Gansman's theory of defense and his proposed jury instruction were perfectly appropriate, rejecting the government's argument that he should not have been allowed to assert such a defense. The court held that Gansman was entitled to support his defense that he lacked intent to commit securities fraud by showing that his history and practice of sharing confidences with Murdoch gave rise to a duty of trust running in favor of Gansman, and that he had confided in her with the understanding that she would not use the information for securities trading purposes. In so holding, the court recognized that the language of Rule 10b5-2, which is typically relied upon by the government to show the existence and breach of a duty of trust and confidence in order to create insider trading liability, can also properly be used as a defense by someone accused of tipper liability

8. *SEC v. Dorozhko*, 574 F.3d 42 (2d Cir. 2009), *rev'd* 606 F. Supp. 2d 321 (S.D.N.Y. 2008) (whether duty is always required in Section 10(b) insider trading case)

   (a) Dorozhko, a Ukrainian national and resident, traded on confidential quarterly earnings reports on IMS Health that he obtained by hacking into Thompson Financial's servers

   (b) Issue: the Court of Appeals was asked to consider "whether, in a civil enforcement lawsuit brought by the [SEC] under Section 10(b) of the Securities Exchange Act of 1934, computer hacking may be 'deceptive' where the hacker did not breach a fiduciary duty in fraudulently obtaining material, nonpublic information used in connection with the purchase or sale of securities"

      (i) The District Court held that no insider trading claim could lie because the hacker did not owe or breach any fiduciary duty

      (ii) The Court of Appeals disagreed and reversed, holding that the hacker could be held liable for insider trading

   (c) The SEC did not argue that Dorozhko's conduct involved a breach of a fiduciary duty in its complaint. Further it asserted in its appellate brief that "no breach of a duty is required when the defendant engages in affirmatively deceptive conduct, such as lying, acting deceptively, or telling half truths"

   (d) The Court of Appeals accepted the SEC's argument that "none of the Supreme Court opinions considered by the District Court require a fiduciary relationship as an element of an actionable securities claim under Section 10(b)"

III. DOJ prosecutions

A. DOJ prosecutions generally

1. Laws that prohibit insider trading are the same, but the difference is the burden of proof

    (a) SEC = civil enforcement action = preponderance of the evidence (i.e., more likely than not that a violation occurred)

    (b) DOJ = criminal prosecution = beyond a reasonable doubt (i.e., highest standard of proof under the law)

2. The DOJ and the SEC can, and do, bring "parallel proceedings" against same defendant for the same wrongdoing

3. Factors that influence the DOJ's decision to bring criminal prosecution include the severity of violations, the effect on victims, the size of the trades or gains, the strength of proof, the general deterrent effect and the defendant's behavior during the parallel SEC investigation

B. Recent trends

1. Paid consultants and expert networks

2. SEC and DOJ cooperation and sharing of information

3. Use of informants and cooperating defendants

4. Wiretaps and search warrants in addition to grand jury subpoenas

5. Longer sentences for criminal convictions

    (a) Raj Rajaratnam

        (i) Convicted in October 2011 for insider trading through his hedge fund management firm, Galleon Group

        (ii) Rajaratnam received a sentence of 11 years imprisonment, longest ever for insider trading

    (b) *The Wall Street Journal* recently analyzed 108 insider trading cases brought in federal courts in New York[2]

    (c) More insider trading defendants being sent to prison now

        (i) Past two years = 79% of convicted defendants imprisoned

        (ii) 2000-2010 = 59% of convicted defendants imprisoned

        (iii) 1993-1999 = less than half of convicted defendants imprisoned

    (d) Of those imprisoned, recent defendants receiving longer sentences

        (i) Median sentence for past two years = 30 months

        (ii) Median sentence for 2000-2010 = 18 months

        (iii) Median sentence for 1993-1999 = 11.5 months

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[2] Chad Bray and Rob Barry, "Long Jail Terms on Rise," *The Wall Street Journal*, Oct. 13, 2011

(e) Why harsher sentences recently?

(i) "Sending a message" (additional deterrent to financial wrongdoing)

(1) *Note:* defendants with 10 or more years remaining on sentences are barred from "minimum security" prison camps typically associated with white-collar defendants ("Club Fed"). Also, as parole has been abolished in the federal system, white-collar defendants must serve at least 85% of their time before release[3]

(ii) Backlash against Wall Street in wake of 2008 financial crisis

(iii) Product of cyclical enforcement (prior period of government crackdowns was in 1980s; hedge funds are much more prominent now)

(iv) Use of wiretaps and other aggressive investigation techniques, which can produce compelling proof of wrongdoing and intent

(v) Federal Sentencing Guidelines — although the Guidelines became advisory in 2005, the sentencing process has broadened the factors and criteria that judges consider when sentencing defendants

6. Use of cooperating witnesses

(a) Use of cooperators in federal cases is not new

Example: In 1990, Michael Milken, former head of Drexel Burnham Lambert Inc.'s "junk" bond department pleaded guilty to violating securities laws. Milken originally was sentenced to 10 years in prison, but his sentence was reduced after he cooperated with prosecutors. He ended up serving 22 months in prison[4]

(b) Between 2009 and December 2011, 56 people have been charged in the S.D.N.Y. with insider trading. Of those, 53 have been convicted[5]

(c) As illustrated by the following chart, there is a noticeable difference in the sentences of three categories of insider trading defendants

(i) Trial defendants — average five years in jail

(ii) Guilty plea defendants (i.e., those who plead guilty without cooperating with the government) — average of 2.5 years in jail

(iii) Cooperator defendants (i.e., those who plead guilty and provide cooperation to the government) — mostly probation/no jail

C. Recent prosecutions

1. Galleon Group[6]

(a) In October 2009, Rajaratnam, Danielle Chiesi, Rajivv Goel, Anil Kumar and Mark Kyrland were arrested for fraud and insider trading

(i) Since then, over 50 people have been charged in connection with illegal trading

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[3] *Id.*

[4] *Id.*

[5] "Times Topics: Insider Trading," *The New York Times*, Dec. 1, 2011

[6] *Bloomberg Businessweek* details the relationships between the three groups of players in the Galleon Group investigation. Caroline Winter, David Glovin, Jennifer Daniel, and David Yanofsky, "The Insider's Guide to Insider Trading," *Bloomberg Businessweek*

(ii) Majority of defendants involved in Galleon Group cases have pleaded guilty

(b) Zvi Goffer

(i) In November 2009, Goffer and other former Galleon employees arrested for insider trading

(ii) Goffer received tips from Thomas Hardin, managing director of Lanexa Global Management and passed information on to Gautham Shankar, a former trader with the Schottenfeld Group

(iii) Paid for tips from corporate attorneys working on mergers and acquisitions at Ropes & Gray

(iv) Franz Tudor, a Galleon portfolio manager, secretly recorded conversations with Goffer and Michael Kimelman, former partner of Emanuel Goffer (Zvi Goffer's brother), in which both discussed tips

(v) Goffer was sentenced in September 2011 to 10 years imprisonment, longest insider trading sentence prior to Rajaratnam's sentence in October 2011 (low end of the recommended Guidelines range of 121-151 months)

2. Expert networks

(a) Primary Global Research LLC ("PGR")

(i) PGR advertised itself as an "independent investment research firm that provides institutional money managers and analysts with market intelligence," through a "global advisory team of experts"

(ii) From late 2010 through 2011, the DOJ and the SEC brought insider trading charges against PGR consultants, employees and clients for illegal tipping concerning technology companies, such as Advanced Micro Devices ("AMD"), Apple, Dell, Flextronics, NVIDIA Corp. and Marvell

(iii) Winifred Jiau was a consultant with PGR

(1) Jiau allegedly formed friendships with company insiders, who provided her with quarterly revenues, gross margins and earnings per share for specific quarters for multiple publicly traded companies

(2) Jiau then communicated this nonpublic information to clients, who paid PGR, which in turn paid Jiau up to $10,000 per month

(3) Clients paid using direct payments or "soft dollar" payments through PGR's designated broker-dealer, then executed trades based on the information in advance of the companies' public announcements of their financial results

(4) The government alleged that the company insiders violated their duty to their companies

(5) Jiau was convicted after trial in June 2011. In September 2011, Jiau was sentenced to four years' imprisonment

(iv) James Fleishman was vice president of sales for PGR

(1) Fleishman allegedly received, and forwarded received emails containing nonpublic information obtained by other consultants, such as Mark Longoria and Walter Shimoon (see below at III.C.2.(a)(vi)), and "funneled" their inside information to clients

a. Information related to financial status of ADM, Dell, etc.

b. Fleishman also allegedly helped conceal the illegal conduct of consultants, telling clients that PGR preserved anonymity and "protected" experts from the public companies' investor relations personnel

c. PGR's clients executed trades based on information in advance of companies' public announcement of financial results

d. In return for the information that Fleishman funneled, clients paid PGR for the consultants and caused trading activity to be directed to PGR's designated broker-dealer

(2) The government alleged that the paid consultants who were the sources of the material, nonpublic information violated their duty to the public companies that employed them

(3) Fleishman was convicted at trial in September 2011. In December 2011, he was sentenced to 2.5 years' imprisonment

(v) Mark Anthony Longoria was a supply chain manager at AMD and a paid consultant for PGR

(1) Nonpublic information disclosed included sales figures for AMD's various operational units and financial results of company — including "top line" quarterly revenue and profit margin information

(2) PGR clients executed trades based on the information before AMD's public disclosure of financial reports

(3) The government alleged that Longoria violated AMD's employee code of conduct, which specifically required AMD employees to keep all nonpublic information confidential

(4) In June 2011, Longoria pleaded guilty to criminal charges filed by the DOJ (awaiting sentencing). In November 2011, final judgment was entered in the parallel SEC case (ordered to pay disgorgement plus interest totaling $197,178.94) (see below at IV.3.)

(vi) Walter Shimoon was vice president of business development for components in the Americas at Flextronics. He managed the group that supplied smart phone companies with components and was a paid consultant for PGR

(1) Nonpublic information disclosed included detailed advance information concerning Flextronics' customers — Apple, Omnivision, and Research in Motion ("RIM"), such as

a. RIM's pending launch of a new smart phone

b. RIM's expected quarterly orders

c. Flextronics was sole source for iPhone chargers and was seeing an increase in demand for units

d. Apple's development of new iPhone and iPad

e. Apple's quarterly financial report

f. Apple's quarterly sales figures for iPhones and iPods

g. Apple's production forecasts

(2) Information allowed clients to gauge Apple's financial results and product developments and trade stock months in advance of Apple's public announcements

(3) The government alleged that Shimoon violated Flextronics' code of business conduct and ethics and Flextronics' nondisclosure agreement with Apple

(4) Shimoon pleaded guilty in July 2011 and is pending sentencing on July 8, 2013

(vii) Daniel Devore was a global supply manager for Dell Inc. and a paid consultant for PGR

(1) Nonpublic information disclosed included inside information about Dell and two of Dell's suppliers, Seagate and Western Digital; Dell's internal sales forecasts; price and volume of purchases of computer disc drives from Seagate and Western Digital

(2) The government alleged that Devore violated Dell's code of conduct, which forbade employees from tipping and sharing information for personal gain

(3) Devore cooperated with authorities, pleaded guilty in December 2010, and is pending sentencing

(b) Noah Freeman

(i) Freeman was employed in the hedge fund industry, including as a research analyst and as a portfolio manager

(ii) In May 2008, Freeman obtained nonpublic financial information from Jiau concerning Marvell's quarterly revenues, gross margins and earnings per share for specific quarters in advance of public announcement. He shared this information with another trader, Donald Longueuil (see below at IV.3.)

(iii) He also obtained confidential financial information from Longueuil concerning other companies

(iv) Freeman and Longueuil executed trades of Marvell stock based on the information before company's announcement of financial reports

(v) The government alleged that the public company employees who gave Jiau the information had a duty of trust and confidence to their employers

(vi) Freeman pleaded guilty pursuant to a cooperation agreement in April 2011 and is pending sentencing

(c) Donald Longueuil

(i) Longueuil allegedly obtained quarterly revenues, gross margins and earnings per share for specific quarters from employees at public companies and from consultants who obtained information from other public company employees on Longueuil's behalf

(ii) The government alleged that the public company employees who were the sources of the material nonpublic information violated their duty of trust and confidence to their employers

(iii) Sentenced in July 2011 to 2.5 years' imprisonment for securities fraud and conspiracy to commit securities fraud and wire fraud

(iv) Final judgment also entered in the SEC case against Longueuil in September 2011 (ordered to pay disgorgement and interest totaling $352,832.60) (see below at IV.3.)

(d) Samir Barai

(i) Founder of Barai Capital, who allegedly swapped tips with Freeman and other portfolio managers and used expert networking firm to communicate with and pay sources of inside information

(ii) Obtained inside information from Jiau on Marvell Technologies financial results for quarter ending in May 2008; he realized trading gains of more than $800,000

(iii) Had regular conference calls with other hedge fund managers, then destroyed taped conversations and erased emails related to information

(iv) Pleaded guilty in May 2011 and is pending sentencing

(e) Joseph “Chip” Skowron III

(i) Chip Skowron, a Yale-educated doctor, was allegedly tipped by a French doctor, Yves Benhamou, who served on the steering committee that oversaw the clinical trial of the hepatitis drug conducted by biopharmaceutical company Human Genome Sciences Inc. (“HGSI”)

(ii) Benhamou also worked as a consultant for an expert networking firm through which he started advising Skowron

(iii) Benhamou allegedly tipped Skowron that hepatitis drug trials were going to be discontinued due to negative results, which allowed Skowron to sell HGSI stock before the negative news was made public and thereby avoid $30 million in trading losses

(iv) The government alleged that, as advisor to clinical trials, Benhamou had contractual duty to keep drug trial information confidential

(v) Benhamou cooperated with authorities and pleaded guilty and was sentenced to time served (24 days) in December 2011

(vi) Skowron pleaded guilty and was sentenced to five years’ imprisonment in November 2011

(f) Donald Johnson and NASDAQ

(i) Donald Johnson was a managing director on the market intelligence desk at the NASDAQ stock market

(ii) Johnson had advance information of NASDAQ company announcements and personnel changes; he also monitored stock of NASDAQ companies and offered them information and analyses

(iii) He executed and hid trades by using brokerage account in wife’s name and did not disclose this account in violation of NASDAQ rules

(iv) The government alleged that Johnson violated his duty as adviser to NASDAQ companies and duty as managing director for NASDAQ

(v) Sentenced in August 2011 to 42 months in prison; he also has a pending SEC case (see below at IV.C.10.)

(g) Drew “Bo” Brownstein and Mariner Energy

(i) Brownstein headed Big 5 Asset Management

(ii) Brownstein received a tip from friend, Drew Peterson, about a pending acquisition of Mariner Energy by the Apache Corp. Peterson received the information from his father, H. Clayton Peterson, former member of Mariner’s board of directors

Information netted him $2.5 million in trading profits

(iii) The government alleged that H. Clayton Peterson violated his duty to Mariner as member of board of directors

(iv) Bo Brownstein and Drew Peterson scheduled to be sentenced in January 2012; H. Clayton Peterson pleaded guilty and was sentenced to two years probation

D. Cases to watch

1. Rajat Gupta, former director of Goldman Sachs Group Inc.

(a) Close friend of Raj Rajaratnam

(b) On Oct. 26, 2011, Gupta was charged with one count of conspiracy to commit securities fraud and five counts of securities fraud

(c) Accused of leaking corporate secrets of Proctor & Gamble and Goldman Sachs, including advance news of Warren Buffett's $5 billion investment in GS in 2008

(d) The scheme allegedly generated profits and loss avoidance of more than $23 million for Rajaratnam

2. Garrett Bauer, Kenneth Robinson and Matthew Kluger

(a) Bauer, a former trader with RBC, JAG Trading and Lighthouse Financial, allegedly concocted a scheme with two conspirators, Kenneth Robinson (who pleaded guilty in April 2011) and Matthew Kluger (pending criminal case)

(i) Robinson allegedly passed along tips received from Kluger, an attorney who worked at several law firms, including Cravath Swaine & Moore; Skadden, Arps, Meagher & Flom; Fried Frank; and Wilson Sonsini

(ii) Communicated using payphones or disposable cell phones

(iii) After Robinson's home was raided, Bauer disposed of a cell phone at a New York McDonald's and instructed Robinson to burn $175,000 in cash because he feared fingerprints were on the money

(b) Bauer pleaded guilty on Dec. 8, 2011 to insider trading, obstruction of justice and money laundering, which earned approximately $37 million. Sentencing pending for March 2012 — faces possible 25 year sentence

(c) Kluger has a pending SEC case (see below at IV.G.2)

3. Scott Allen and John Bennett

(a) Allen, a former consultant at a global human resources consulting firm, allegedly learned of April 2008 acquisition of Millennium Pharmaceuticals Inc. and Sepracor Inc. by Japanese companies prior to any public announcements. Allen then told his longtime friend, Bennett, an independent film producer, who then made several securities transactions

(b) Bennett allegedly delivered more than $100,000 cash payments to Allen on more than 20 occasions

(c) Rather than call Bennett on his cell phone, Allen was said to have contacted Bennett using a public phone at LaGuardia Airport

(d) Both criminal cases are pending; Allen also has a pending SEC case (see below at IV.C.3.)

4. Anthony Scolaro

   (a) Scolaro, a former portfolio manager, allegedly received information concerning an impending acquisition from Arthur Cutillo and Brien Santarlas, two lawyers at Ropes & Gray

   (b) Scolaro pleaded guilty and is pending sentencing; he also has a pending SEC case (see below at IV.G.1.)

5. Cheng Yi Liang

   (a) Cheng Yi Liang, an FDA chemist, traded in developmental drug companies, including Vanda Pharmaceuticals Inc., whose stock rose significantly after the FDA cleared sales of its schizophrenia drug in May 2009

   (b) Liang allegedly passed on this information to his son Andrew, who was also charged with securities fraud (charges were dropped based on a plea agreement involving possession of child pornography that was found in the course of the fraud investigation)

   (c) Liang pleaded guilty and is pending sentencing; he also has a pending SEC case (see below at IV.D.3.)

6. George Holley and Phairot Iamnaita

   (a) Holley, former chairman and CEO of Home Diagnostics Inc., allegedly disclosed information about anticipated acquisition of Home Diagnostics by Nipro Corp. to his traveling companion Iamnaita

   (b) Holley directed several people he tipped to, if questioned, to falsely claim they bought Home Diagnostics stock based on their own research

   (c) Both Holley and Iamnaita's criminal cases are pending; Holley also has a pending SEC case (see below at IV.C.19.)

IV. Recent SEC cases

A. Cases involving hedge funds

1. *SEC v. Gupta* (S.D.N.Y. Oct. 26, 2011) (see facts above at III.D.1.)

   (a) Parallel criminal case

   (b) *Galleon*-related case

   (c) No disposition yet

2. *SEC v. Skowron* (S.D.N.Y. April 13, 2011) (see facts above at III.C.2.(e))

   (a) Parallel criminal case

   (b) Skowron's hedge fund repaid $33 million as relief defendant

3. *SEC v. Longoria, et al.* (S.D.N.Y. Feb. 8, 2011) (see facts above at III.C.2.(a)(v))

   (a) Parallel criminal case

   (b) Settlement

      (i) Permanent injunctions

      (ii) Permanent bars

(iii) No civil penalties based on cooperation

(iv) Longoria paid disgorgement of $178,850 and prejudgment interest of $18,328.94

(v) Longueuil paid disgorgement in the amount of $250,000, and prejudgment interest of $102,832.60

(vi) DeVore paid disgorgement of ill-gotten gains of $145,750 and prejudgment interest of $6,098.50

B. Case where the material nonpublic information concerned ETFs

1. *In the Matter of Mindlin* (SEC Sept. 21, 2011) (see facts above at I.B.2.)

(a) No disposition yet

C. Cases where the material nonpublic information concerned mergers and acquisitions

1. *SEC v. Richardson* (S.D.N.Y. Nov. 22, 2011)

(a) A person "close to the negotiations" allegedly tipped Jeffrey S. Richardson that Genesis Energy had agreed to acquire several energy related businesses. Richardson allegedly tipped family and friends to the information and traded in Genesis

(b) Illicit gains of more than $88,000

(c) Settlement

(i) Permanent injunction

(ii) $88,026 in disgorgement with $21,534 in prejudgment interest, and a civil penalty of $88,026

2. *SEC v. Hanold* (S.D.N.Y. Oct. 11, 2011)

(a) M. Jason Hanold allegedly learned from his wife, an executive at Aon Corp. Inc., that Aon planned for its subsidiary to merge with Hewitt Associates

(b) Hanold allegedly purchased Hewitt stock based on this information

(c) Illicit profits of $10,241

(d) Settlement

(i) Permanent injunction

(ii) $20,766 in disgorgement, prejudgment interest and civil penalties

3. *SEC v. Allen* (S.D.N.Y. Sept. 15, 2011) (see facts above at III.D.3.)

(a) Parallel criminal case

(b) Scott Allen, an employee at a consulting firm that advised Japanese companies as they looked into acquiring Millennium Pharmaceuticals Inc. and Sepracor Inc., allegedly tipped his friend, John Bennett, of the impending acquisitions, and Bennett allegedly told his business partner

(c) $2.6 million in illicit profits

(d) No disposition yet

4. *SEC v. Clay Capital Management* (D.N.J. Aug. 31, 2011)

   (a) Scott Vollmar, a director at Autodesk Inc., allegedly tipped his brother-in-law, James Turner, who ran a hedge fund called Clay Capital Management, and neighbor, Mark Durbin, that Autodesk intended to merge with Moldflow Corp. and regarding Autodesk's fourth quarter 2008 earnings. Turner allegedly shared the information with his friend, Scott Robarge

   (b) Robarge, a recruiting technology manager for Salesforce.com Inc., allegedly tipped Turner with non-public information about Salesforce.com's performance. Turner allegedly spread the information to Vollmar, friends and family

   (c) $3.9M in illicit gains

   (d) Settlements

      (i) Permanent injunction

      (ii) Robarge paid disgorgement of $232,591.91, prejudgment interest of $31,884.93 and a penalty of $232,591.91

      (iii) Durbin paid disgorgement of $8,391.26, prejudgment interest of $1,110.86, and a penalty of $8,391.26

5. *SEC v. Scammell* (C.D. Cal. Aug. 11, 2011)

   (a) Toby G. Scammell purchased call options for shares in Marvel Entertainment Inc. before the Walt Disney Co acquired Marvel

   (b) Scammell allegedly obtained nonpublic information about the acquisition from his girlfriend, who was an extern at Disney's corporate strategy department

   (c) At times, Scammell's transactions represented over 90% of the market volume for the option series that he purchased. Scammell had never before traded in Marvel securities and had only one, very unsuccessful, prior experience trading call options

   (d) Illicit profits of more than $192,000

   (e) No disposition yet

6. *SEC v. Peterson* (S.D.N.Y. Aug. 5, 2011) (see facts above at III.C.2.(g))

   (a) Parallel criminal case

   (b) H. Clayton Peterson, a board member of Mariner Energy, allegedly informed his son, Drew Peterson, who was a managing director at an investment adviser, that Mariner was being acquired by Apache Corp.. Drew traded in Mariner stock for himself, relatives, clients, and a friend, and he allegedly tipped several other close friends who traded in Mariner

   (c) $5.2M in illicit profits

   (d) No disposition yet

7. *SEC v. DeCinces* (C.D. Cal. Aug. 4, 2011)

   (a) Doug DeCinces was a third-baseman with the Orioles, Angels and Cardinals during the 1970s and 80s (.259 career hitter with 237 HRs and 879 RBIs). He was traded from the Orioles to make room for Cal Ripken, Jr.

(b) A source at Advanced Medical Optics allegedly tipped DeCinces that the company was being acquired by Abbott Laboratories Inc.

(c) DeCinces allegedly shared the information with Joseph Donohue, Fred Jackson and Roger Wittenbach, and all four traded in Advanced Medical Optics

(d) $1.7 million in illegal profits

(e) Settlements

(i) Permanent injunctions for DeCinces, Donohue, Jackson and Wittenbach

(ii) DeCinces paid disgorgement of $1,282,691, prejudgment interest of $19,311 and a penalty of $1,197,998 for a total of $2.5 million

(iii) Donohue paid disgorgement of $75,570 and a penalty of $37,785 for a total of $113,355

(iv) Jackson paid disgorgement of $140,259, prejudgment interest of $12,508 and a penalty of $140,259 for a total of $293,026

(v) Wittenbach paid disgorgement of $201,692, prejudgment interest of $5,768 and a penalty of $214,906 for a total of $422,366

8. *SEC v. Marovitz* (N.D. Ill. Aug. 3, 2011)

(a) William A. Marovitz allegedly misappropriated non-public information from his wife, Christie Hefner, who was the CEO of Playboy Enterprises Inc., and traded in Playboy stock in advance of announcements related to Iconix's potential acquisition of Playboy, Playboy's negative earnings announcements and Playboy's stock offering

(b) Total illicit gains were greater than $100,000

(c) Settlement

(i) Permanent injunction

(ii) $168,352 in disgorgement, prejudgment interest and civil penalties

9. *SEC v. Doyle* (S.D.N.Y. July 19, 2011)

(a) Robert Doyle traded in the securities of Brink's Home Security after he allegedly obtained non-public information regarding Tyco International. Inc.'s impending buyout of Brink's

(b) Doyle allegedly learned of the buyout from a draft presentation that was left at his home inadvertently by an employee of Tyco's investment bank. He also allegedly knew that the banker was flying on a Tyco corporate jet to Tyco's headquarters

(c) Illicit profits of $88,555

(d) Settlement

(i) Permanent injunction

(ii) $44,277.50 civil penalty, $88,555 in disgorgement and $4,288.66 in prejudgment interest

10. *SEC v. Johnson* (S.D.N.Y. May 26, 2011) (see facts above at III.C.2.(f))

(a) Parallel criminal case

(b) No disposition yet

11. *SEC v. Hollander* (S.D.N.Y April 28, 2011)

(a) Jonathan Hollander, a former hedge fund professional, traded in Albertson's LLC after allegedly being tipped that Albertson's was being acquired. Tipper was an employee at the financial advisor hired by Albertson's to work on the acquisition. Hollander also allegedly tipped a family member and friend

(b) Over $95,000 in illegal profits

(c) Settlement

(i) Disgorgement of $95,807 and civil penalty of $95,807

(ii) Barred for three years

12. *SEC v. Deskovick* (March 17, 2011)

(a) Kim Deskovick, a director at First Morris Bank and Trust, allegedly tipped a friend that Provident Financial Services Inc. had agreed to acquire First Morris and provided the friend with periodic updates about the merger negotiations

(b) The friend allegedly told another person, Haig, who in turn told another person

(c) Illicit gains of more than $68,000

(d) Settlement

(i) Permanent injunctions

(ii) Haig paid disgorgement of $68,277, prejudgment interest of $18,007 and a civil penalty of $34,138. The SEC reduced Haig's penalty after considering his significant cooperation, which included providing information about the involvement of others

(iii) Deskovick paid a civil penalty of $68,277

(iv) Bar for Deskovick for five years

13. *SEC v. Carroll* (W.D. Ky. March 17, 2011)

(a) Patrick M. Carroll, William T. Carroll, David A. Stitt and David Mark Calcutt, all vice presidents at Steel Technologies Inc., allegedly obtained nonpublic information about the forthcoming acquisition of Steel by Mitsui & Co. Inc. Patrick Carroll, Calcutt and Stitt also allegedly tipped family members or friends

(b) $320,000 in illegal profits

(c) No disposition yet

14. *SEC v. Dawson* (N.D. Ill. March 8, 2011)

(a) Joseph A. Dawson, purchased call options of SPSS Inc. in advance of a July 28, 2009 announcement of an acquisition by IBM after allegedly learning material nonpublic information about the acquisition from a family member of SPSS. Dawson also allegedly orchestrated a fraudulent offering scheme with a trading firm

(b) Illicit profits of more than $437,000

(c) Settlement

(i) Permanent injunction

(ii) Pay disgorgement and prejudgment interest

15. *SEC v. Seib* (N.D. Ga. March 1, 2011)

    (a) Gregory A. Seib, who was employed by an outside director of Cambridge Display Technology Inc., purchased stock and call options in Cambridge after allegedly reading his employer's emails describing a pending merger agreement between Cambridge and Sumitomo Chemical Co. Ltd.

    (b) Illicit profit of more than $71K

    (c) Settlement

        (i) Permanent injunction

        (ii) $71,654.14 in civil penalties, $71,654.14 in disgorgement and prejudgment interest of $13,393.88

16. *SEC v. Ni* (N.D. Cal. Feb. 16, 2011) (see facts above at I.B.5.)

    (a) Ni paid disgorgement and penalties over $300,000

17. *SEC v. Cohen* (S.D. Cal. Feb. 15, 2011)

    (a) Aaron J. Scalia, a patent agent formerly employed by Sequenom Inc., allegedly learned material nonpublic information about the development of one of Sequenom's diagnostic products and about Sequenom's proposed acquisition of Exact Sciences Corp.

    (b) Scalia allegedly tipped his brother, who in turn allegedly tipped Brett A. Cohen, who in turn allegedly tipped his uncle, David V. Myers

    (c) Myers purchased Exact Sciences stock allegedly because of the information

    (d) Illicit profits of approximately $607,000

    (e) No disposition yet

18. *18. SEC v. Smith* (S.D.N.Y. Jan. 26, 2011)

    (a) Adam Smith, a portfolio manager at New York-based hedge fund investment adviser Galleon Management LP, allegedly traded in the securities of ATI Technologies Inc. based on material nonpublic information concerning the acquisition of ATI by Advanced Micro Devices Inc.

    (b) Smith allegedly learned of the acquisition from an investment banker who had received such information while serving as an employee of an investment bank that was advising one of the parties

    (c) $1.3 million in illicit profits

    (d) No disposition yet

19. *SEC v. Holley* (D.N.J. Jan. 13, 2011) (see facts above at III.D.6)

    (a) Parallel criminal proceeding

    (b) George Holley, chairman of the board at Home Diagnostics Inc., allegedly provided non-public information regarding an impending acquisition of the company by Nipro Corp. to friends and business associates, including Steven Dudas and Phairot Iamnaita

    (c) Holley allegedly gave Dudas $121,500 to buy Home Diagnostics stock, which he did before the acquisition

(d) Holley allegedly provided the information to two other friends, a relative and a business associate, all of whom traded in the stock

(e) Holley allegedly gave at least two of these individuals copies of analyst reports that they could use as cover stories for the trades

(f) More than $260,000 in illicit gains

(g) Case administratively terminated by the court after it had already issued a stay of discovery so that the parallel criminal proceeding could proceed

D. Cases in which the material nonpublic information concerned company performance

1. *SEC v. Clay Capital Management* (D.N.J. Aug. 31, 2011) (see facts above at IV.C.4.)

2. *SEC v. Marovitz* (N.D. Ill. Aug. 3, 2011) (see facts above at IV.C.8.)

3. *SEC v. Liang* (D. Md. June 2, 2011) (see facts above at III.D.5.)

(a) Parallel criminal case

(b) Cheng Yi Liang, an FDA chemist, traded in stock of 19 corporations after obtaining nonpublic information regarding FDA drug approval decisions

(c) $3.6 million in illicit gains

(d) Settlement

(i) Permanent injunction

(ii) Disgorgement of $3,776,152

4. *SEC v. Feinblatt* (S.D.N.Y. Jan. 10, 2011)

(a) Sunil Bhalla, a senior executive at Polycom Inc., allegedly tipped defendants to Polycom's fourth quarter 2005 earnings and first quarter 2006 earnings

(b) Shammara Hussain, an employee at a financial consulting firm, allegedly tipped non-public information to defendants regarding Google's second quarter 2007 earnings

(c) Roomy Khan allegedly traded on, and tipped others to, inside information about the impending acquisition of Kronos by Hellman & Friedman, a private equity firm

(d) Settlement

(i) Permanent injunctions

(ii) Feinblatt paid disgorgement of $829,765, plus $186,023 in prejudgment interest, plus a civil penalty of $1,659,530

(iii) Yokuty paid disgorgement of $127,595.10, plus $34,935.12 in prejudgment interest, plus a civil penalty of $127,595.10

5. *SEC v. Fan* (W.D. Wash. Jan. 10, 2011)

(a) Zizhong Fan, a manager at Seattle Genetics Inc., allegedly learned confidential information about positive clinical trials of the company's cancer drug and tipped the information to a relative, who purchased several hundred thousand dollars of Seattle Genetics stock and options

(b) Over $803,000 in illicit profits

(c) No disposition yet

6. *SEC v. Radcliffe* (D.D.C. Jan. 14, 2011)

(a) Joseph Radcliffe and Michael Radcliffe controlled and partly owned Image Innovations Holdings Inc., a public company, and they allegedly created fictitious revenue for the company that was reported to the public

(b) Joseph Radcliffe allegedly engaged in insider trading by selling, or arranging the sale of shares of Image at the fraud-inflated prices while in possession of material, nonpublic information regarding the company's true financial performance

(c) $975,000 in illegal profits

(d) Settlement

(i) Permanent injunction

(ii) $955,000 in disgorgement, $299,541 in prejudgment interest and $175,000 in civil penalty

E. Cases in which the material nonpublic information concerned stock offerings and repurchases

1. *SEC v. Powell* (S.D.N.Y. June 10, 2011)

(a) Phillip E. Powell, who was chairman of First Cash Financial Services Inc., traded in stock of First Cash while allegedly possessing non-public information concerning First Cash's commencement of a stock repurchase

(b) Illicit profits of $124,000

(c) When the SEC began investigating Powell, he allegedly tried to mislead them by stating that he knew an entity he controlled had purchased First Cash shares but he did not know when, and that he did not know who had placed the trade for that purchase

(d) No disposition yet

2. *SEC v. CytoCore, Inc.* (N.D. Ill. Jan. 13, 2011)

(a) Daniel Burns, a consultant for CytoCore Inc., the company's Chairman, and Robert McCullough the company's CEO and CFO, allegedly sold CytoCore stock based on nonpublic information about an ongoing CytoCore private stock offering

(b) "Hundreds of thousands of dollars" in illicit gains

(c) Settlement

(i) Permanent injunction

(ii) McCullough paid $100,000 in civil penalty

(iii) 12-month bar for McCullough

F. Cases involving accountants' breach of duty

1. *SEC v. Konyndyk* (S.D.N.Y. Nov. 18, 2011)

(a) Mark Konyndyk worked for Ernst & Young, doing due diligence for its client Vivendi SA, and purchased stock in Activision Inc. after allegedly receiving nonpublic information that it was being acquired by Vivendi

(b) Illicit profits totaling $9,725

(c) Settlement

(i) Permanent injunction and bar

(ii) Disgorgement of $9,725, $1,789.28 in prejudgment interest, and $9,725 civil penalty

G. Cases involving lawyers' breach of duty

1. *SEC v. Scolaro* (S.D.N.Y. Aug. 31, 2011) (see facts above at III.D.4.)

(a) Parallel criminal case

(b) Arthur J. Cutillo and Brien P. Santarlas, lawyers at Ropes & Gray, allegedly gave non-public information about their client's upcoming acquisition plans in exchange for kickbacks

(c) Through a long chain of actors, they allegedly gave information regarding the impending acquisition of Axcan Pharma Inc. to Anthony J. Scolaro, Jr., a portfolio manager, in exchange for kickbacks

(d) Scolaro allegedly used this information to trade in Axcan on behalf of a hedge fund

(e) Illicit profits of approximately $1.1 million

(f) Settlement

(i) Permanent injunction and bar

(ii) Disgorgement of $125,980, prejudgment interest of $14,420 and a civil penalty of $62,945

2. *SEC v. Kluger* (D.N.J. April 6, 2011) (see facts above at III.D.2.)

(a) Parallel criminal case

(b) Matthew Kluger, an attorney at an international law firm, allegedly communicated nonpublic merger information regarding the law firm's clients through a middleman to Garrett Bauer, who worked as a trader on Wall Street

(c) Bauer allegedly traded in the stocks of the client corporations and provided kickbacks to the middleman and Kluger

(d) The middleman allegedly traded in two deals on the basis of information that he received from Kluger and profited at least $690,000

(e) $32 million in illicit gains

(f) No disposition yet

3. *SEC v. Treadway* (S.D.N.Y. March 7, 2011)

(a) Todd Leslie Treadway, an attorney at an international law firm, allegedly used nonpublic information from his firm's clients to buy stock in Accredited Home Lenders Holding Co. and CNET Networks Inc., which were targets for acquisition

(b) Illegal profits of approximately $27,000

(c) No disposition yet

H. Cases with unknown defendants and "highly profitable and suspicious purchases"

1. *SEC v. One or More Unknown Purchasers of Common Stock of Jaguar Mining, Inc.* (S.D.N.Y. Dec. 2, 2011)

   (a) The SEC monitored the "highly profitable and suspicious purchases" of Jaguar Mining by an unknown buyer

   (b) Buyers purchased stock in advance of a public announcement that Jaguar had received an unsolicited takeover offer from Shandong Gold Group Co.

   (c) Purchases exceeded 24% of all Jaguar trading on two days

   (d) Illicit profits of approximately $8.3 million

   (e) No disposition yet

2. *SEC v. One or More Unknown Purchasers of Securities of Global Industries, Ltd.* (S.D.N.Y. Sept. 16, 2011)

   (a) SEC monitored unknown purchasers making "highly profitable and suspicious purchases" of the U.S.-based Global Industries Ltd. in the two trading days immediately preceding a public announcement that Global would be acquired by the French company Technip SA

   (b) The purchases were made through an omnibus account in the name of Raiffeisen Bank International AG, based in Austria

   (c) After the announcement, on the same day, the unknown purchasers sold all of the stock that had been purchased on the two preceding trading days

   (d) More than $1.7 million in illicit gains

3. *SEC v. Compania Internacional Financiera S.A.* (S.D.N.Y. July 18, 2011)

   (a) Three Swiss firms trading in Connecticut-based Arch Chemicals Inc. allegedly based on non-public information that Arch would be acquired by Switzerland-based Lonza Group Ltd.

   (b) Shares were purchased mostly in London

   (c) The SEC obtained a freeze of the firm's assets and the court ordered repatriation of all assets obtained from the trading

   (d) The SEC requested emergency relief noting that because the defendants are foreign entities and placed their trades in overseas accounts, there was a substantial risk that, upon clearance at U.S. brokerage firms, the proceeds of the trades would likely be transferred overseas

   (e) Millions in illicit profits

   (f) The court scheduled a preliminary injunction hearing

4. *SEC v. One or More Unknown Purchasers of Securities of Telvent GIT S.A.* (S.D.N.Y. June 3, 2011)

   (a) The SEC monitored "highly profitable and suspicious purchases" of Telvent call options by unknown buyers

   (b) Options were purchased leading up to the impending announcement that Schneider Electric SA, a French company, would acquire Spain-based Telvent

   (c) Purchases made through an omnibus account in the name of Audi Saradar Private Bank, Single Agency Account, Pershing LLC, Beirut, Lebanon

(d) Most of the options were purchased within two before the announcement and equaled more than a 50% increase in the daily trading volume

(e) The value of the options increased significantly after the announcement

(f) The SEC filed its complaint two days after it announced that it would freeze the assets

(g) Illicit profits of $475,000

(h) The court entered an order to freezing the assets relating to the trading, requiring the unknown purchasers to identify themselves, imposing an expedited discovery schedule and prohibiting the defendants from destroying documents

V. Reducing risk

A. Compliance procedures and ways to reduce risk — while compliance programs will necessarily vary depending on the nature of the investment firm's business, its size and other factors, below is a list of policies and procedures and other steps that firms should consider in tailoring an insider trading compliance program that is appropriate and reasonably designed to mitigate their relative risk for insider trading

1. Written prohibitions against insider trading
2. Written policy regarding rumors
3. Requirement that personnel acknowledge compliance policies in writing
4. Frequent training of personnel
5. Insider trading "point person" for questions
6. Monitoring of electronic communications between investment personnel or traders and third parties
7. Method of back-testing to identify insider trading
8. Preapproval of purchases, for personal trading accounts, of new issue or privately placed securities (required for SEC-registered investment advisers)
9. Identification of access persons' personal trading accounts and the reporting of trades therein (required for SEC-registered investment advisers)
10. Ongoing review process for personal trading by firm personnel (required for SEC-registered investment advisers)
11. Identification of public companies in which portfolio managers' or traders' close relatives are employed in a high-level position (e.g., chief financial officer)
12. Watch lists and restricted trading lists
13. 10b5-1 plans
14. Information barriers
15. Paid consultant compliance plans
16. Written verification from paid consultant that information provided was not inside information
17. Documentation of communications with paid consultants
18. Possible self-reporting

Insider trading and criminal convictions: defendants and sentences by case

Galleon and related cases		
Defendant	**Trial or plea?**	**Status**
Ali Far (co-founder and managing partner of Spherix Capital)	Plea with cooperation	Pending sentencing
Anil Kumar (former senior partner at McKinsey & Co.)	Plea with cooperation	Pending sentencing
Brien Santarlas (former Ropes & Gray attorney)	Plea with cooperation	6 months (11/30/11)
David Slaine (Galleon Group trader)	Plea with cooperation	Pending sentencing (01/20/12)
David Plate (Schottenfeld trader)	Plea with cooperation	Probation (11/02/11)
Donna Murdoch (managing director of Keystone Equities Group LP)	Plea with cooperation	Probation (07/27/11)
Roomy Khan (Galleon Group trader)	Plea with cooperation	Pending sentencing (03/01/12)
Steven Fortuna (co-founder and principal of S2 Capital)	Plea with cooperation	Pending sentencing
Adam Smith (former portfolio manager and analyst at Galleon Group)	Plea	Pending sentencing
Ali Hariri (former VP of Atheros Comm. Inc.)	Plea	18 months (11/18/10)
Anthony Scolaro (former portfolio manager)	Plea	Pending sentencing
Arthur Cutillo (former Ropes & Gray attorney)	Plea	2.5 years (06/30/11)
Craig Drimal (Galleon Group trader)	Plea	5.5 years (08/31/11)
Danielle Chiesi (analyst at New Castle Funds LLC)	Plea	2.5 years (07/20/11)
Gautham Shankar (Schottenfeld trader)	Plea	Pending sentencing (03/16/12)
Jason Goldfarb (private practice attorney)	Plea	3 years (08/19/11)
Mark Kurland (co-founder of New Castle Funds LLC)	Plea	27 months (05/21/10)
Rajiv Goel (former employee of Intel)	Plea	Pending sentencing
Robert Moffat (former executive with IBM)	Plea	6 months (09/13/10)
Emanuel Goffer (Spectrum Trading trader)	Trial	3 years (10/7/11)
James Gansman (former Ernst & Young partner)	Trial	1 year (02/08/10)
Michael Kimelman (former partner of Emanuel Goffer in Incremental Capital)	Trial	2.5 years (10/12/11)
Raj Rajaratnam (Galleon Group founder)	Trial	11 years (10/13/11)
Zvi Goffer (Galleon Group/Schottenfeld trader)	Trial	10 years (09/21/11)
Deep Shah (Moody's analyst)	Fugitive	N/A
Rajat Gupta (former director of Goldman Sachs)	Pending trial (04/09/12)	N/A

Expert networks		
Defendant	**Trial or plea?**	**Status**
Daniel Devore (global supply manager for Dell)	Plea with cooperation	Pending sentencing (12/10/13)
Don Ching Trang Chu (former consultant at Primary Global Research LLC)	Plea with cooperation	Probation (09/09/11)
Jason Pflaum (former research analyst for Samir Barai)	Plea with cooperation	Pending sentencing
Karl Motey (independent technology consultant)	Plea with cooperation	Pending sentencing (12/16/13)
Mark Anthony Longoria (supply chain manager of AMD)	Plea with cooperation	Pending sentencing (07/01/13)
Noah Freeman (former SAC Capital Advisors trader)	Plea with cooperation	Pending sentencing
Samir Barai (portfolio manager)	Plea with cooperation	Pending sentencing
Son Ngoc Nguyen (NVIDIA Corp.)	Plea with cooperation	Pending sentencing
Walter Shimoon (senior director of business development at Flextronics)	Plea with cooperation	Pending sentencing (07/08/13)
Richard Choo-Beng Lee (founder of Spherix Capital)*	Pending (with cooperation)	Pending sentencing (01/06/12)
Donald Longueuil (SAC Capital Advisors trader)	Plea	2.5 years (07/29/11)
Manosha Karunatilaka (former Taiwan Semiconductor Manufacturing Co. manager, Primary Global Research LLC consultant)	Plea	18 months (09/16/11)
Stanley Ng (former SEC reporting manager for Marvell Technology Group)	Plea	Pending sentencing (04/09/12)
James Fleishman (former employee at Primary Global Research)	Trial	2.5 years (12/21/11)
Winifred Jiau (Primary Global Research LLC consultant)	Trial	4 years (09/21/11)

Mariner		
Defendant	**Trial or plea?**	**Status**
Drew Peterson (investment adviser)	Plea with cooperation	Pending sentencing (01/11/12)
H. Clayton Peterson (former board member of Mariner Energy)	Plea	Probation (10/11/11)
Bo Brownstein (head of Big 5 Asset Management)	Plea	Pending sentencing (01/04/12)

* In addition to charges in connection with expert network firm Primary Global Research LLC, Lee is also implicated in the Galleon investigation. He has been cooperating with authorities since April 2009

Human Genome Sciences Inc.		
Defendant	**Trial or plea?**	**Status**
Yves Benhamou (French doctor)	Plea with cooperation	Time served (24 days imprisonment) (12/21/11)
Joseph "Chip" Skowron III (former health care fund manager)	Plea	5 years (11/18/11)

Other		
Defendant	**Trial or plea?**	**Status**
Cheng Yi Liang (FDA chemist)	Plea	Pending sentencing (0/3/05/12)
Daniel Corbin (day trader)	Plea	6 months (12/9/11)
Donald Johnson (former NASDAQ managing director)	Plea	3.5 years (08/12/11)
Garrett Bauer (former trader with RBC, JAG Trading and Lighthouse Financial)	Plea	Pending sentencing (03/11)
George Holley (chairman and CEO of Home Diagnostics Inc.)	Pending	Pending
Jamil Bouchareb (day trader)	Plea	2.5 years (12/9/11)
John Bennett (independent film producer)	Pending	Pending
Joseph Contorinis (former Jeffries Paragon Fund money manager)	Trial	6 years (12/18/10)
Kenneth Robinson (mortgage broker)	Plea	Pending sentencing
Matthew Devlin (co-conspirator of Daniel Corbin and Jamil Bouchareb)	Plea	Pending sentencing (03/02/12)
Matthew Kluger (attorney)	Pending trial	N/A
Nicos Stephanou (former UBS banker)	Plea	Time served (19 months) (12/22/10)
Phairot Iamnaita (co-defendant with George Holley)		
Scott Allen (former global human resources firm consultant)	Pending	Pending

Defendants and sentences by type of conviction

Plea with cooperation defendants		
Defendant	**Case**	**Sentence**
Brien Santarlas	Galleon	6 months
David Plate (Schottenfeld trader)	Plea with cooperation	Probation
Don Ching Trang Chu	Expert networks	Probation
Donna Murdoch	Galleon	Probation
Nicos Stephanou	Other	Time served (19 months) (12/22/10)
Yves Benhamou	Human Genome Sciences Inc.	Time served (24 days)
		Average = 4.33 months

Straight plea defendants		
Defendant	**Case**	**Sentence**
Ali Hariri	Galleon	18 months
Arthur Cutillo	Galleon	2.5 years
Craig Drimal	Galleon	5.5 years
Daniel Corbin	Other	6 months
Danielle Chiesi	Galleon	2.5 years
Donald Longueuil	Expert networks	2.5 years
Donald Johnson	Other	3.5 years
H. Clayton Peterson	Mariner	Probation
Jamil Bouchareb	Other	2.5 years
Jason Goldfarb	Galleon	3 years
Joseph "Chip" Skowron III	Human Genome Sciences Inc.	5 years
Manosha Karunatilaka	Expert networks	18 months
Mark Kurland	Galleon	27 months
Robert Moffat	Galleon	6 months
		Average = 28.5 months

Trial defendants		
Defendant	**Case**	**Sentence**
Emanuel Goffer	Galleon	3 years
James Fleishman	Expert networks	2.5 years
James Gansman	Galleon	1 year
Joseph Contorinis	Other	6 years
Michael Kimelman	Galleon	2.5 years
Raj Rajaratnam	Galleon	11 years
Winifred Jiau	Expert networks	4 years
Zvi Goffer	Galleon	10 years
		Average = 5 years

Recent Developments in Bankruptcy and Distressed Investing

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Practices

Business Reorganization

Distressed Debt & Claims Trading

Distressed Investing

Lawrence V. Gelber

Lawrence V. Gelber is a partner in the New York office, where his practice concentrates in the areas of distressed mergers and acquisitions, debtor-in-possession financing, corporate restructuring, creditors' rights and prime brokerage insolvency/counterparty risk. Larry's extensive experience in Chapter 11 reorganization cases includes his representation of debtors, secured and unsecured creditors, lenders, investors and acquirers. His debtor representations have included Quigley Company Inc., NTL Inc., Safety-Kleen Corp., Fansteel Inc., and CAI Wireless Systems Inc. Among his lender and creditor representations are Ableco Finance LLC, Cerberus Partners LP, King Street Capital Management LP and Wells Fargo Capital Finance LLC. Investors and acquirer representations include Cerberus Capital Management LP, Mount Kellett Capital Management LP, Prentice Capital Management LP, Tinicum Inc. and Petra Capital Management.

Larry is recognized by *The Legal 500 United States* as a leader in his field. He is a contributor to *The Bankruptcy Strategist* and has spoken at conferences sponsored by the American Bankruptcy Institute, the William J. O'Neill Great Lakes Regional Bankruptcy Institute and other organizations. Some recent presentation topics include "M&A in Bankruptcy," "Counterparty Relationships" and "Selected Bankruptcy Considerations in the Acquisition of Distressed Assets." He recently presented on " 'Avoiding Powers' — Augmentation of the Estate" at Practising Law Institute's Nuts and Bolts of Corporate Bankruptcy 2011 Conference, participated in an SRZ webinar titled "Real Estate Mezz Loans: What You Need to Know," and participated in an ExecSense webinar covering "What Bankruptcy Lawyers Need to Know About UCC Article 9 — Best Practices for Mezzanine Foreclosures in 2011."

After receiving his B.A., *magna cum laude*, from Tufts University, Larry obtained his J.D., *cum laude*, from New York University School of Law.

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- Activist Investing
- Alternative Dispute Resolution
- Complex Commercial Litigation
- Internal Investigations
- Investment Funds Litigation
- Regulatory & Compliance
- Securities & Shareholder Litigation

Alan R. Glickman

Alan R. Glickman, a partner at Schulte Roth & Zabel, practices in the areas of complex commercial, securities, shareholder derivative, bankruptcy and creditors' rights, RICO, accountants' liability, intellectual property, class action defense and mergers and acquisitions litigation.

Significant matters have included the defense of a former senior executive of Bear Stearns in class actions brought in the wake of the firm's collapse and acquisition; representation of a creditors' committee, an indenture trustee and individual investors respectively in three major bank holding company bankruptcy litigations; representation of large private equity funds in a dispute with respect to control of a major U.S. shipping company; the defense of three investment banks and issuers against class action claims relating to alleged misstatements in connection with securities offerings; and the defense of a major Olympic international sports federation in an antitrust litigation.

Alan also has conducted numerous internal investigations, including on behalf of the boards of directors of a major pharmaceutical company and a major food wholesaler/distributor relating to alleged accounting improprieties and recently served as Chair of the Practising Law Institute's New York panel on the conduct of internal investigations.

Alan writes and speaks on litigation topics, recently co-authoring "The Elements of an Insider Trading Claim" and "Tender Offers," chapters in the *Insider Trading Law and Compliance Answer Book* published by Practising Law Institute. In practice for almost 30 years, Alan is listed in *Best Lawyers* and *New York Super Lawyers*.

Alan received his B.A., *cum laude*, from Harvard University, and received his J.D. from New York University School of Law, where he was editor of the Moot Court Board.

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Practices

- Business Reorganization
- Distressed Debt & Claims Trading
- Distressed Investing

Adam C. Harris

Adam C. Harris is a partner at Schulte Roth & Zabel and a member of the firm's Executive Committee. His practice covers corporate restructurings, workouts and creditors' rights litigation. Adam's practice has a particular focus on the representation of investment funds and financial institutions in distressed situations, including both in-court and out-of-court restructurings, and distressed acquisitions by third-party investors or existing creditors through "credit bid" or similar strategies. In addition to representing creditors and acquirors in distressed situations, Adam has also represented Chapter 11 debtors, as well as portfolio companies in out-of-court exchange offers, debt repurchases and other capital restructurings.

A speaker and author on bankruptcy and restructuring issues, Adam recently spoke on "Bankruptcy Prenups: Planning and Negotiation Before Chapter 11" at the 85th National Conference of Bankruptcy Judges and he co-authored the chapter "Out of Court Restructurings, the Bankruptcy Context and Creditors' Committees" in the *Insider Trading Law and Compliance Answer Book*, published by Practising Law Institute. Adam is listed in both *Chambers USA* and *Best Lawyers in America*.

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Internal Investigations

Investment Funds Litigation

Regulatory & Compliance

Securities & Shareholder Litigation

Securities Enforcement & White Collar Defense

Trusts & Estates Litigation

Marcy Ressler Harris

Marcy Ressler Harris, a partner at Schulte Roth & Zabel, concentrates her practice in the areas of securities enforcement and regulatory investigations and litigation for financial services industry clients, including hedge funds and funds of funds. Marcy also has an active litigation practice involving family disputes, will contests and other Surrogate's Court matters, contested guardianships and family office fraud.

Since December 2008, Marcy has been actively involved defending former customers of Bernard L. Madoff Investment Securities LLC against clawback litigation in the SIPA Bankruptcy case and in related proceedings, including Jeffry M. Picower, his estate, executor and affiliated parties. Previously, Marcy successfully defended several funds within the Sterling Stamos group against clawback litigation brought by the receiver for Bayou Group LLC and Bayou Superfund LLC. Marcy has represented numerous individuals and fund clients in SEC enforcement matters and investigations, including those related to insider trading, market manipulation, disclosure and valuation issues, market timing, and securities fraud. She also has been involved in RMBS litigations and investigations in recent years.

During her 25 years at the firm, Marcy has litigated in federal and state courts in New York and elsewhere, conducted trials, arbitrations and mediations, provided ongoing litigation and regulatory compliance counseling, and represented companies, officers, directors and board committees in connection with activist litigation, failed corporate transactions, and internal investigations related to accounting fraud, conflicts of interest, insider trading and internet abuse.

Marcy writes and speaks regularly on regulatory and litigation topics, recently co-authoring "Regulation Fair Disclosure," a chapter in the *Insider Trading Law and Compliance Answer Book* published by Practising Law Institute, and "Madoff 'Net Winners' Lose Out," which appeared in *Law360*. Marcy also participated in an SEC Hot Topics panel addressing the Dodd-Frank Whistleblower Rules and discussed "Ethical Issues Facing In-House Counsel" at SRZ's Investment Management Alumni Roundtable.

Marcy graduated *magna cum laude* from Yale University with a B.A. and received her J.D. from New York University School of Law.

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David J. Karp is a partner at Schulte Roth & Zabel, where his practice focuses on corporate restructuring, special situations and distressed investments, distressed mergers and acquisitions, and the bankruptcy aspects of structured finance. David leads the firm's Distressed Debt and Claims Trading Group, which provides advice in connection with U.S., European and emerging market debt and claims trading matters.

Among his broad work in reorganization and distressed investments, David has represented debtors, ad hoc and official committees, and individual secured and unsecured creditors. His recent representations include an investment bank in connection with the sale of a distressed CDO portfolio; an investment fund in connection with loan-to-own acquisition of the largest private U.S. party supply and novelty company; an investment fund in connection with loan facility secured by bankruptcy claims; an investment fund in connection with membership on the official committee of equity security holders in connection with the Chapter 11 cases of Seahawk Drilling Inc.; a secured lender in connection with the acquisition of Philadelphia Newspapers LLC; and bondholders in connection with the Chapter 11 cases of Visteon Corporation.

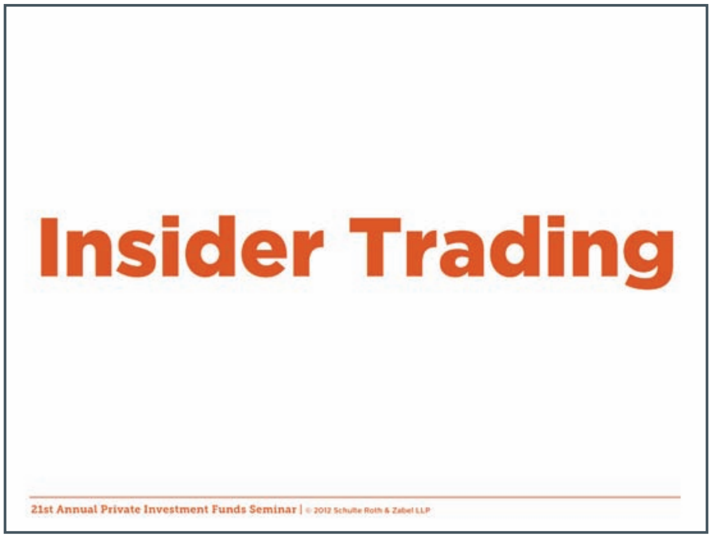
David has also represented broker-dealers, investment funds, private equity funds and CLOs in connection with distressed investments in Aleris Corporation, Centro Properties Group, Charter Communications, Cinram International Inc., Delta Air Lines Inc., Fairpoint Communications Inc., General Motors Corp, Glitnlr Bank hf, Idearc Inc., Jane Norman Group, Kaupthing Bank hf., Landsbanki Íslands hf., MF Global Inc and its affiliated debtors, Sands Corp., Lear Corp., Lehman Brothers Holdings Inc. and its affiliated debtors; Pacific Ethanol Inc., Penton Media Inc., Quality Home Brands Holdings LLC, Quinn Group Ltd., SemGroup Corp., Stallion Oilfield Services Ltd., Tribune Co., Tropicana Entertainment LLC and Young Broadcasting Inc.

David is an author and speaker on distressed investing topics. He recently co-authored "The Impact of Asymmetric Information, Trade Documentation, Form of Transfer and Additional Terms of Trade on Hedge Funds' Trade Risk in European Secondary Loans" and "Regulatory, Tax and Credit Documentation Factors Impacting Hedge Funds' Trade Risk in European Secondary Loans," for *The Hedge Fund Law Report*, "European Insolvency Claims Trading: Is Iceland The Paradigm?" for *Butterworths Journal of International Banking and Financial Law*, as well as "Claims Traders Beware: More Risk Than You Bargained For!" for the *Bloomberg Bankruptcy Law Report*. In addition, he presented "Distressed Investing: European Bank Debt and Claims — Before You Say 'Done'" and "Current Issues in Trading Fixed Income Securities" at SRZ conferences.

David is a member of the American Bankruptcy Institute, the Asia Pacific Loan Market Association, the Emerging Markets Trade Association, the International Swaps and Derivatives Association, INSOL Europe, the Loan Market Association and the Loan Syndications and Trading Association.

David earned his J.D. from Fordham University School of Law and his B.S. from Cornell University.

Recent Developments in Bankruptcy and Distressed Investing



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Safe Harbor

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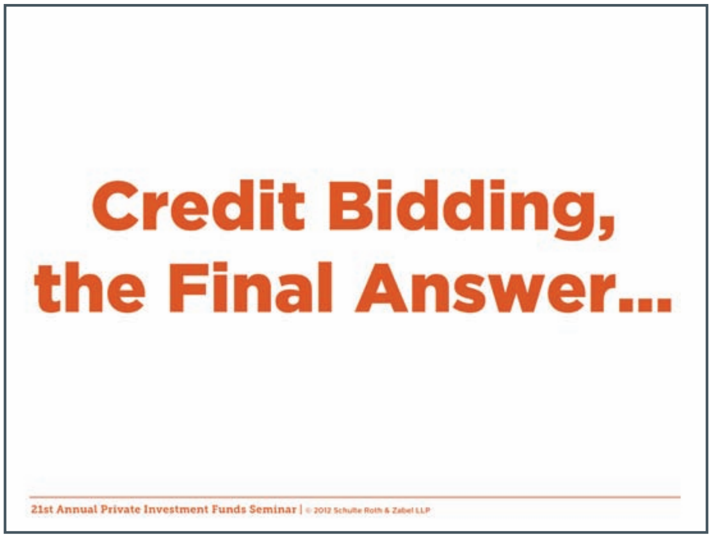
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Recent Developments in Bankruptcy and Distressed Investing

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Recent Developments in Bankruptcy and Distressed Investing

I. How insider trading issues arise in bankruptcy

A. Anti-fraud provisions of federal securities laws are potentially applicable to out-of-court restructurings and bankruptcy cases

B. Securities laws may be implicated in bankruptcy cases if parties make securities trades while in possession of material non-public information ("MNPI")

C. Under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 promulgated thereunder, the elements of a claim for insider trading are as follows: (1) trading; (2) on the basis of MNPI about a security or issuer; (3) in breach of a duty of trust or confidence owed to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of MNPI; and (4) with the requisite level of scienter

D. Trades may give rise to insider trading liability based on either the "classic" theory or the "misappropriation" theory

1. "Classic" theory of insider trading — corporate insiders, like officers or directors, or "temporary insiders" who work on behalf of the company, may violate the securities laws if they trade on the basis of MNPI in breach of a fiduciary duty owed to corporate shareholders

2. "Misappropriation" theory of insider trading — a party may violate the securities laws when he or she misappropriates MNPI in breach of a fiduciary duty or similar relationship of trust and confidence and uses that information in a securities transaction

II. Washington Mutual bankruptcy case[1]

A. On Sept. 13, 2011 the Bankruptcy Court in the District of Delaware issued an opinion that found that the Committee of Equity Security Holders (the "equity committee") stated a colorable claim sufficient to confer standing on the equity committee to pursue equitable disallowance against certain hedge fund creditors' claims based on allegedly improper trading

B. The court noted that the threshold for stating a colorable claim is low. The opinion does not constitute a finding that there actually had been any insider trading

C. Background

1. Washington Mutual Inc. ("WMI") is the former parent of Washington Mutual Bank ("WMB"). WMB was seized by the Office of Thrift Supervision on Sept. 25, 2008. The next day, WMI and one of its affiliates filed bankruptcy petitions in Delaware

2. The debtors and certain other parties began negotiating a resolution of their disputes in March 2009. The funds participated in discussions with the debtors and other parties about settlement of claims

3. As a condition to their participation in the discussions, the funds entered into confidentiality agreements with the debtors. Those agreements required the funds either to restrict trading in the debtors' securities or to establish an ethical wall between those who made trading decisions and those engaged in settlement negotiations

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[1] SRZ represents one of the four creditors in the case. As such, this discussion will be limited to the facts and arguments contained in the public record. Nothing herein is intended to constitute an endorsement of the court's opinion, or to suggest that the opinion accurately reflects the facts or correct state of the law in this area. This is also not intended to be a complete description of the judge's opinion and readers are referred to the opinion for a full description of its contents at *In re Washington Mutual, Inc.*, Case No. 08-12229 (MFW), (Bankr. D. Del. Sept. 13, 2011) [Docket No. 8612]. The court's decision has been appealed

4. The confidentiality agreements contained an express termination date and also required that at the end of the confidentiality period, the debtors publicly disclose any MNPI that may have been communicated during the confidentiality periods

5. There is no dispute that the funds abided by the confidentiality agreements and that the debtors represented at the end of those periods that any MNPI had been disclosed. After the expiration of the confidentiality periods, the funds traded in the securities of the debtors

D. Insider trading issues

1. Among the issues in the proceedings were: (1) whether the funds were trading while in possession of MNPI about the status of the settlement discussions; (2) whether they had a duty to refrain from such trading; (3) whether they acted with scienter; and (4) whether equitable subordination or equitable disallowance were available remedies

2. Materiality

    (a) The funds argued that the information they had was not material because the discussions to which they were privy were not sufficiently advanced

    (b) The court held that it could not find at this stage that the discussions were not material and that the equity committee presented enough evidence to suggest that settlement negotiations may have shifted to the material end of the spectrum

3. Duty

    (a) The funds argued that, even if the information had been material, they had no duty to refrain from trading after the confidentiality periods because, among other things, they were not insiders. The funds also noted that the debtors were not deceived in any way by the funds' conduct

    (b) The court held that the equity committee stated a colorable claim that the funds became "temporary insiders" of the debtors when the debtors gave them confidential information and allowed them to participate in settlement negotiations

    (c) The court also held that the funds may have been "non-statutory" insiders of the debtors by virtue of holding blocking positions in two classes of the debtors' debt securities

4. Scienter

    (a) The funds argued that they did not act with the requisite scienter because, among other things, they took a variety of steps in good faith throughout the process to ensure that they did not trade on the basis of any MNPI[2]

    (b) The funds also pointed out that their trading patterns were not consistent with each other, suggesting that they had no information that provided guidance as to the appropriate way to trade

    (c) The court held that the equity committee had presented enough evidence to state a colorable claim that the funds acted with scienter, saying, among other things, that the funds could not rely on a third party's representations

5. Equitable subordination and disallowance

    (a) The court held that equitable subordination was not a potentially available remedy but equitable disallowance could be available

[2] The funds did not assert the defense of reliance on advice of their counsel at this stage of the proceedings after the court indicated that doing so would constitute a waiver of the attorney-client privilege

(b) The court did so notwithstanding, among other things, the funds' argument that an issuer has no claim for alleged insider trading in connection with trading in its securities between other parties

E. Current posture of the case

1. Rather than permitting the equity committee to proceed with an action against the funds, the court directed the parties to mediation

2. Simultaneously with engaging in the mediation, the funds and others appealed the court's decision to the District Court

3. As a result of mediation, a proposed plan of reorganization was developed and filed that, in addition to dealing with the myriad other issues in the bankruptcy, also would dispose of the insider trading claims

4. The plan contains a condition requiring that portions of the opinion dealing with the insider trading issues be vacated

5. The court has not yet held a hearing on whether the plan should be confirmed

III. How safe is the "safe harbor" under 11 U.S.C. § 546(e)?

A. Introduction

1. The Bankruptcy Code provides several "safe harbors," including

The avoidance actions safe harbor under Section 546(e), which protects pre-bankruptcy margin and settlement payments in connection with a securities contract, commodity contract or forward contract despite the existence of a preference under Section 547 or a fraudulent transfer under Section 548

B. The text of Section 546(e) and relevant definitions

1. Section 546 of Title 11 of the United States Code, titled "Limitations on Avoiding Powers," provides various boundaries on a trustee's power to avoid transfers of property in a proceeding brought under Title 11

2. 11 U.S.C. § 546(e) provides: "Notwithstanding Sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a *margin payment*, as defined in Section 101, 741, or 761 of this title, or *settlement payment*, as defined in Section 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a *transfer* made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a *securities contract*, as defined in Section 741(7), *commodity contract*, as defined in Section 761(4), or *forward contract*, that is made before the commencement of the case, *except* under Section 548(a)(1)(A) of this title." (emphasis added)

3. "Settlement payment" is defined as "a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade." 11 U.S.C. § 741(8)

4. "Securities contract" is defined expansively in Section 741(7) to include, among other things

(a) "A contract for the purchase, sale or loan of a security," 11 U.S.C. § 741(7)(A)(i)

(b) "Any margin loan," 11 U.S.C. § 741(7)(A)(iv)

(c) "Any other agreement or transaction that is similar to an agreement or transaction referred to in this subparagraph," 11 U.S.C. § 741(7)(A)(vii), and

(d) "Any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in this subparagraph, including any guarantee or reimbursement obligation by or to a stockbroker, securities clearing agency, financial institution or financial participant in connection with any agreement or transaction referred to in this subparagraph." 11 U.S.C. § 741(7)(A)(xi)

C. Purpose and legislative history of the Section 546(e) safe harbor

1. Section 546(e) was enacted to ensure settlement finality and market stability

(a) Congress enacted Section 546(e) to "minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries"[3]

(b) Congress sought to prevent "the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected industry"

2. Section 546(e)'s safe harbor is designed to maintain stability in the commodities and securities markets by ensuring that settled transactions in those markets remain final and exempt from avoidance

(a) If a market participant is required to repay amounts received in settled securities transactions, it could have insufficient capital or liquidity to meet its current securities trading obligations, thereby placing other market participants — and possibly the securities markets themselves — at risk[4]

(b) The Section 546(e) safe harbor limits this risk by protecting from avoidance margin and settlement payments by, to or on behalf of securities brokers, financial institutions and various other financial participants, except in the case of actual fraud under Section 548(a)(1)(A)

(c) By restricting a bankruptcy trustee's power to recover payments that are otherwise avoidable under the Bankruptcy Code, Congress chose to promote capital formation, stability and investor confidence, and to protect ordinary course of business transfers related to the purchase or sale of securities

D. Traditional scope and application

1. Application to leveraged buyouts

(a) Typically in a leveraged buyout ("LBO"), the acquiring entity funds the acquisition of the target with borrowed money using the target company's assets as collateral. The target company's shareholders tender their shares to the target in exchange for cash (the loan proceeds). Section 546(e) is implicated if the target company subsequently files for bankruptcy and the transfers to the former shareholders are sought to be avoided

(b) Federal courts routinely apply the Section 546(e) safe harbor to LBO transactions involving publicly held securities, but some courts have declined to apply the safe harbor to LBOs involving privately held securities of nonpublic companies, reasoning that unwinding private stock transactions would not trigger the "ripple effect" or instability which Section 546(e) was enacted to protect. *E.g.*, *Geltzer v. Mooney (In re MacMenamin's Grill Ltd.)*, 450 B.R. 414, 422 (Bankr. S.D.N.Y. 2011) ("Congress did not intend section 546(e)'s exemption to apply to the modest private LBO transaction at issue here"); *Jewel Recovery, L.P. v. Gordon*, 196 B.R. 348, 353 (N.D. Tex. 1996)

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3 H.R. Rep. 97-420, at 1 (1982), as reprinted in 1982 USCCAN 583, 583

4 See *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329, 334 (2d Cir. 2011)

(Section 546(e) did not protect selling shareholders from avoidance because transaction was private stock purchase and Section 546(e) only applies to "settlement payments in the clearance and settlement process in the public market"); *In re Grand Eagle Cos., Inc.*, 288 B.R. 484, 493-95 (Bankr. N.D. Oh. 2003) (Section 546(e) did not preclude creditors committee's challenge to LBO involving privately held stock)

(c) In *Kaiser Steel Corp. v. Charles Schwab & Co.*, 913 F.2d 846 (10th Cir. 1990), the Tenth Circuit interpreted "settlement payment" to include the transfer of consideration in an LBO. *Id.* at 849. The court reasoned that the LBO was a securities transaction because it concerned the "delivery and receipt of funds and securities." *Id*. at 850. And because the payments were made to Charles Schwab on behalf of the tendering shareholders, the settlement payments were made to a "stockbroker" and were therefore exempt from avoidance under Section 546(e). *Id*.

(d) Other circuits also have applied the Section 546(e) harbor to LBO transactions, regardless of whether the LBO involves publicly traded or privately held securities

E.g., In re QSI Holdings, 571 F.3d 545, 548-50 (6th Cir. 2009) (payments to shareholders in LBO are settlement payments for purposes of Section 546(e) regardless of whether LBO involves publicly traded or privately held securities)

(e) But some courts have declined to extend the Section 546(e) safe harbor to certain LBO transactions, reasoning that unwinding private stock transactions would not trigger the "ripple effect" or widespread market instability Section 546(e) was enacted to protect

2. By its terms, the Section 546(e) safe harbor does not apply to "settlement payments" made with actual intent to hinder, delay or defraud creditors under Bankruptcy Code Section 548(a)(1). *See Johnson v Neilson,* 525 F.3d 805, 817 (9th Cir. 2008) (safe harbor inapplicable to transfer made as part of Ponzi scheme); *Wider v. Wooton*, 907 F.2d 570, 572-72 (5th Cir. 1990) (same); *In re Manhattan Inv. Fund Ltd.*, 310 B.R. 500, 513 (Bankr. S.D.N.Y. 2002) (same), *leave to appeal denied*, 288 B.R. 52 (S.D.N.Y. 2002); *see also In re Adler Coleman Clearing Corp*., 263 B.R. 406. 478-85 (S.D.N.Y. 2006) (payments made as part of criminal conduct not protected by Section 546(e) safe harbor)

E. Circuit courts' expansive view of Section 546(e)

1. The Third,[5] Sixth,[6] Eighth,[7] Ninth[8] and Tenth[9] Circuits have defined "settlement payment" broadly in recent years

2. The Second Circuit, in *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329 (2d Cir. 2011) ("*Enron*"), also adopted an expansive view of Section 546(e), holding that it protects from avoidance an issuer's payments to redeem commercial paper prior to maturity, even where: (1) redemption payments made at accrued par value exceeded the market value of the commercial paper; (2) the issuer did not acquire title to the commercial paper; and (3) a financial intermediary did not take a beneficial interest in the commercial paper

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[5] *In re Plassein Intl. Corp.*, 590 F.3d 252, 257-58 (3d Cir. 2009) (payments to shareholders in LBO are "settlement payments" for purposes of § 546(e) regardless of whether LBO involves publicly traded or privately held company); *see also Bevill, Bresler & Schulman Asset Mgmt. Corp.*, 878 F.2d 742, 751-52 (3d Cir. 1989) ("[i]t is clear that 'settlement payment' does not only mean payment of cash to the dealer by the purchaser, but also encompasses transfer of the purchased securities to the purchaser from the dealer")

[6] *QSI Holdings, Inc. v. Alford (In re QSI Holdings, Inc.)*, 571 F.3d 545, 548-50 (6th Cir. 2009) (§ 546(e) safe harbor applied to LBO payments involving privately held securities)

[7] *Contemporary Indus. Corp. v. Frost* (564 F.3d 981, 985, 986 (8th Cir. 2009) ("extremely broad" meaning of "settlement payment" includes payments in exchange for privately held securities in LBO)

[8] *Jonas v. Resolution Trust Corp. (In re Comark)*, 971 F.2d 322, 326 (9th Cir. 1992) (safe harbor protects repo participant that delivered securities to debtor that subsequently returned securities to repo participant)

[9] *Kaiser Steel Corp. v. Charles Schwab & Co.*, 913 F.2d 846, 848, 850 (10th Cir. 1990) (interpreting "settlement payment" as "extremely broad" and to include transfer of consideration in LBO because it concerned the "delivery and receipt of funds and securities")

3. *Enron's* background facts

   (a) In the Fall of 2001, Enron drew down on its $3 billion revolving lines of credit and paid out more than $1.1 billion to retire unsecured and uncertificated commercial paper before maturity, even though the offering memoranda that accompanied issuance of the commercial paper provided that the notes would not be redeemable or subject to voluntary prepayment by Enron before maturity. Enron redeemed the notes at par value plus accrued interest, prices that were well above market value

   (b) After Enron filed for bankruptcy, the reorganized entity brought adversary proceedings against approximately 200 financial institutions to avoid and recover the difference between the redemption price and the lower market value of the notes

   (c) Enron alleged those payments were recoverable as: (1) preferential transfers under Section 547(b) because they were made within 90 days prior to bankruptcy; and (2) constructively fraudulent transfers under Section 548(a)(1)(B), because the redemption price exceeded the fair market value of the notes

   (d) Alfa and ING moved unsuccessfully to dismiss, and, after discovery, for summary judgment, relying on Section 546(e). The Bankruptcy Court denied the motions, concluding that "settlement payments" under Section 546(e) included only payments made to buy or sell securities, not to retire debt; the purpose behind Enron's redemption payments remained unclear; and the redemption payments did not constitute settlement payments because Enron did not acquire title to the commercial paper it redeemed

4. The appellate decisions in *Enron*

   (a) District Judge McMahon reversed the Bankruptcy Court ruling, and the Second Circuit agreed, declining to read a purchase or sale requirement into the definition of "settlement payment" under Section 741(8), and affirming that a "settlement payment" is "any transfer that concludes or consummates a securities transaction"

   (b) Following *Enron*, no transfer of title to the subject securities is required to effect a transfer or exchange of money or securities that completes a securities transaction, nor is involvement of a financial intermediary that takes title to the securities during the course of the transaction required (financial intermediaries that serve as mere conduits are sufficient)

   (c) Moreover, the Second Circuit found that "undoing Enron's redemption payments, which involved over a billion dollars and approximately 200 noteholders, would … have a substantial negative effect on the financial markets"[10]

   (d) Dissenting from the *Enron* holding, Judge Koeltl warned that the Second Circuit's interpretation of "settlement payment" is far too broad, and that if no purchase or sale of a debt security is required (and merely a cash transfer is sufficient), virtually all payments on debt instruments would be subject to Section 546(e) protection, eliminating the avoidance powers provided by the Bankruptcy Code

   (e) Impact

      (i) The *Enron* decision is a win for investors in the commercial paper market, particularly those that invest in commercial paper of distressed companies on the secondary market. The decision helps to create stability and predictability for settled transactions in commercial paper

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[10] *In re Enron Creditors Recovery Corp.*, 651 F.3d at 339

(ii) The decision also may lead to wider application of the Section 546(e) safe harbor to transactions that do not threaten systemic risk, such as LBO's involving privately held securities

(iii) Before *Enron*, courts would generally refer to the purpose and legislative history of Section 546(e) for guidance in how to apply it. The Second Circuit's holding in *Enron* "effectively eliminates the need for any inquiry into the legislative history of § 546(e)." *E.g.*, *In re Quebecor World (USA), Inc.*, 453 B.R. 201, 219 (Bankr. S.D.N.Y.)

F. Two different views of Section 546(e) in the context of Madoff

1. Two recent decisions reflect conflicting views as to the applicability of the 546(e) safe harbor to Madoff customer withdrawals. The issue will remain unresolved until the Second Circuit decides it

(a) *Picard v. Merkin*, 440 B.R. 243 (Bankr. S.D.N.Y. 2010)

(i) The Bankruptcy court held that Section 546(e) did not apply to the trustee's avoidance claims because Madoff never purchased any securities for customer accounts and, therefore, was not "engaged in the business of effecting transactions in securities" under 11 U.S.C. § 101(53A)(B)

(ii) In addition, the court found that the account agreements between Madoff and its customers were not "securities contracts"

(iii) Refusing an interlocutory appeal of the Bankruptcy Court's holding, District Judge Wood stated that "[t]he Court finds no substantial grounds for difference of opinion as to the correctness of the standards relied on by the Bankruptcy Court[.]" *Picard v. Merkin*, No. 11-MC-0012 (KMW), 2011 WL 3897970, at *12 (S.D.N.Y. Aug. 31, 2011)

(b) *Picard v. Katz*, No. 11-03605 (JSR), 2011 WL 4448638 (S.D.N.Y. Sept. 27, 2011)

(i) By contrast, Judge Rakoff reached the opposite result and concluded that the Section 546(e) safe harbor applies to customer withdrawals in the Madoff case

(ii) Following *Enron*, Judge Rakoff relied on the plain language of Section 546(e) to find that Madoff was a "stockbroker" under Section 101(53A), the account agreements between Madoff's firm and its customers were "securities contracts" under Section 741(7), and transfers from Madoff's firm to customers were "settlement payments" or "transfers made in connection with securities contracts" under Section 741(8)

(iii) Judge Rakoff also found that applying the Section 546(e) safe harbor would minimize displacement in the commodities and securities markets, while avoiding transfers would have a substantial negative effect on the financial markets, since Madoff's fraud involved an estimated $68 billion and 4,800 customers

(iv) The *Katz* holding has the potential to drastically reduce the trustee's total recovery from former Madoff customers. If upheld on appeal, *Katz* would bar the trustee from bringing any avoidance actions against Madoff customers except under Section 548(a)(1)(A) to recover transfers made within two years prior to the bankruptcy filing

G. Efforts to bypass the Section 546(e) safe harbor

1. *Tribune* and *Lyondell* are two large bankruptcies that arose in the context of failed LBO transactions. Both cases address

(a) Whether individual creditors of the debtor may assert state law fraudulent transfer claims if the bankruptcy estate does not bring all the fraudulent transfer claims that could be brought by the time the Bankruptcy Code Section 546(a) two-year statute of limitations expires, on the theory that rights available under state law revert back to the individual creditors upon expiration of the limitations period applicable to the estate representative

(b) Whether the Section 546(e) safe harbor applies outside of bankruptcy court to prevent individual creditors from asserting state law fraudulent conveyance claims that, if brought by or on behalf of a debtor's estate in bankruptcy court, would be precluded by the Section 546(e) safe harbor, and

(c) Whether the Section 546(e) safe harbor preempts and precludes a trustee of a litigation trust from asserting state law fraudulent transfer claims as the "successor" to or "assignee" of individual creditors' claims rather than as the bankruptcy estate's representative (*Lyondell* only)

2. It is far from clear whether the state law claims will succeed in circumventing the Section 546(e) safe harbor. If they do, markets that depend on the stability and finality of settled transactions would be disrupted by making it difficult to assess risks, particularly the risks of participating in a leveraged buyout of a distressed company

3. *In re Tribune Co., et al.*, No. 08-13141 (Judge Carey) (Bankr. D. Del.)

(a) In December 2010, the creditors' committee brought fraudulent transfer claims against certain former shareholders of Tribune based on a theory of actual fraudulent transfer under Section 548(a)(1)(A)

(b) On April 25, 2011, the Bankruptcy Court held that the state law fraudulent conveyance claims reverted to creditors once the Section 546(a) statute of limitations expired and permitted the indenture trustee for certain noteholders to bring claims in various state courts prior to the expiration of the applicable state law statutes of limitations

As a result, individual Tribune creditors brought state law fraudulent conveyance actions against former Tribune shareholders in 44 courts around the country

(c) The cases were consolidated and assigned to S.D.N.Y District Judge Holwell, who on Dec. 28, 2011 stayed all of the state cases until further order of the Delaware Bankruptcy Court without addressing the merits of the state law actions or whether it was appropriate to circumvent the Section 546(e) safe harbor in this way

4. *In re Lyondell Chemical Co., et al.,* No. 09-10023 (Judge Gerber) (Bankr. S.D.N.Y.)

(a) In *Lyondell*, a litigation trustee appointed under the Lyondell plan of reorganization is seeking to assert state law fraudulent conveyance claims that were purportedly "abandoned" by the debtor, reverted back to individual creditors, and are now "assigned" to the trust by those creditors. Thus, the trustee is asserting the state law claims not on behalf of the debtor pursuant to Code Section 544, but instead as the "assignee" of individual creditors' state law claims

(b) The defendants have argued that the claims were not "abandoned" but, rather, were barred by the Section 546(e) safe harbor, which is why the debtor did not pursue them, and that the state law claims are pre-empted by federal law

(c) To date, the Bankruptcy Court has not determined whether the Section 546(e) safe harbor applies, and whether it pre-empts the state law claims

IV. Credit bidding in plan sales — is it still an option?

A. What is required to confirm a plan sale?

1. Whether or not it contemplates a sale, to be confirmed a reorganization plan must either:

    (a) Not impair a creditor's claim; *or*

    (b) Be acceptable to the creditor if its claim is impaired[11]

2. Even if the plan fails to meet either of these requirements, a bankruptcy court can still confirm a plan over the objection of a class of impaired creditors, if the plan is found to be "fair and equitable."[12] Plans confirmed over the objection of a class of creditors are colloquially referred to as "cram-down" plans because they are "crammed down the throats of objecting creditors"[13]

B. What is "fair and equitable"?

1. The Bankruptcy Code provides three scenarios under which a plan may be found to be "fair and equitable" to secured creditors:[14]

    (a) Lien transfer prong — permits confirmation if: (1) the secured creditor's collateral remains subject to its existing lien; and (2) the creditor receives deferred cash payments in an amount equal to the present value of the allowed amount of its claim[15]

    (b) Sale prong — permits sale of the secured creditor's collateral free and clear of its liens, subject to the secured creditor's right (unless the court "for cause" orders otherwise) to "credit bid" at the sale, with its liens to attach to the sale proceeds[16]

    (c) Indubitable equivalent prong — permits confirmation if the secured creditor realizes the "indubitable equivalent" of its claim.[17] The Third Circuit Court of Appeals has held that the term "indubitable equivalent," while not defined in the Bankruptcy Code, is "the unquestionable value of a [secured creditor's] secured interest in the collateral"[18]

2. Significantly, these three prongs are crafted in the disjunctive, separated by the word "or."[19] Debtors seeking confirmation of a "cram-down" plan historically have relied most often on the lien transfer and sale prongs[20]

C. What is credit bidding?

1. Credit bidding is the right of a secured creditor to purchase its collateral by bidding up to the full amount of its secured claim, rather than bidding cash. The Bankruptcy Code generally permits a secured creditor to "credit bid" at a sale of its collateral under Section 363 or the sale prong (which incorporates Section 363(k)) up to the full amount of its claim to acquire its collateral, *regardless of the value of its collateral at the time the creditor bids*. If a credit bid is successful, the secured creditor cancels indebtedness in the amount of its bid

2. Credit bidding can be advantageous to a secured creditor because: (1) it does not need to bid additional new money for its collateral; and (2) if it is undersecured, it can bid more than another bidder without coming out of pocket, in the hope that the value of the collateral will increase over

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11 11 U.S.C. § 1129(a)(8)

12 11 U.S.C. § 1129(b)

13 *River Road Hotel Partners, LLC v. Amalgamated Bank*, 651 F.3d 642, 647 (7th Cir. 2011)

14 11 U.S.C. § 1129(b)(2)(A)

15 *Id.*

16 11 U.S.C. § 363(k)

17 11 U.S.C. § 1129(b)(2)(A)

18 *In re Philadelphia Newspapers*, 599 F.3d 298, 310 (3rd Cir. 2010)

19 11 U.S.C. § 1129(b)(2)(A)

20 *River Road*, 651 F.3d at 647-648

time (i.e., to protect its upside potential). For this reason, debtors and creditors' committees often have sought to curtail secured creditors' credit bidding rights, asserting that they have a chilling effect on bidding

D. What is the indubitable equivalent prong and why does it matter?

1. Recently, some plan proponents have sought confirmation of sale plans under the indubitable equivalent prong, rather than the sale prong, as a means of depriving undersecured creditors of the right to credit bid for their collateral at auction. Plan proponents assert that prohibiting credit bidding by undersecured creditors with large deficiency claims will encourage bidding, because third-party bidders will no longer fear competing with secured creditors that have a lot of credit bid currency and very little downside. The indubitable equivalent prong is attractive to proponents looking to craft novel plans because the language used is "both sparse and general"[21]

2. These plan proponents assert that plan sales of a secured creditor's collateral free and clear of its liens can be "fair and equitable" if the secured creditor receives the indubitable equivalent of its secured claim (i.e., the value of its collateral at the time of the sale). They assert further that the then-current value of the secured creditors' collateral is best determined by a public auction

3. Thus, while a secured creditor has the right to credit bid the full amount of its claim in a plan sale under the sale prong, that same creditor is only entitled, under the indubitable equivalent prong, to the then-current value of its collateral

E. Circuits split on "fair and equitable" treatment to a secured creditor

1. Three circuit courts have reached two different conclusions on whether a plan proponent must provide a secured creditor the right to credit bid at a plan sale in order to satisfy the Bankruptcy Code's fair and equitable standard for confirmation of a cram-down plan

2. The Third Circuit (which includes Delaware), and the Seventh Circuit (which includes Illinois) reached these different conclusions on substantially the same facts.[22] The Supreme Court recently agreed to hear an appeal of the Seventh Circuit's decision. Absent congressional input, the Supreme Court will have the final say on whether a secured creditor has an absolute right to credit bid in a plan sale

F. Analysis of the competing decisions

1. In each of *In re Philadelphia Newspapers*, decided by the Third Circuit, and *River Road Hotel Partners, LLC v. Amalgamated Bank*, decided by the Seventh Circuit, plan proponents proposed plans that, under the indubitable equivalent prong, provided the secured creditors with the value of their claims at the time of the auction

2. The secured creditors in each case objected on essentially the same two grounds, that:

(a) The Bankruptcy Code section containing the three-prongs of the "fair and equitable" test is ambiguous, and

(b) Secured creditors are entitled to special rights under the Bankruptcy Code

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[21] *Id.* at 648

[22] A slightly older decision from the Fifth Circuit also addressed whether a secured creditor has a statutory right to credit bid at a plan sale. *In Re Pacific Lumber*, 584 F.3d 229 (5th Cir. 2009), held that a plan could be confirmed even if the secured creditors were not afforded an opportunity to credit bid at an auction of their collateral because the lenders were guaranteed to receive the judicially determined "indubitable equivalent" of their claims. *Id.* at 246-47. Because the bankruptcy court had held an evidentiary hearing and actually determined the value of the secured lenders' collateral, *Pacific Lumber* is distinguishable from *Philadelphia Newspapers* and *River Road*, where the value of the lenders' collateral was being "determined" at a public auction and not by judicial review

G. The courts' treatment of the question of ambiguity

1. The plan proponents in both cases asserted that the statute was unambiguous. According to the proponents, the use of the word "or" to separate the three prongs means a plan proponent may choose between the sale prong and the indubitable equivalent prong when determining how to sell encumbered assets free of liens under a plan[23]

2. The secured creditors countered that rules of statutory interpretation require that all elements of the sale prong be satisfied in order to sell collateral free of a secured creditor's prepetition lien because the sale prong is more specific than the indubitable equivalent prong. According to the secured creditors, the prongs are exclusive of one another, and it is the proposed treatment of the collateral that determines which prong will apply. In other words, they argued

   (a) Plans proposing the sale of assets encumbered by their original liens must proceed under the lien transfer prong

   (b) Sales free and clear of a secured creditor's liens must proceed under the sale prong

   (c) Only those plans proposing a disposition not covered by the lien transfer prong or the sale prong (e.g., the substitution or return of collateral), may proceed under the indubitable equivalent prong

3. The Third Circuit held that the statute was unambiguous because there is "no statutory basis to conclude that [the sale prong] is the only provision under which a debtor may propose to sell its assets free and clear of liens."[24] If the secured creditors' interpretation of the statute were correct, no sale free of a creditor's liens could ever be permitted under the indubitable equivalent prong — even one that would pay the secured creditor in full.[25] Reading the statute so narrowly would significantly curtail the ways in which a debtor could fund its reorganization — an outcome at odds with the fundamental function of the asset sale, which is to permit the debtor to "provide adequate means for the plan's implementation"[26]

4. The Seventh Circuit held that the statute was ambiguous because the Bankruptcy Code was silent as to whether the indubitable equivalent prong can be used to confirm *any* type of plan at all, or whether it can be used only to confirm plans that treat or dispose of assets in ways other than those covered by the lien transfer and sale prongs.[27] According to the Seventh Circuit, permitting a debtor to use the indubitable equivalent prong under a cram-down plan to sell assets encumbered by prepetition liens would effectively swallow the sale prong entirely, which clearly was not Congress' intent when enacting the Bankruptcy Code."[28] The "infinitely more plausible interpretation" of the statute, according to the court, is that each prong sets forth the requirements for a particular type of sale; each of the subparagraphs must be construed as conclusively governing the category of proceedings it addresses[29]

H. The courts' treatment of whether secured creditors are entitled to special rights

1. The secured creditors also argued that they could not receive the indubitable equivalent of their secured claims unless they were permitted to credit bid at the auction of their collateral.[30] The secured

[23] *Phila. Newspapers*, 599 F.3d at 305

[24] *Id.* at 308

[25] *Id.*

[26] *Id.*

[27] *River Road*, 651 F.3d at 649-650

[28] *Id.* at 652

[29] *Id.* ("We cannot conceive of a reason why Congress would state that a plan must meet certain requirements if it provides for the sale of assets in particular ways and then immediately abandon these requirements in a subsequent subsection.") (quotations and citations omitted)

[30] *Phila. Newspapers*, 599 F.3d at 311, *River Road*, 651 F.3d at 645

creditors asserted that an auction under a plan sale should be no different than under a Section 363 sale, either in terms of a secured creditor's ability to credit bid or in terms of how the value of that creditor's collateral was determined

2. The Third Circuit held that secured creditors were not entitled to any special rights that were not already specifically delineated under the Bankruptcy Code. According to the Third Circuit, a vastly undersecured creditor is not "entitled" to win at auction in a plan sale by bidding the face amount of its claim for assets worth substantially less. The Third Circuit noted that the lien transfer prong caps the value of the creditor's allowed secured claim, as established by judicial valuation and limited to the present value of the deferred cash payments, and a secured creditor is not absolutely guaranteed the right to credit bid at an auction because the court may deny credit bidding "for cause." Thus, the Bankruptcy Code does not entitle a secured creditor to participate in the future upside of its collateral

3. The Seventh Circuit held that determining the value of an undersecured creditor's claim is problematic because it is generally difficult to ascertain the current market values of the types of assets sold in corporate bankruptcy cases.[31] Thus, the *River Road* plan was unconfirmable because there was an increased risk that the winning bid would not provide the secured creditors with the current market value of their collateral. The court held, accordingly, that a plain-meaning reading of the indubitable equivalent prong does not establish that it can be used to confirm plans that propose auctioning off a debtor's encumbered assets free and clear of liens without allowing secured creditors to credit bid.[32] The Seventh Circuit did not consider the issue raised by the *Philadelphia Newspapers* court that sales pursuant to the lien transfer prong do not provide for credit bid protections, or that the court may deny credit bidding for cause

I. Conclusion

1. Both *Philadelphia Newspapers* and *River Road* are well reasoned decisions, however, the Third and Seventh Circuit Courts each were compelled to gloss over weaknesses inherent in both cases. For example, it is counterintuitive that the value of an undersecured creditor's collateral can be determined in a Section 363 sale by the amount it credit bids — which can be up to the face amount of its claim — yet that same creditor can be prohibited from credit bidding at a plan sale, leaving any determination of the value of its collateral to the whim of other bidders, bidders whose economic incentive is to pay as little as possible for the assets

2. On the other hand, it is difficult to escape the seemingly inescapable fact that the statute containing the "fair and equitable" prongs is drafted in the disjunctive. The *River Road* court dismissed the statute's use of "or" in a footnote, stating that its "mere presence" is insufficient to resolve the issue because there are several judicially recognized exceptions to its standard use.[33] Despite this delicate tap-dance around the plain meaning of "or," the Seventh Circuit's overall analysis of the statute is more compelling as, unlike the Third Circuit's analysis, it avoids rendering the sale prong superfluous

V. Recent challenges to debt trading and settlement customs

A. General practice in both the U.S. and U.K. secondary bank debt and claims trading markets is that a trade is binding upon oral[34] or written agreement on material terms. In other words, "a trade is a trade"

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31 River Road, 651 F.3d at 650

32 *Id.* at 651

33 *River Road*, at 650 n.5 (citations omitted)

34 Under New York and English law, oral trades are binding as the statute of frauds does not apply for the assignment, sale, trade, participation or exchange of indebtedness or claims relating thereto under the Qualified Financial Contracts. *See* N.Y. Gen. Oblig. Law § 5-701(b)(2)(i) and (ii) the recent decision of *Bear Stearns v. Forum Global Equity (2007)*, in which the court considered the binding effect of a telephone conversation between traders agreeing to terms of a purchase of Parmalat notes

B. However, recent U.S. case law suggests that the New York courts may use a strict contract law analysis and approach when considering the binding effects of trade confirmation terms prior to finalizing the definitive settlement documents

C. In bankruptcy claims trading, in which both trade confirmations and definitive documents are specifically tailored and heavily negotiated, case law suggests that courts may view an email confirmation and phone calls as only a preliminary agreement to negotiate the settlement documents in good faith, rather than a binding commitment to settle the trade. *See Bear Stearns Inv. Products, Inc. v. Hitachi Automotive Products (USA), Inc.*, 401 B.R. 598 (S.D.N.Y. 2009), where the seller, a trade creditor, agreed to sell its claims to the buyer, but subsequently sold to another third party instead. As a trade confirmation between the seller and the buyer was never executed, the court held that the parties had not entered into a binding agreement but rather only a preliminary agreement to negotiate in good faith. The court held that the buyer only had a right to demand the seller negotiate the terms of the sale in good faith and that the question of whether the seller acted in good faith was an issue for trial, not suitable for summary judgment. In making this determination, the court considered: (1) whether there was express reservation of right not to be bound in the absence of a writing; (2) the context of the negotiations; (3) the existence of open terms; (4) whether there was partial performance; and (5) the necessity of putting the agreement in writing. Shortly after the court opinion, the parties filed a stipulation dismissing the complaint

D. Although the *Hitachi* case was dismissed prior to the court considering the requirements for negotiating bankruptcy claims trades in good faith, this issue may be discussed in a currently pending case. *See* Complaint*, Kingate Global Fund Ltd. and Kingate Euro Fund Ltd. v. Deutsche Bank Securities Inc*., No. 11-9364 (S.D.N.Y. Dec. 21, 2011). In its complaint, the plaintiff ("Kingate") alleges that it entered into a binding trade confirmation to sell to Deutsche Bank Securities ("DB") approximately $1.6 billion in claims against Bernard L. Madoff Investment Securities LLC. The relevant language in the subject trade confirm states that it is a "confirmation of our firm, irrevocable and binding agreement (the "Transaction") to sell the Claims" but the trade confirmation also states that the "Transaction is subject to execution of a Purchase and Sale Agreement (governed by New York law) in a form that is reasonably and mutually agreed between Seller and Buyer and which Seller and Buyer shall negotiate in good faith." *See id*. at ex. 1. Kingate argues that DB's negotiations of provisions of the purchase and sale agreement and certain protections under the settlement agreement between Kingate and the trustee were motivated not by genuine concerns over the protections but rather by a bad faith desire to avoid the transaction due to recent market rate declines

E. In a bank debt trading context, where bank debt is typically traded on standardized documents, there is a strong market custom that a trade confirm represents is binding. However, case law in this area is undeveloped and there is the possibility that New York courts could make a similar good faith negotiation interpretation as in the bankruptcy claims trading context. In dicta, in a recent case that ultimately settled out of court, both the New York trial court and appellate court appeared to consider the standard LSTA trade confirmation at issue as a preliminary agreement to negotiate in good faith as opposed to a requirement to settle, focusing on "subject to" the "negotiation, execution and delivery of reasonably acceptable contracts and instruments of transfer" language in the trade confirmation. *See Credit Suisse First Boston v. Utrecht-America Finance Co.*, 80 A.D.3d 485 (N.Y. App. Div., 1st Dep't 2011); *Credit Suisse First Boston v. Utrecht-America Finance Co*., No. 601123/2004, at 19-20 (Sup. Ct. N.Y., N.Y. Cnty Feb. 3, 2010)

F. What exactly constitutes lack of good faith negotiations in the contexts of bank debt or bankruptcy claims trades has not been directly settled by case law. In other contract contexts, whether negotiations following a preliminary agreement were conducted in good faith is a fact-specific analysis. *See e.g., Amcan Holdings, Inc. v. Can. Imperial Bank of Commerce, 70 A.D.3d 423, 894 N.Y.S.2d 47 (N.Y. App. Div. 2010); Network Ents., Inc. v. APBA Offshore Prods., Inc., 427 F. Supp 2d 463 (S.D.N.Y. 2006); Rus, Inc. v. Bay Indus., Inc.*, 322 F. Supp 2d 302 (S.D.N.Y. 2003); *Simone v. N.V. Floresta, Inc.*, 1999 WL 429504, 1999 U.S. Dist. LEXIS (S.D.N.Y. Jun. 18, 1999); *Teachers Ins. and Annuity Ass'n of Am. v. Tribune Co.*, 670 F. Supp. 491 (S.D.N.Y. 1987)

G. In a recent New York case, the court considered when parties are required to settle a trade in light of language in the standard LSTA trade confirmation stating that parties agree to settle the trade "as soon as practicable on or after the Trade Date." *See Goldman Sachs Lending Partners, LLC v. High River L.P.*, No. 603118/2009, at 4 (Sup. Ct. N.Y., N.Y. Cnty Dec. 22, 2011), where the seller entered into a trade confirmation as part of a short selling strategy, but later did not have the inventory to settle the trade. *See id.* at 1. When the price increased, the seller did not obtain the necessary inventory and did not respond to the buyer's attempts to contact it to settle the trade, even as a critical record date approached. *See id.* at 6-7, 10. The court held that the trade confirmation created a "fundamental obligation of the parties to proceed in good faith to close the trade by 'assignment' and 'as soon as practicable' following the trade date." *Id.* at 21-22. The court interpreted "practicable" to mean "speedily" and at least by the record date considering the seller's awareness of its significance

VI. Different settlement methods available for trade parties

A. Traders should be cognizant of what forms of settlement will be available and acceptable before entering a trade. This is particularly true in Europe, where decreased trade and settlement liquidity can result in significantly increased investment risk

B. Under both LMA and LSTA secondary trade documentation, as well as market practice, once a trader agrees to a trade, orally or via email, the trader is bound to complete the trade (taking into account the "trade is a trade" considerations noted above)

C. However, there are various scenarios that could restrict legal transfer as a settlement option

1. Eligibility requirements — in Europe, some credit agreements (most commonly middle market) do not expressly allow investment funds to hold the debt directly, allowing only financial institutions to hold direct positions. English case law supports that an investment fund would fall within the definition of a "financial institution," but ideally the credit documentation would explicitly allow for investment funds as permitted lenders

2. Minimum threshold requirements — it is also common for credit agreements to require a minimum transfer amount and that the amount be in specific integral multiples, such as in multiples of $1 million. If a transfer is allocated across related funds, not all credits will allow for the aggregation of the transfers in order to meet the minimum threshold

3. Borrower consent — although most borrower consent rights, when present, require that consent not be unreasonably withheld, there is a dearth of case law defining what constitutes reasonable grounds for withholding consent. Examples of when a borrower might attempt to withhold consent include situations where the borrower seeks to control the composition of its lending syndicate or borrower concerns that a proposed lender might be unsympathetic to future restructuring efforts

D. The default under the LMA and the LSTA is that a trade that cannot settle by legal transfer will settle via funded participation

E. Participations are undesirable for many distressed investors because they do not provide a direct contractual relationship with the borrower, thereby limiting the investor's direct influence in a restructuring

F. In Europe, unlike the LSTA's "true sale" participations, LMA participations create a derivative debtor/creditor relationship between seller and buyer. This leaves participants exposed to the credit risk of not only the borrower but also the seller. Depending on the credit quality of the counterparty seller and whether or not an investor plans to be active in a restructuring, this could be a highly unattractive form of settlement

G. If trade parties wish to bypass the option of participation and elect an alternative settlement option this should be considered at the time of trade and specified in the trade confirmation. If legal transfer is not available and the parties have elected to bypass settlement by participation, the parties must still settle the trade but on an alternative method of settlement generating the economic equivalent of the agreed upon trade

H. If a party to a trade feels strongly against settling via participation or an economic equivalent, it is possible for the parties to agree at the time of trade to a "walk away" provision, which would allow the parties to not settle the trade if the desired settlement mechanism becomes unavailable. Given that "walk away" provisions are not common practice in the market, additional language needs to be added to the trade confirmation clearly stating the parties' intent. Additionally, a trader should not assume that a counterparty to a trade will be agreeable to such an inclusion

VII. European insolvency procedures and location of a debtor's center of main interest ("COMI")[35]

A. Background of EC regulation on insolvency (Council Regulation (EC) 1346/2000)

1. Effective May 31, 2002, the Regulation establishes common rules and a common framework regarding the court competent to open insolvency proceedings, the applicable law and the recognition of the court's decisions for cases where a debtor becomes insolvent. It is based on the principles of mutual recognition and cooperation. It does not seek to harmonize substantive law or policy between EU member states

2. The Regulation is directly applicable in all EU member states except for Denmark. The Regulation is not applicable to credit or insurance institutions

3. The Regulation governs the opening of insolvency proceedings in member states by setting rules for deciding where main insolvency proceedings can be opened in circumstances where a company has a presence in more than one member state

4. A debtor's main insolvency proceedings should take place in the member state of the debtor's COMI. However, because the meaning of COMI is not defined in the body of the Regulation, this leaves the opportunity for COMI migration to another EU member state

5. There is a rebuttable presumption that a debtor's COMI is where its registered office is situated (Article 3). However, determination of the COMI has been held as a fact-specific analysis and the presumption can be rebutted with objective factors for consideration, including: (1) internal accounting functions; (2) business relations with clients; (3) the law governing its main contracts; (4) creditors; (5) strategic control functions; (6) IT systems; (7) tax domicile and the domicile of its directors; (8) board meetings; and (9) general supervision

6. The member state of the debtor's COMI will have jurisdiction over the main insolvency proceedings, and any appeal against a finding of COMI must be brought in that court. Main insolvency proceedings cannot be brought in multiple jurisdictions. Once the court of one member state has determined COMI, it cannot be reconsidered by the courts of other member states

7. Secondary insolvency proceedings may be opened in another EU country and run in parallel with the main proceedings if the debtor has an establishment in that country. An "establishment" means any place of operations where the debtor carries out a non-transitory economic activity with human

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[35] Chapter 15 of the Bankruptcy Code, which is the U.S. adoption of the Model Law on Cross-Border Insolvency promulgated by the United Nations Commission on International Trade Law, also contains the concept of COMI. However, the importance of COMI in a Chapter 15 case is slightly different than under the Regulation. In the context of chapter 15 COMI comes into play as to whether a U.S. Bankruptcy Court should recognize a foreign insolvency proceeding as a "foreign main proceeding," or "foreign non-main proceeding." A foreign main proceeding is a proceeding in the country where the debtor has its COMI. 11. U.S.C. § 1502. Depending on whether a U.S. Bankruptcy Court recognizes the foreign proceeding as a foreign main or foreign non main proceeding, the debtor and its foreign representative are entitled to different relief. *Compare* 11 U.S.C. § 1520 *with* 11 U.S.C. § 1521. In contrast to chapter 15, under the Regulation the COMI issue is where to commence the insolvency proceeding in the first instance, not whether it is a foreign main proceeding. As further described in this outline, a debtor subject to the Regulation should commence its insolvency proceeding in the country where that debtor has its COMI

resources and goods (Article 2(h)). The effects of the secondary insolvency proceedings must be limited to the assets of the debtor located in that jurisdiction and there must be some functional activity taking place within that jurisdiction (i.e., not merely just the presence of assets). The opening of such proceedings may be requested by the liquidator of the main proceedings or by other persons or authorities according to the law of the country in which the opening of the proceedings is requested. Where secondary insolvency proceedings are brought, the assets in that jurisdiction may be carved out of the main proceedings and become subject to the insolvency law of the secondary jurisdiction

B. COMI migration as a means to implement a more favorable restructuring procedure

1. COMI migration may be employed by debtors and creditors as a means of seeking more favorable insolvency proceedings in another EU member state. Certain jurisdictions may have more transparent, sophisticated, efficient and flexible insolvency regimes over others

2. There is appeal to migrate a foreign debtor's COMI to the U.K. because of some of the more flexible and favorable restructuring procedures available in the jurisdiction. Examples include a "Company Voluntary Arrangement" (CVA) or a "Scheme of Arrangement," both of which can be used by creditors to cram down minority creditors or shareholders in order to push through a restructuring

3. Recent example of COMI migration to the U.K.

(a) *Deutsche Nickel* (2004) and *Schefenacker* (2007): Schefenacker was a German automotive supply group and Deutsche Nickel was a German alloy supply group. In each case, creditors wanted to restructure bondholder debt though a debt-for-equity swap implemented by a CVA. Achieving an out of court debt-for-equity swap in Germany is possible but requires the consent of 100% of the bondholders. The alternative is to go through the court system which can be a long and uncertain process. In both cases, COMI was migrated from Germany to the U.K. by transferring the assets and liabilities of a German holding company to an English holding company

(b) *Wind Hellas* (2009): The company operates fixed line and mobile technology services in Greece. The company sought to restructure via a pre-pack administration in the U.K. The COMI of Wind Hellas' parent company (Hellas II, a Luxembourg entity) was migrated to the U.K. by undertaking a number of corporate steps, including: (1) making an English registered company the corporate general partner; (2) appointed U.K. resident individuals to be directors of Hellas II; (3) opening a new head office in London; and (4) conducting all negotiations with creditors in London

C. Risks associated with COMI migration

1. The uncertainty of a debtor's COMI and the resulting uncertainty of what insolvency proceedings will apply in a debtor's winding-up may be detrimental on formulation and ultimate success of an investor's distressed investing strategy

2. In the context of a proposed restructuring, the opportunity to migrate a debtor's COMI may be beneficial for creditors with large debt positions and a strong voice in a debtor's proposed restructuring plan. Alternatively, if a creditor holds only a minority debt position, it may find itself "crammed down" as a result of a COMI migration

3. Where a debtor's COMI is being shifted, investors should ascertain whether the insolvency proceedings taking place in a debtors' COMI are recognized as effective in all countries where the debtor's operating company/ies, guarantors, and affiliates, have businesses or assets

4. The costs for advising and implementing a COMI migration can be substantial

VIII. Selected issues in counterparty failure

Different regulatory and insolvency regimes exist for broker-dealers registered with the U.S. Securities and Exchange Commission and commodity brokers registered as futures commission merchants ("FCMs") with the U.S. Commodity and Futures Trading Commission ("CFTC"). These regimes may come into conflict in the event of the insolvency of a brokerage firm dually registered as both a broker-dealer and an FCM

The following discussion is limited to U.S. entities. Non-U.S. entities will be subject to the insolvency regimes of their respective jurisdiction. For example, a U.K. brokerage firm would be subject to the "Special Administration Regime," which is a newly established administration procedure designed to facilitate return of client assets. The discussion of foreign insolvency regimes is beyond the scope of this outline

A. Liquidation procedures and priority of claims for broker-dealers and FCMS

1. Broker-dealer liquidation procedure under SIPA

(a) The Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa et seq. ("SIPA") established the Securities Investor Protection Corporation (the "SIPC"), a non-profit corporation comprised of all registered brokers, dealers and members of national securities exchanges. If a broker-dealer is a member of SIPC and meets the insolvency requirements described below, then SIPC may initiate a customer protection proceeding in federal district court

(b) In order to initiate a liquidation proceeding, SIPC must make a determination that the SIPC member has failed or is in danger of failing to meet its obligations to its customers, and one of the following four conditions must be met:

(i) The member is insolvent within the meaning of the Bankruptcy Code (in essence, a balance sheet test) or is unable to meets its obligations as they mature;

(ii) The member is subject to a pending proceeding in which a receiver, trustee or liquidator has been appointed;

(iii) The member is in violation of the financial responsibility or hypothecation of customer securities rules of the SEC or any self-regulating organization; *or*

(iv) The member is unable to make computations necessary to establish compliance with financial responsibility or hypothecation rules

(c) In an SIPC customer protection proceeding, the SIPC trustee liquidates the business of the broker-dealer in an effort to satisfy the claims of the customers and the broker-dealer's other creditors. The underlying policy is to protect, and return to the customer, the customer's securities portfolio as it existed on the date that SIPC applied for a decree that the broker-dealer's customers are in need of SIPA protection

(i) For SIPC members having: (1) liabilities to unsecured general creditors and subordinated lenders greater than $750,000; and (2) more than 500 customers, SIPC *must* designate a trustee not associated with SIPC to supervise the liquidation proceedings

(ii) The trustee must promptly notify the customers of the broker-dealer's liquidation in two ways: (1) notification in a newspaper of general circulation; *and* (2) notice mailed to each person appearing in the broker-dealer's records as a customer within the 12 months prior to the filing date. 15 U.S.C. § 78fff-2(a)(1)

(iii) The trustee also will attempt as soon as practicable to transfer the customer accounts to one or more healthy broker-dealers, thereby giving the customers prompt control of their assets and enabling them to continue trading with limited interruption. 15 U.S.C. § 78fff-2(f); Guttman, Modern Securities Transfers, at §20-24 (3rd Ed. 2006) [hereinafter "Guttman"].

Failing this, the trustee is required by statute to distribute to customers, to the greatest extent practicable, their actual securities portfolios, in order of priority of the customers' claims (discussed below). 15 U.S.C. § 78fff-1(b)

(iv) Customers must file a written statement of their claim with the trustee no later than six months after the date of publication of the broker-dealer's liquidation. The statement of claim need not be a formal proof of claim as required under the Bankruptcy Code. 15 U.S.C. § 78fff-2(a)(2) and 2(a)(3)

2. Priority of customers' claims under SIPA

(a) First, the trustee must return to customers all "customer name securities." These are limited to non-negotiable securities registered in the name of the customer (or in the process of being so registered), held for the account of a customer on the filing date. It is rare that customers will have securities with a broker-dealer registered in their name in non-negotiable form. Securities registered in "street name" are not considered customer name securities, even if the securities are fully paid, non-fungible securities, and are credited to the customer in the broker's books and records

(b) Second, the trustee must then seek to satisfy the "net equity" claims of the customers. Net equity claims are satisfied out of the aggregate pool of customer property (excluding any "customer name securities"), which is distributed *pro rata* among the broker's customers to satisfy their respective claims as described below

(i) "Net equity" is the dollar amount of the cash and/or securities on deposit in the customer's account or accounts on the filing date, determined by subtracting (x) any amount owed to the broker-dealer by the customer from (y) the amount that would have been owed to the customer if the broker-dealer had liquidated the customer's account as of that date. Because net equity claims are valued as of the filing date, the customer bears the risk of fluctuations in the market value of the securities between the filing date and the date of distribution

(ii) To satisfy a customer's net equity claim, the trustee first uses securities at any time received, acquired or held by the broker for the securities account(s) of a customer and the proceeds of any such property. If this payment of net equity is inadequate to make the customer whole, SIPC will fund up to $500,000 for each customer to satisfy the deficiency, of which up to $250,000 may be for cash on deposit for securities transactions. To supplement this SIPC coverage, some broker-dealers maintain additional coverage from the Customer Asset Protection Company ("CAPCO"), a captive insurer owned by the broker-dealers it insures, or some other insurance provider, to provide further asset protection to their customers (sometimes referred to as "excess-SIPC coverage"). According to its website, CAPCO provides total net equity protection covering the same asset classes as are protected under SIPC. Still other broker-dealers have obtained and provide parent company guarantees to satisfy potential shortfall

(iii) Any amount not covered by the $500,000 SIPC payment (or any excess insurance) becomes a general unsecured obligation that will be satisfied out of the general estate of the broker-dealer on a *pro rata* basis with the other general unsecured creditors

3. FCM liquidations under SIPA, the Bankruptcy Code, the Commodity Exchange Act ("CEA") and CFTC Part 190 Regulations

(a) If an FCM becomes insolvent, a trustee is appointed to liquidate the assets of the FCM and return customer property. SIPA imposes all of the duties of a trustee under the commodity broker liquidation provisions of subchapter IV of Chapter 7 of the Bankruptcy Code (11 U.S.C. §§ 761-767), to the extent consistent with SIPA, except for the duty to liquidate securities positions held in the FCM's estate. 15 U.S.C. § 78fff-1(b). The CEA and the CFTC regulations promulgated in 17 C.F.R.

§§ 190.01 though 190.10 (“Part 190 Regulations”) set forth different segregation requirements based on the type of account that a customer has with the FCM (e.g., futures and options account traded on U.S. contract markets versus futures and options account traded on foreign contracts market). The Part 190 Regulations detail the framework for allocation and distribution of FCM customer property by account class. Like SIPA, the Bankruptcy Code and the Part 190 Regulations seek to protect customers of failed FCMs by affording them priority over general unsecured creditors and providing *pro rata* distribution among customers

(b) Pursuant to the Part 190 Regulations, a trustee liquidating an FCM has the duty to make immediate and best efforts to effect the transfer of open customer contracts and equity to one or more solvent FCMs. 17 C.F.R. § 190.02(e)(1). “Customer” claims receive priority over the claims of general unsecured creditors and any “customer property” (i.e., property in customer accounts) must be segregated from the FCM’s general estate to be distributed to its customers. “Customer property” is broadly defined by the Bankruptcy Code as “cash, a security, or other property, or proceeds of such cash, security or property, received, acquired or held by or for the account of the FCM, from or for the account of a customer…” and includes customer property that should have been segregated. 11 U.S.C. § 761(10); 17 C.F.R. § 190.08(a)(1)(ii)(F). Commodity futures customer property is not part of the FCM’s securities estate or general estate under SIPA, and is not subject to the claims of an FCM’s creditors

(c) To marshal separate pools of commodity customer property for each account class, the segregated property plus customer property readily traceable to that class will be allocated to that pool and distributed *pro rata*. Each distinct class will have its own pool of assets available for distribution to customers in that class

For example, in MF Global Inc., the trustee has proposed a securities estate, a commodities estate containing assets traded on domestic futures markets and a separate commodities estate containing assets traded on foreign exchanges. Claims to specifically identifiable property also may be in a separate account class

4. Priority of FCM customers’ claims under SIPA, the Bankruptcy Code, CEA and Part 190 Regulations

(a) The trustee must return customer property, on the basis and to the extent of a customer’s allowed net equity claim, to customers with commodity accounts other than proprietary accounts (as defined by CFTC rule, regulation or order)

(i) The allowed net equity claim of a customer is equal to the aggregate of the funded balances of such customer’s net equity claim for each account class plus or minus adjustments for operations subsequent to the primary liquidation date (i.e., assets held less indebtedness or setoffs). 17 C.F.R. § 190.07(a)

(ii) Six step process for calculating net equity

(1) Equity determination — the equity balance of each customer account is determined by adding: (1) the ledger balance; (2) the open trade balance; and (3) the current realizable market value. 17 C.F.R. § 190.07(b)(1)

(2) Aggregation — the credit and debit equity balances of all accounts of the same class held by a customer in the same capacity are aggregated. 17 C.F.R. § 190.07(b)(2)

(3) Setoffs — any obligation the customer may owe the FCM which has not already been deducted in the computation of account equity must be deducted. A customer’s negative equity balance in one account class must be set off against a positive equity balance in any other account class of such customer held in the same capacity. 17 C.F.R. § 190.07(b)(3)

(4) Correction for distributions — the value on the date of the transfer or distribution of any property transferred or distributed subsequent to the filing date and prior to the primary liquidation date with respect to each class of account held by a customer must be added to the equity obtained for that customer for accounts of that class. 17 C.F.R. § 190.07(b)(4)

(5) Correction for subsequent events — the net equity calculation must be corrected for misestimates or errors, including corrections for subsequent events such as the liquidation of unliquidated claims at a value different from the estimated value previously used in computing net equity. 17 C.F.R. § 190.07(b)(5)

(6) Open accounts — if a customer's accounts contain commodity contracts which remain open subsequent to the primary liquidation date, the net equity must be adjusted until liquidation or transfer of all such open commodity contracts of that customer of the same class, as follows: (1) the unrealized and realized gains and any receipts of margin with respect thereto must be added to the funded balance; and (2) unrealized and realized losses, and the normal costs attributable to the maintenance or liquidation of such open commodity contracts, and any distributions must be subtracted from the funded balance. 17 C.F.R. § 190.07(b)(6) and (d)(1)-(d)(2)

(iii) (Customer property must be valued as of the date of its return or transfer. 17 C.F.R. § 190.07(e). Thus, on open commodity contracts, customers bear the risk of fluctuations between filing date and liquidation date

(b) Claims of customers with proprietary accounts (e.g., insiders, affiliates, etc.) are subordinated to claims of customers with non-proprietary commodity accounts. No portion of the commodity customer property estate may be allocated to pay proprietary account customer claims until all non-proprietary account customer claims have been paid in full

(c) If there are deficiencies in the customer accounts, customers will share *pro rata* in the shortfall and have general unsecured claims against the FCM for the shortfall amounts

B. Protecting customer assets; mitigating counterparty risk

1. Broker-dealer insolvency risk

The following measures may help to minimize the impact of a broker-dealer insolvency

(a) Customers should be vigilant in monitoring the financial condition of their broker-dealers. For example, customers should review regularly its brokers' Form X-17A-5 filings

(b) Customers should establish multiple broker-dealer accounts, particularly with those brokers who are participants in CAPCO or have purchased or arranged for supplemental insurance (i.e., excess-SPIC coverage), both to spread risk and to facilitate rapid transfer of assets if one broker shows signs of an imminent failure

(c) Customers should consider holding securities in custodial accounts at third-party banks or trust companies to avoid having assets entangled in a broker-dealer liquidation proceeding. Custodial accounts provide some measure of added protection to the customer's assets because, among other things, banks and trust companies, unlike brokers, are prohibited from rehypothecating customer securities held in these accounts

(d) As and to the extent practicable, customers should consider investing excess cash in highly liquid, short-term securities to eliminate any risk of cash being deemed non-customer property. For example, Treasury securities would be considered customer property subject to a heightened liquidation priority in the event of a customer protection proceeding

(e) Customers may also consider reducing the amount of excess cash held in brokerage accounts by entering into sweep agreements with their broker-dealers providing that cash be regularly swept into highly liquid, short-term securities

(f) Customers, particularly customers of non-CAPCO participants, may consider purchasing insurance to provide excess SIPC coverage

(g) In the context of swaps, repos and other financial markets contracts requiring counterparties to post collateral to one another, customers should consider entering into tri-party agreements with their broker-dealer and a third party custodian. Under this arrangement, collateral posted by the customer will be held away from the broker, and thus will not become entangled in the broker's estate if the broker were to become subject to a liquidation proceeding

(h) Customers should be cognizant of, and consider, the jurisdiction in which the broker-dealer is organized, as this determines what jurisdiction's insolvency regime would be applicable to the broker-dealer

2. FCM insolvency risk

   The following measures may help to mitigate the impact of an FCM insolvency

   (a) Customers should consider maintaining multiple FCM relationships to spread credit risk and provide porting options

   (b) Customers should consider discussing with their FCMs the FCM's customer asset segregation and reinvestment policies, and options to monitor status of assets, including the FCM providing a risk profile report upon request

   (c) Customers should consider requiring their FCMs to top-up margin if value of posted collateral declines due to the FCM's reinvestment

   (d) Customers may consider pre-negotiating commitments with other FCMs in the event that accounts need to be ported promptly, including agreements to reasonable margin levels related to ported positions

3. As in the case with broker-dealers, customers should be cognizant of, and consider, the jurisdiction in which the FCM is organized

Form PF Workshop

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Practices

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Investment Management

Private Equity

Jennifer Dunn

Jennifer Dunn is a partner at Schulte Roth & Zabel, where her practice focuses on advising 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 laws matters, and regulatory and compliance issues. Jennifer's experience includes structuring and negotiating seed and strategic investments, advising investment managers regarding the structure of their investment management businesses and compensation arrangements, and representing investment managers in connection with managed accounts and single investor funds.

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

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Investment Management

Private Equity

Daniel F. Hunter

Daniel F. Hunter, a partner at Schulte Roth & Zabel, concentrates his practice on the design, structure and regulation of alternative investment products, including hedge funds, hybrid funds and private equity funds. He regularly advises funds that invest in distressed debt, asset-backed securities and bank loans. 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 authored "The Changing Face of Capital Introduction" for the *MFA Reporter* and spoke on "Legal, Regulatory & Tax" issues at Goldman Sachs' Prime Brokerage Hedge Fund Conference and "TIC Form SLT" at Goldman Sachs' Prime Brokerage Regulatory Reporting Overview.

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.

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Practices

Hedge Funds
Investment Management
Private Equity
Regulatory & Compliance

Jason S. Kaplan

Jason S. Kaplan is a partner at Schulte Roth & Zabel, where he concentrates in the areas of investment management and regulatory & compliance. Jason works with investment managers on structuring their businesses and on day-to-day corporate matters and advises on securities, corporate and compliance issues, including structuring and organizing hedge, private equity and hybrid funds; advising on and negotiating seed and strategic investments and relationships; advising on carry-sharing arrangements and other incentive compensation systems; and advising investment managers with respect to regulatory and compliance issues.

Among recent writing and speaking engagements, Jason co-authored “Dodd-Frank Becomes Law: Key Issues for Private Fund Managers” published in *The Hedge Fund Journal* and spoke on “Dodd-Frank Regulatory Reporting: A Practical Discussion on the Impact of Implementation of Form PF” as part of KPMG’s Alternative Investment Webcast and discussed “Proposed Form PF” at Goldman Sachs’ Prime Brokerage Regulatory Reporting Overview.

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.

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Vendor Finance

Robert R. Kiesel

Robert R. Kiesel is a partner and chairs the Intellectual Property, Sourcing & Technology Group at Schulte Roth & Zabel. He focuses his practice on the preparation and negotiation of various types of commercial agreements, including information technology agreements, equipment and vendor finance agreements, supply agreements and services agreements.

A frequent speaker and author on finance and intellectual property topics, Rob recently authored "Hedge Fund-Specific Issues in Portfolio Management Software Agreements and Other Vendor Agreements" for *The Hedge Fund Law Report* and the chapter on "Vendor Finance" in *Equipment Leasing* published by Matthew Bender/LexisNexis. He recently spoke on "Negotiating with Hedge Fund Vendors" at the Hedge Fund CFO Association Membership Meeting.

Rob has been a member of the Executive Committee of the New York State Bar Association Intellectual Property Section and is a former chair of that section's Committee on the Proposed Uniform Computer Information Transactions Act. Rob has been included in *New York Super Lawyers* in the Business/Corporate category, placing him in the top five percent of lawyers in the New York metropolitan area.

Rob received his B.A. from the University of Louisville and his J.D., with honors, from The George Washington University Law School, where he was Managing Editor of *The George Washington Law Review*.

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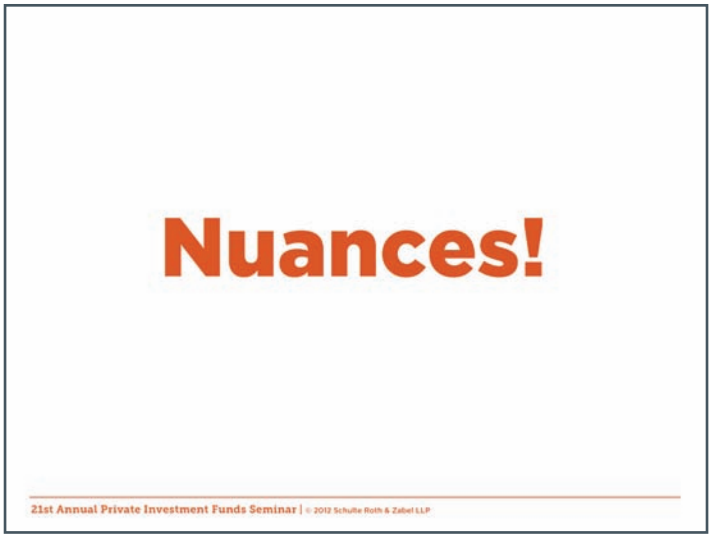
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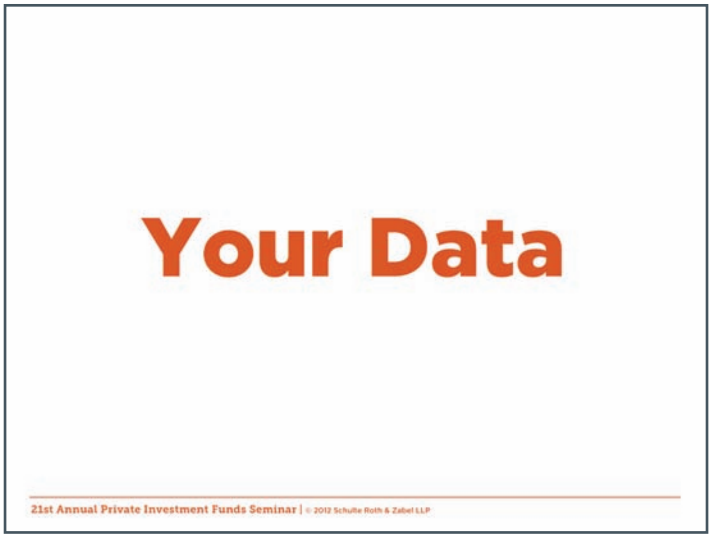

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I. Why are investment advisers subject to a new reporting requirement?

A. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") established the Financial Stability Oversight Council ("FSOC"), which has been tasked with monitoring systemic risk in the U.S. financial system. Dodd-Frank requires various agencies, including the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC"), to assist the FSOC with its monitoring responsibilities

B. In accordance with Dodd-Frank, the FSOC will rely on the SEC (and other governmental agencies) to collect the data needed to perform its risk analysis. Prior to adopting Form PF, there was no coordinated effort to gather data relating to the risk attributes of private funds (e.g., performance, counterparty exposure, liquidity, geography and leverage). Form ADV was never intended to collect information about a private fund's risk exposures; it is a disclosure form designed to be used for investor protection purposes

C. The SEC and CFTC jointly adopted Rule 204(b)-1 requiring registered investment advisers to report detailed information about their private funds on Form PF. The SEC staff consulted with many international agencies (including the FSA, ESMA, IOSCO and the Hong Kong Securities and Futures Commission) when designing the form, as other countries had already started to gather data relating to private funds

D. The SEC intends to use Form PF primarily as a confidential systemic risk disclosure tool to assist the FSOC in monitoring and assessing systemic risk. The FSOC may use this data to determine whether a particular nonbank financial company (a group of firms that includes private fund advisers) presents sufficient risk to the U.S. financial system that it should be subject to oversight by the U.S. Federal Reserve

E. The SEC also may use data from Form PF for examinations, investigations and investor protection efforts

II. Who is required to file Form PF?

A. All registered investment advisers with at least $150 million of private fund regulatory assets under management

1. Form PF uses two terms interchangeably: "the firm" and "private fund advisers"

2. You will be required to file Form PF if:

(a) You are either registered with the SEC as an investment adviser or areare required to do so;

(b) You advise one or more private funds; and

(c) You and your "related persons" have $150 million in "private fund assets under management" as of the last day of your most recent fiscal year

Private fund assets under management are a subset of "regulatory assets under management." Regulatory assets under management is a term defined in Form ADV. For private fund advisers, this means the current market value of your private fund's assets and the amount of any uncalled capital commitments (see Part 1A, Instruction 5.b). You should not reduce this amount by any indebtedness of the fund

3. By definition, exempt reporting advisers and advisers that do not manage private funds are excluded

B. Large private fund advisers must disclose more detailed information and generally must file Form PF more frequently

1. Who is a "large private fund adviser"?

(a) Advisers with at least $1.5 billion in regulatory assets under management attributable to hedge funds as of the last day of any month in the fiscal quarter immediately preceding such advisers' most recently completed fiscal quarter

(b) Advisers with at least $2 billion in regulatory assets under management attributable to private equity funds as of the last day of such advisers' most recently completed fiscal year

(c) Advisers with at least $1 billion in combined liquidity and registered money market fund assets as of the last day of any month in the fiscal quarter immediately preceding such advisers' most recently completed fiscal quarter

2. What is a "hedge fund"?

   (a) Form PF defines "hedge fund" to include any private fund having any one of the three common characteristics of a hedge fund:

      (i) A performance fee or allocation that is based on market value (and not solely on realized gains);

      (ii) High leverage (which under Form PF means a fund's ability to borrow an amount in excess of one half of its net asset value (including any committed capital) or have gross notional exposure in excess of twice its net asset value (including committed capital)); or

      (iii) The ability to sell securities and other assets short or enter into similar transactions (other than for the purpose of hedging currency exposure or managing duration)

   (b) Vehicles established for the purpose of issuing asset backed securities (so-called "securitized asset funds") are expressly excluded from the definition of "hedge fund"

   (c) A private fund that accrues fees or allocations in its financial statements for accounting purposes would be considered to be a "hedge fund" solely as a result of this practice

   (d) A private equity fund that calculates currently payable performance fees and allocations based on realized amounts but reduces these fees and allocations by taking into account unrealized losses net of unrealized gains in the portfolio would also not be a "hedge fund" for purposes of Form PF

   (e) Failure to expressly prohibit a fund from borrowing or incurring derivative exposures in excess of the specified amounts or from engaging in short-selling in the organizational document does not mean that such fund would be considered a "hedge fund" so long as the fund does not in fact engage in these practices (other than for the limited permitted purposes of hedging currency exposure or managing duration in the case of short-selling) a reasonable investor would understand, based on the fund's offering documents, that the fund will not engage in these practices

3. What is a "liquidity fund"?

   Form PF defines a "liquidity fund" as any private fund that seeks to generate income by investing in a portfolio of shor- tems obligations in order to maintain a stable net asset value per unit or to minimize principal volatility for investors (i.e., a private money market fund)

4. What is a "private equity fund"?

   Form PF defines "private equity fund" as any private fund that is not a hedge fund, liquidity fund, real estate fund, securitized asset fund or venture capital fund and does not provide investors with redemption rights in the ordinary course

III. When is Form PF due?

A. Initial filings to occur in two stages

1. Advisers with more than $5 billion in hedge, private equity or liquidity fund assets are required to file as of the first fiscal quarter or year ending after June 15, 2012. Accordingly, Aug. 29, 2012 is the effective filing date for those hedge fund advisers required to file for the quarter/year ending June 30, 2012

2. All other advisers will be required to file for their first fiscal quarter/year ending aftng Dec. 15, 2012

B. Timing of filings

1. Large private fund advisers to hedge funds must file within 60 days of quarter-end (which includes the fourth quarter)

2. Large private fund advisers for private equity funds aer advisers that are not large private fund advisers must report annually within 120 days of year-end

3. A newly registering adviser (small or large) must submit its initial Form PF for the first fiscal quarter or year (as applicable) in which it was required to be registered with the SEC, subject to the same deadlines as described above

IV. What information is required on Form PF?

A. Information required by Form PF

1. Section 1a (for all advisers) generally requires information about identity of the adviser and its related persons, amount of regulatory AUM and net AUM attributable to various fund types

2. Section 1b (for each private fund) generally requires information about identity of fund, NAV and GAV, breakdown of the fund's borrowing, breakdown of fund ownership by investor type and net and gross performance (on annual basis, at minimum). You can use good-faith estimates based on available data to answer the question on the breakdown of fund ownership by investor type with respect to investors that own interests that were issued prior to March 31, 2012. You will need to obtain the necessary information from any investor that is issued or transferred an interest after March 31, 2012

3. Section 1c (for each hedge fund) generally requires information about investment strategy, approximate percentage of assets managed using high-frequency trading strategies, disclosure of significant counterparties and information on trading and clearing practices

4. Section 2a (for all large hedge fund advisers) generally requires information about aggregate data on exposure by asset class, value of turnover in certain asset classes and geographical breakdown of investments

5. Section 2b (for each "qualifying hedge fund") generally requires information about exposure by asset class, value of unencumbered cash, large positions (5% or more of the fund's NAV) by asset class and as a percentage of NAV, disclosure of significant counterparties, risk metrics (including VaR, if applicable), effect of specific market factors on performance, financing information and investor liquidity

   (a) A "qualifying hedge fund" is a hedge fund with a net asset value of at least $500 million as of the end of any month in the prior quarter (note that net asset value may differ from regulatory assets under management)

(b) For purposes of determining whether a fund is a qualifying hedge fund, you must aggregate any parallel funds, any funds that are part of the same master-feeder arrangement, any parallel managed accounts (unless the value of those accounts exceeds the value of the private funds with which they are managed in parallel) and any relevant funds of related persons

(c) Note that if you advise only one large hedge fund (or one pair of parallel funds or a single master-feeder complex), certain of the information reported in Section 2b will be duplicative of certain information filed in Section 2a

6. Section 3 (for each liquidity fund of a large liquidity fund adviser) generally requires information about operations, NAV, maturity profile by instrument, large positions (5% or more of the fund's NAV) by asset class and as a percentage of NAV and investor concentration and liquidity

7. Section 4 (for each private equity fund of a large private equity fund adviser) generally requires information about guarantees of portfolio company obligations, leverage of portfolio companies the fund controls, breakdown of the fund's investments in portfolio companies by industry and geography. Most of the reporting in Section 4 relates to portfolio companies because leverage in private equity structures is generally incurred at the portfolio company level

B. Nuances

1. Funds-of-funds (assets invested in the equity of other private funds) may generally be disregarded for purposes of Form PF reporting

2. To avoid duplicative reporting, subadvisers are not required to separately file a Form PF for the funds to which they provide subadvisory services. Instead, the investment adviser that is required to report the private fund on Schedule D of its Form ADV is the adviser that is required to file Form PF for the private fund

3. You may choose to aggregate or separately provide the information regarding master-feeder arrangements and parallel fund structures

(a) For determining whether you must file, you are required to aggregate the value of your parallel funds and master-feeder funds. For this purpose, you also include funds or accounts managed by your "related persons"

(b) When filling out the form, you may report parallel fund structures and master-feeder structures either separately or in the aggregate (i.e., as if the master-feeder complex were one private fund)

(c) You must take the same approach throughout Form PF

4. Advisers must aggregate assets of parallel managed accounts (unless the value of those accounts exceeds the value of the corresponding private funds) and private funds advised by related persons (unless such persons are separately operated)

V. Getting it done

A. There is strategic importance to the firm in updating data systems and establishing a comprehensive framework that can adjust and evolve with the firm

B. Create clear roles and appoint people to monitor and complete different categories of Form PF related to their role

1. Identify the essential departments of the firm, including accounting, treasury and finance, legal, IT, marketing, traders, investor relations, etc.

2. Consider different approaches to organizing the Form PF effort, including creation or purchase of software or use of consultants

(a) Consultants can assist with many phases of the project, including providing gap analysis, identifying the various sources of information, coordinating internal and external sources of data and setting up systems to process and organize data

(b) Software providers can assist with data-gathering software and interface software

(c) It is unlikely that your existing service providers (e.g., your administrator, prime broker or auditor) will be willing or able to take on your Form PF obligations without additional contracts and negotiations. For instance, administrators will have access to much of your investor information but none of your counterparty, risk or position level information

3. Notify vendors that require coordination, including administrators, prime brokers and accountants

C. Form PF will require new data and data that is not already collected electronically

1. Existing methodologies for certain data may need to be adjusted for compatibility with Form PF

2. Certain data may need to be extracted through manual processes

D. It is important to establish a comprehensive system to mine accurate data and complete Form PF consistently with accurate data. While the SEC removed the proposed certification language that would have required an authorized individual to affirm "under penalty of perjury" that the statements made in Form PF are "true and correct," a willful misstatement or omission of a material fact in any report filed with the SEC under the Advisers Act is unlawful

VI. How and where?

A. Form PF will be filed with the SEC through the existing Investment Adviser Registration Depository

1. FINRA is working to develop additional privacy protections and compatibility with extensible markup language tagged data format

2. There are no exceptions to the electronic filing requirement

3. Only a seven-business-day delay is permitted and the delay rules are narrow

B. Form PF data may be shared with others

1. Form PF data may be shared with the CFTC, FSOC and other federal departments or agencies or with self-regulatory organizations, subject to the confidentiality provisions of the Dodd-Frank Act

2. Information reported on Form PF may also be shared with various foreign financial regulators under information-sharing agreements

C. Managers should think about responses to investor requests for information contained in Form PF

1. Consider selective disclosure issues (i.e., disclosing Form PF to some investors and not others)

2. Consider legends/disclaimers to be inserted in the event you determine to disclose Form PF to investors

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